

## POLICY UPDATE

# Federal Debt Limit Raised to Cover Shortfalls

BY STEPHEN SLIVINSKI

**O**n February 12, President Obama signed into law a \$1.9 trillion increase in the federal debt limit. The new debt limit sits at \$14.3 trillion.

Over the past year, lagging revenue and spending programs created to shore up the banking system and to respond to various other elements of the recession spurred the issuing of new Treasury debt for auction to the public. The amount of outstanding federal debt subject to the limit was rapidly closing in on the \$12.4 trillion cap at the time the president signed the increase. If the limit had not been raised, the Treasury would have had no legal authority to issue additional debt to finance the spending.

An immediate consequence of not raising the debt limit is that it could cause operational problems, such as an inability to pay for the day-to-day expenses of government agencies, which might spur disruptions in a variety of federal programs. A potential but arguably improbable outcome is that the federal government could default on debt. That could result in a loss of confidence by investors in the U.S. government and sharply raise the cost to the government of financing debt in the future as lenders demand higher interest rates to compensate for new risk.

How likely these outcomes might be is open to debate. For instance, it's quite unlikely that pressure to raise the debt level would be resisted by policymakers. Since the late 1950s, the debt limit has been raised by Congress approved by the president almost every year except in the five-year span between fiscal years 1998 and 2001. Those were years in which the federal government actually ran budget surpluses and didn't need to issue any debt. In fact, the government was able to buy back some bonds and marginally reduce its debt load.

The genesis of the debt limit can be found in the Second Liberty Bond Act of 1917. This law allowed the Treasury to issue long-term debt to finance the military expenditures of the United States during World War I.

Before the war, Congress would have to authorize specific loans or debt instruments on a case by case basis, as when it approved the debt to build the Panama Canal, for instance. The limit in the act applied to both certificates of indebtedness and Liberty Bonds. This was meant to allow some discretion and flexibility to the Treasury to meet its needs.

In the next two decades, however, Congress would pass separate limits on other categories of debt that included traditional Treasury bonds. In 1939, Congress eliminated these separate limits and created the first aggregate limit that covered nearly all federal debt.

The debt limit as we know it today covers publicly held

debt — bonds that are sold by the Treasury at auction and are purchased by foreign governments and individual private investors, just to name a few. The federal government can also hold debt that is subject to the limit. Since the mid-1980s, the Social Security program has collected more in revenue than it has paid out in benefits. This surplus has been committed to current spending on other programs by Congress. In its place, Treasury bonds have been issued to the Social Security account.

Some argue that a debt cap so frequently raised hardly seems like a constraint. The importance of fiscal restraint, however, isn't always absent from the minds of some policymakers. Some of the legislative debate over the recent debt limit hike centered on the need to restrain the rates of government spending and to limit the amount of new debt needed. But a number of amendments to place some constraints on the budget process were voted down.

Many analysts argue that debt levels should be viewed in relation to the size of the economy. Today, debt held by the public is equal to about 60 percent of GDP. The Congressional Budget Office (CBO) estimates that, under current policies, the level of publicly held debt could reach 66 percent of GDP by 2020. Enacting new spending proposals in the president's budget could increase that figure to 90 percent in the next 10 years, according to the CBO. In contrast, that figure never rose above 50 percent between 1970 and 2008.

Others argue that the important number to keep in mind is the amount of interest the federal government needs to pay on the national debt. As long as the interest rates on the bonds — the cost of carrying that debt — are low, there will be less real fiscal strain. Today the interest on the debt equals 1.4 percent of GDP. Even in the worst-case scenario currently projected by the CBO, that figure will equal 3 percent of GDP in 2020.

Many observers also note that the high cost of federal benefits to be paid to retirees in the future should be cause for concern. As members of the baby boom generation begin to retire, the money to fund their benefits will have to come from the current revenue stream because the Social Security accounts are filled not with cash but with Treasury securities. Pressure to issue even more debt or to raise taxes will likely increase. An alternative would be to cut benefits or raise the retirement age, but it's unclear how those proposals would fare politically.

If the past is an indication of future political will to restrain budget deficits and maintain the debt limit, we may be in for much higher debt levels — and higher debt limits — in the years to come. **RF**