The Federal Debt Limit

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Introduction

The Federal budget deficit and resulting debt have generated much attention lately, with threats of a government shutdown and dueling proposals from the Democrats and Republicans for a 2012 budget.[i] The budget deficit is the amount by which Federal outlays (cash or equivalents) exceed revenues for a particular year. Debt is the amount of cash borrowed (primarily from sources outside of the Federal government) to cover the cumulative net amount of all the deficits (and a few surpluses) incurred. The 2009 Federal deficit exceeded $1 trillion (T) for the first time, and it is expected to stay over $1 T each year through 2012. The President's 2012 Budget estimates that total Federal debt will rise to $25 T by 2020, a 280% increase from the 2008 Federal debt level.

Congress uses a Debt Limit to regulate government borrowing, but actual borrowing is handled by the Treasury Department. This Debt Limit does not constrain the ability of Congress to authorize spending through appropriations or other statues, but it does limit the ability of the Treasury Department to borrow funds and ultimately to pay (i.e., issue cash or equivalents) for spending already authorized and executed.

The Debt Limit is not well understood by many Americans. Recent polls have indicated that 62% of Americans oppose an increase in the Debt Limit, probably because they are concerned about deficit spending. As you will see in this paper, the Debt Limit can be a confusing concept. However, the key point is that the Debt Limit does not affect how much Congress authorizes to be spent. That is done through appropriations and other legislation. Because many Americans do not understand the Debt Limit, politicians in both parties could be concerned that voting for a Debt Limit increase would be portrayed (especially by their political opponents) as encouraging deficit spending.

Much of the spending authorized by Congress in one year is not paid out until future years. Therefore, borrowing (and Debt Limit changes) may not be required until future years for the spending authorized this year. The Debt Limit covers most government payments; it can affect the Treasury Department's ability to issue checks and other cash equivalents to pay federal employee and military salaries, contractors' invoices, as well as social security benefits and Medicare bills.

Because Debt Limit legislation is "must pass" legislation, it represents a political opportunity. Each time the Debt Limit must be increased, both Democrats and

Republicans typically use the occasion to focus on related (or unrelated) issues. Total Federal debt met the current Debt Limit in May 2011, but the Treasury Department was able to manage certain investments in a way that would extend the limit until early August 2011. Legislation to increase the Debt Limit must pass by then. Republicans have indicated that they will not support an increase in the Debt Limit unless Democrats agree to significant budget reductions for 2012 and beyond. These budget reductions will impact the Debt Limit some day, but they are not actually relevant to the currently required increase.

News stories about the Debt Limit often discuss the potential economic havoc that could be caused by the government defaulting on its loans, even though the amount of revenue the government collects would *easily be sufficient* to pay interest to its investors. The problem is that the government does not currently have enough revenue to pay creditors **and** to pay for current operations, including social security, Medicare, and retiree benefits, a point that is rarely discussed. The only way the government can renege on its debt is by deliberately choosing not to use its revenues to pay its investors.

This paper examines some of the details behind the Debt Limit to allow the reader to better understand the mechanics of the Limit and its political impact.

History[ii]

The first authorized US public debt was $78 million (M) in 1789. Over the next century and a quarter, Congress occasionally authorized additional debt, but it did so for each individual debt issuance.

In 1917, Congress authorized the issuance of general bond indebtedness up to a ceiling amount to finance US entry into World War I. At that time, there were still limits for each type of debt – bonds, bills, notes, certificates, etc. In 1939, Congress aggregated all public debt instruments into a single Federal Debt Limit.

From 1940, when the Debt Limit was $49 billion (B), through 2010, when the Debt Limit was $14.294 T, Congress has changed the Debt Limit 69 times, averaging about one change per year. A few of those changes were decreases, but those were very small and the last one occurred in 1963. From 2000 to 2009, there were nine changes in the Debt Limit, averaging $716 B; the one change in 2010 was an increase of $1.9 T.

Components of the Debt Limit

The Debt Limit is composed of two parts: Debt Held by the Public and Debt Held by Government Accounts.[iii] Debt Held by the Public is the value of all Federal securities sold to the public and still outstanding. Debt Held by Government Accounts represents surplus balances in government trust fund accounts that are invested in special, nonmarketable US Treasury securities, allowing the Treasury Department to use the surplus cash to offset some of the deficit from government operations and reduce the need to sell securities to the public.

Another way to look at this is that Debt Held by the Public is money we have borrowed from others, while Debt Held by Government Accounts represents “loans” from one part of the government to the other that must be repaid someday with interest. So, from the very beginning, the two parts of the Debt Limit are notably different things.

As of September 30, 2010, the actual debt balances were:

$9.001 T	66.6%	Debt Held by the Public
$4.510 T	33.4%	Debt Held by Government Accounts
$13.511 T		Total

The Debt Limit covers both types of debt without distinction in the limit, so growth in either type causes an increase in total debt and possibly a need to increase the Debt Limit.

Debt Held by the Public

When the government collects less revenue than it spends, it can sell various US Treasury securities to raise the funds required to make up the difference. The debt incurred by selling these securities is the Debt Held by the Public, and it is typically broken into these categories, with the percentages as of September 2010 (Total value = $9.0 T):

- Domestic private (36%)
- Federal Reserve (9%)
- State and local governments (7%)
- International (48%)

Some of the Debt Held by the Public is money that the government owes to its citizens, who might have bought Treasury securities or savings bonds, included in Domestic private. The amount held by International (48%) is what some are addressing when they suggest that China and other countries own much of our debt.

Debt Held by Government Accounts

The government uses a variety of trust funds to account for programs where dedicated revenues (e.g., social security, Medicare) are used to pay out benefits to the applicable account beneficiaries. There are over 200 Federal Investment Funds, and the Treasury Secretary manages the 18 largest. When the government collects more dedicated revenues than are required that year to pay benefits or expenses, the surplus funds are "loaned" to the US Treasury to help to finance general government spending. The sum of all these "loans" is the Debt Held by Government Accounts.

For example, think of social security. In a given year, the government collects social security revenues from employees and their employers, as well as interest from the government on past investments. These funds go into the social security trust fund. During the same year, the government pays out benefits to social security recipients. The authority for this spending is in the initial social security legislation and all subsequent amending legislation. In a year in which the revenues exceed the benefit payments, there is cash left in the trust fund. The cash does not just sit there. Rather, the Treasury Department uses that surplus cash to help to offset budget deficits in non-trust fund operations, i.e., general government. In exchange, the Treasury Department records a debt to the social security trust fund for the amount of that surplus. The nonmarketable securities which represent this debt earn interest, and the Treasury Department records payment to and receipt of the interest into the social security trust fund, where it becomes part of the trust fund revenues. First, the Treasury Department borrows money by selling US Treasury securities, which increases Debt Held by the Public. Then the Treasury Department credits the interest to the social security trust fund. If the social security trust fund does not need the funds to pay current benefits, it then loans the excess cash back to the Treasury Department, which increases Debt Held by Government Accounts.

Debt Held by Government Accounts is typically broken into these categories, with percentages as of September 2010 (Total value = $4.5 T):

- Social Security (57%)
- Civil Service Retirement and Disability (17%)
- Medicare (8%)
- Military Retirement and Health (9%)
- Other (9%)

As you can see, Debt Held by Government Accounts is different from Debt Held by the Public. For one thing, all of Debt Held by Government Accounts is in nonmarketable securities, which no one can buy or trade. For another, Debt Held by the Public increases when government operations run a *deficit*, but Debt Held by Government Accounts increases when the trust fund operations run a *surplus*. Running a surplus may be a good thing, but it can cause an increase in Federal debt.   To examine this more closely, we have to look at the concept of on- and off-budget.

Other Considerations

On- and Off-Budget

The Federal budget accounts for <u>all</u> government revenues and spending. Programs that have dedicated revenue sources (e.g., social security) are called off-budget programs. Programs that are financed by general revenues are called on-budget programs.[iv] Debt that is generated by borrowing for on-budget program deficits is Debt Held by the Public. Debt that is generated by loaning funds from off-budget program surpluses is Debt Held by Government Accounts.

In the 74 years since 1937, when the government started accounting for off-budget programs, off-budget programs had a net deficit in 12 years, the last one in 1984. Since 1998, the average annual off-budget surplus has been in the range of $100-200 B, even though individual off-budget programs may have run deficits. For example, in 2009, social security ran its first deficit since the 1980s overhaul.

Since 1961, on-budget programs have run deficits every year except 1999 ($2 B surplus) and 2000 ($86 B surplus). From 2002 to 2008, the average annual on-budget deficit was in the $320-650 B range. In 2009, the on-budget deficit jumped to $1.5 T and is expected to stay over $1 T through 2012.

Changes in Debt

The most common occurrence is for on-budget programs to run *deficits* and for off-budget programs to run *surpluses*. When this happens, Debt Held by the Public ***and*** Debt Held by Government Accounts both increase. Debt Held by the Public increases because the government must borrow funds to cover the on-budget deficit. Debt Held by Government Accounts increases because the surplus funds are "loaned" to the general fund to use for offsetting some of the on-budget deficit. In those cases when the on-budget accounts run a surplus (as happened in 1999 and 2000) or when the off-budget surplus is larger than the on-budget deficit (as happened in 1998 and 2001), Debt Held by the Public decreases.

In those cases when off-budget accounts are in balance or running a relatively small deficit, Debt Held by Government Accounts is still going to increase due to interest earned by the debt. The funds represented by Debt Held by Government Accounts were "loaned" to the government, and the government is required to pay interest from time to time for the use of those funds. However, since the off-budget accounts do not require any or much of the interest they earn (because they are already balanced or only slightly deficit), the earned interest is "loaned" right back to the government, thereby increasing Debt Held by Government Accounts.

Practical Distinctions
Much of the debt focus is on Debt Held by the Public because this is money that the Nation owes to people and countries that have purchased Treasury securities with an expectation of earning interest and recouping their principal. Debt Held by Government Accounts is viewed by some as “money that we owe ourselves.” There is some truth to this, but we must also remember that, unless the on-budget accounts are running a surplus, when the time comes to repay these “loans to ourselves,” we will have to do so by selling more Treasury securities and thereby increasing Debt Held by the Public. As the US population ages, there will be increasing demands on the social security, Medicare, and government and military retirement accounts, driving the off-budget accounts into a deficit position and requiring the government to redeem loans from those accounts.

Debt as a percent of Gross Domestic Product (GDP)
Just as a family can afford to take on more debt as its income rises, the Nation can afford more debt as its economy grows. For this reason, the Federal debt is often expressed as a percent of GDP. Some approaches to reducing the deficit are expressed as efforts to reduce the debt to a targeted percent of GDP, for example, ensuring that total debt is no more than 60% of GDP. Using this approach, the rapid growth of the Federal debt is still alarming:

Debt as Percent of GDP				
End of Fiscal Year	Total Debt	Debt Held by the Public	Debt Held by Government Accounts	Growth per Year
1980	33.4%	26.1%	7.2%	
1990	55.9%	42.1%	13.9%	6.7%
2000	57.3%	34.7%	22.6%	0.3%
2008	69.4%	40.3%	29.1%	2.6%
2009	84.2%	53.5%	30.7%	21.3%
2010	93.2%	62.2%	31.1%	10.7%
2012 est.	105.3%	75.1%	30.2%	6.5%

Foreign Ownership of Federal Debt
We noted above that the International category represented 48% of Debt Held by the Public as of September 30, 2010. China (26.6% of all International) and Japan (19.9% of all International) were the primary foreign holders (both official government and

private investors) of this debt. The third largest foreign holder (United Kingdom) was a quantum drop from China and Japan at 4.4% of all International.

Chinese investment in US debt has risen dramatically since 2002, and with Japanese investment, accounted for 40.2% of all International in 2002 and 46.0% in 2010.

	China		Japan	
	$B	%[v]	$B	%
December 2002	118	9.6	378	30.6
December 2007	581	24.7	478	20.3
December 2010	1160	26.1	882	19.9

Private investors of US debt, whether they are domestic or foreign investors, are usually motivated by profit opportunities. However, there is some concern that official foreign government purchases of US debt could be related to foreign governments' plans to manage their exchange rates against the dollar, potentially impacting the US economy in adverse ways.

Past Debt Limit Crises

Since 1990, the requirement for increases in the Debt Limit has typically generated political controversy, notwithstanding the true nature of the Debt Limit. There have been two major controversies, one in 1995-1996 and another in 2002-2003. In some cases, there were threats of government shutdowns, but the government did not lack authority to obligate funds for needed goods and services; it simply lacked the ability to pay for those goods and services, i.e., to disburse cash. For example, at one point in the 1995-1996 crisis, President Clinton announced that the government would be unable to process the next month's social security payments. In response, the Congress immediately passed a temporary increase in the Debt Limit, equal to the amount required to meet those social security payments.

Generally during these various crises, when total debt reached the Debt Limit prior to Congressional action, the Treasury Department managed various debt instruments in Debt Held by Government Accounts to avoid a nominal default. In these situations, the Treasury Department has a number of options, but they are all short-term. Ultimately the Debt Limit must be increased. GAO has reviewed the Department's past actions and found that they were reasonable and legal[vi]. In May 2011, the Treasury Department once again began to manage debt instruments to forestall default.

A typical approach used by the Treasury Department to manage debt instruments was to *suspend reinvestment* of selected Debt Held by Government Accounts, such as

Federal retiree accounts and Federal employee Thrift Savings Plan investments. When selected securities matured in these accounts, they reduced the amount of Debt Held by Government Accounts until they were reinvested. During the period until they were reinvested, Debt Held by the Public could be increased by a like amount since both parts of the debt are covered under the same Debt Limit. When the Debt Limit was finally increased, the Treasury Department would reinvest these accounts, also restoring whatever expected interest was not earned during the suspension period. As a result, the accounts did not suffer a permanent loss.

How Much Additional Debt Limit is Required Now?

Since it appears that an increase to the current Debt Limit is inevitable, the next question is how much will Congress increase the Debt Limit at this time. Since the budget projects that Federal debt will be $16.654 T at the end of 2012 (September 30, 2012), it is reasonable to expect that the Administration will not want to get into another debate about increasing the Debt Limit just before the national elections in November 2012. That would indicate a requirement for an increase in excess of $2.4 T now, to carry the government at least through November 2012. It is also reasonable to expect that Republicans would prefer to have another debate about the size of the Federal debt just before the national elections. They could do this with an increase around $2.0 T now. Another option for both sides is an increase of about $1.2 T now, allowing another debate before the national elections, but allowing it well before those elections, though it is unclear how much of this brinksmanship the Nation can stand.

Doing Away With the Debt Limit?

Considering all the preceding discussion, it is difficult not to conclude that perhaps the best approach moving forward might be for Congress to eliminate the Debt Limit and simply authorize the Treasury Department to borrow as much as is necessary to pay for the spending that Congress had already authorized through legislation. The House of Representatives had something like this, known as the "Gephardt Rule," named for the former Democratic Majority Leader. That rule allowed the amount of the Debt Limit to be deemed to have passed the House by the same vote as the conference report on the annual budget resolution. Therefore, there was no recorded vote on increasing the Debt Limit. The Senate had no comparable provision.

On the other hand, there may be some utility for Congress and the Nation to occasionally review total government debt. As Congress passes each individual piece of spending legislation, it can be difficult to see the big picture. Similarly, Congress has often passed legislation authorizing spending far into the future, such as social security and Medicare. Although the Congressional Budget Office (CBO) forecasts the future spending impact of these bills, the numbers can get lost in the distant future, and change happens. Having a Debt Limit forces Congress now and then to come to grips with the total spending it has authorized and for which the Nation continues to go deeper into debt.

A third option would be to change the definition of the Debt Limit to cover only Debt Held by the Public. This would end some of the confusion created by changes in Debt Held by Government Accounts. For example, from 1980 to 2010, total Federal debt rose almost 1500%, but Debt Held by the Public rose "only" 1267% while Debt Held by Government Accounts rose 2288%. Under this option, Debt Held by Government Accounts would still be tracked, but it would not be covered by the Debt Limit.

Conclusion

There will be many news stories about the Debt Limit in the weeks and months ahead, but the relevant issues are not about the Limit itself. The relevant issue is the level of government spending, which creates a future need for increasing the Debt Limit. The requirement for an inevitable increase allows political parties to bring up other issues for discussion and compromise.

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[i] Years in this paper are Federal fiscal years.
[ii] Both the Congressional Research Service (CRS) and the Government Accountability Office (GAO) have many excellent publications on the Federal Debt. Those that were used to research this paper included:
CRS, "Foreign Holdings of Federal Debt," #RS22331, March 12, 2008
CRS, "The Debt Limit: History and Recent Increases," #RL31967, April 29, 2008
GAO, "Federal Debt: Answers to Frequently Asked Questions," GAO-04-4855P, August 12, 2004
[iii] There is also a small component of Federal debt ($51 B as of September 30, 2010) that is not subject to the Debt Limit, primarily debt issued by Federal agencies other than the Treasury Department.
[iv] Some programs have trust funds, but they also have resources appropriated into the trust funds, e.g., Leaking Underground Storage Tanks.
[v] Percent of total International ownership
[vi] GAO, "Analysis of Actions During the 1995-1996 Crisis," GAO/AIMD-96-130, August 30, 1996
GAO, "Analysis of Actions During the 2002 Debt Issuance Suspension Periods," GAO-03-134, December 2002
GAO, "Analysis of Actions During the 2003 Debt Issuance Suspension Periods," GAO-04-526, May 2004