Debt Ceiling Q&A

<u>Where does U.S. debt originate from?</u>

There are two main categories of government debt: internal and external debt.

U.S. internal debt is essentially money that the U.S. government lends itself. In an effort to raise funds the government may borrow money from various intra-governmental trust funds. These intra-governmental trust funds finance programs like Social Security and Medicare. The government may "shift" funds from one program to another, with the promise that the funds will be paid back.

U.S. external debt occurs when the government issues marketable and nonmarketable Treasury securities. Marketable Treasury securities come in the form of bonds, bills, and notes which - are considered "marketable" because they can be quickly liquefied and converted to cash assets. Nonmarketable Treasury securities come in the form of savings bonds and state and local government securities and are considered nonmarketable because they cannot be easily liquefied and often must be kept by the holder until they reach maturity.

External debt is debt that has accumulated from the federal government issuing or selling Treasury securities to individuals, foreign lenders, institutional investors like pensions and mutual funds, state and local governments and other investors.. The money raised from the sales is used to fund the U.S. government and is guaranteed to be paid back with interest.

Current Treasury projections show that the U.S. is borrowing at a rate of about $125 billion a month, putting the U.S. debt that is subject to limit at nearly $14.3 trillion.

<u>What is the debt limit?</u>

The U.S. Treasury faces a legal limit ("debt limit") on how much money it can borrow in order to pay for its expenses. The debt limit was originally instituted as a measure to provide the Treasury with more "flexibility" to manage its finances. The current debt ceiling stands at $14.3 trillion. The Treasury is currently predicting the debt ceiling will be hit on August 2, given the current rate of U.S. borrowing.

To clarify, raising the debt limit does not grant the government the authority to borrow more money for future expenses. Rather, raising the debt limit allows the government to pay back debt accumulated from previous borrowing.

Raising the debt limit allows the U.S. to pay back lenders for any money that was previously borrowed as well as interest.

<u>What happens if the debt limit is not raised?</u>

In short, no one really knows what will happen if the debt limit is not raised because it has never happened in the history of the United States. However, there have been many assertions that catastrophic consequences await if Congress fails to raise the debt limit. Currently, the Treasury is predicting the U.S. will reach the debt limit by August 2.

Paycheck to Paycheck

If Congress does not raise the debt limit by that date, we do know the Treasury would be forced to use only its cash on hand to finance government obligations. In other words, the government would be "living paycheck to paycheck". According to a report by the Bipartisan Policy Center, an independent think tank in Washington, in August the federal government will spend an estimated $306.7 billion. However it will only take in an estimated $172.4 billion in revenues; existing cash balances on August 2 will cushion the immediate blow, but beyond that date the government won't be able to meet all its obligations.

Prioritization

We also know Washington would have to pick and choose which federal government priorities to fund: it is simply impossible for the government to pay for everything currently on the books.

For example, the Bipartisan Policy Center report estimates about $23 billion in Social Security checks are due August 3, but the Treasury will only take in $12 billion in revenues that day. While existing cash balances may combine with that $12 billion to provide enough wiggle room to make those Social Security payments, the Treasury Department wouldn't be able to meet all its other obligations, such as payments to defense contractors, Medicare and Medicaid benefits and salaries for federal workers.

The report also estimates the government would be forced to prioritize payments on the 80 million different monthly bills that it owes, and asserts that roughly 40%-45% of the nation's bills would go unpaid. The government would be forced to choose between making debt interest payments ($29 billion due Aug. 15), or making payments to Social Security recipients ($49.2 billion), or paying active duty military officers ($2.9 billion). Regardless of how the Treasury prioritizes payments, there will be winners and losers.

Weakened Economic Recovery

As the Congressional Research Service (CRS) has pointed out, removing government spending from the economy would reduce GDP while failure to make payments to individuals, service providers and state and local governments would impact their own spending decisions. In short, if the government stops paying its bills, agencies, recipients of government program funding, and state and local governments won’t have the money to pay their bills. The U.S. economy is driven largely by consumer spending and when consumers don't have money to spend, the economy suffers.

Default could lead to higher interest rates and increase the overall deficit

If the U.S. government defaults on its debt, lenders would view U.S. debt as a risky investment and likely sell off their Treasury securities. New lenders looking to buy U.S. debt that has been viewed as a risky investment and subsequently sold by previous lenders will likely demand higher interest rates on any new Treasury securities they purchase. Higher interest rates on U.S. debt equate to a decrease in investor (lender) confidence in U.S. debt security. If our creditors lose confidence in U.S. debt, they will sell off their securities and this will weaken the value of the dollar.

Because Treasury securities set the benchmark for a wide range of credit products such as, mortgages, student loans, credit cards, and business loans; an increase in U.S. Treasury interest rates would likely lead to an increase in the interest rates of credit products widely used by consumers. An increase in the interest rates of popular credit products would make it much more expensive for a family to buy a home, finance a college education, or pay for basic necessities. People looking to a start business would experience greater difficulty in securing a loan and the economy would lose out on potential new job creation.

To make matters worse, Standard & Poor's, an internationally recognized credit rating agency (CRA) has already stated that they will downgrade the United States' coveted AAA credit rating if the government defaults. A downgrade of the U.S. AAA credit rating will lead to further erosion in the confidence of U.S. debt. Higher interest rates on U.S. debt will make it more difficult for the government to pay back existing debt, as well as any future debt accumulated. The U.S. has historically enjoyed relatively low interest rates. For example, 10-year Treasury notes today are yielding less than 3%. The Congressional Budget Office estimates that each 1% increase in interest rates could add $1.3 trillion to the deficit over the next decade.

<u>Would the government shut down?</u>

Yes and no. It would not be a situation like the one narrowly avoided by Congress and President Obama in April. However, normal government operations would be impacted. For example, National parks wouldn’t close and federal workers wouldn't be furloughed – at least not right away. Any agency that operates under an annual appropriations act (spending bill), can continue to spend funds it has been appropriated even in the event of reaching the debt limit. However, being dependent on exiting cash balances and relying solely on new incoming revenues only gets us so far. Eventually the money will run out and that’s where trouble arises. If the government runs out of money, federal operations will be hindered and state and local budgets which rely on federal aid will also be impacted.

Why are some members of Congress reluctant to raise the debt limit?

Simply put, raising the debt limit has become a high stakes game of chicken. Many conservative members view not raising the debt limit as a way to control government spending, which they cite as being excessive. Republican members are using the threat of not raising the debt limit as a bargaining chip to achieve their goals of reduced government spending and entitlement program reforms.

Debt ceiling votes are generally a highly political exercise allowing the party out of power to exercise its displeasure over the policies of the occupant of the White House. In 2006, when President George W. Bush requested an increase in the debt limit, one Democratic senator in particular condemned the request as "a sign of leadership failure." The Democratic senator in question was Barack Obama and he along with most Democrats voted against a debt limit increase; the measure only passed as a result of every Republican voting for it.

This time is also different in that the Tea Party-aligned freshman House Republicans who campaigned on a pledge to cut spending immediately and deeply do not seem to care about either the political or economic ramifications of default on the debt ceiling. In that sense, the fight most resembles the 1996 debt-ceiling standoff between President Bill Clinton and then-House Speaker Newt Gingrich (R-GA), who had his own band of conservative freshman Republicans demanding cuts. Clinton eventually won the fight when it appeared Republicans were losing the public relations fight, but Gingrich claimed the debate paved the way for a major budget deal the following year.

What are the possible outcomes of the debt ceiling negotiations? (7/19/2011)

The Mega Deal

A grand bargain that would cut $4-$4.5 trillion from the 10-year deficit had been introduced in private talks between the President and House Speaker John Boehner (R-OH). This possible deal seeks additional savings through an increase in the Medicare eligibility age from 65-67, the implementation of means-testing premiums, increasing co-pays, and adjusting Social Security cost-of-living increases so that they remain downward. The plan would also include the promise of tax reform by a certain date, seeking to raise an additional $1 trillion in revenue (mainly affecting the wealthiest earners). The deal would also include a permanent extension of Bush-era tax cuts for those earning less than $250,000. Because of its sizeable tax revenue component, this option appears to have lost steam at this point.

The Biden Framework

This plan would include spending cuts totaling $1.9-$2.1 trillion. Cuts would be applied in the following ways: $1.1 trillion cut from discretionary spending, $334-$353 billion in Medicare/Medicaid savings, and $264-$332 billion in other program savings – including student financial aid, farm subsidies, civilian and military retirement and health benefits, federal asset sales, spectrum auctions, increased Fannie Mae/Freddie Mac guarantee fees and other items. This deal would also include $300 billion in interest savings. This option also does not appear to be gaining traction.

The "In-Between" Approach

This plan would settle for $1.5-$2 trillion in spending cuts, perhaps eliminating the recently publicized "private jet tax benefit" and the $0.45 per gallon ethanol blenders' credit. The plan would also include $1 trillion-plus in discretionary savings, $100-$200 billion in Medicare/Medicaid savings – including $50 billion in Medicare prescription drug discounts, $200-$250 billion in other mandatory programs/fees, as well as $200-$300 billion in interest savings. The plan could also include some "stimulus" measures, like an extension of unemployment benefits and the 2011 payroll tax cut through next year. This plan has potential, but still would require another debt ceiling increase vote before the 2012 elections, something both sides are trying to avoid.

The McConnell – Reid Approach

This deal would combine the "In-Between" Approach with a new plan introduced recently by Senator McConnell; reportedly Senator Reid is crafting a similar plan. The deal would authorize a $2.5 trillion debt limit increase in three separate stages, with automatic increases unless both chambers of Congress vote 'no'. This plan would likely be adopted with the roughly $1.5 trillion in cuts described in the "In-Between" Approach. The plan would also create a commission that would recommend additional trillions of dollars in savings; recommendations would be voted up-or-down. At this time, this option seems to be the most likely path to passage of a debt ceiling increase, but time will tell.