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Debt Ceiling: A Stop Sign for Federal Borrowing

The debt ceiling is likely to become a focal point for negotiations on broad fiscal issues, including the federal budget and tax reform.

The Bipartisan Budget Act of 2015 suspended the federal government's statutory debt limit — commonly called the debt ceiling — through March 15, 2017. That deadline came and went with little fanfare as Congress focused on other matters, but the debt ceiling cannot be ignored for long, and it's likely to become a focal point for negotiations on broad fiscal issues, including the federal budget and tax reform.

As an investor and taxpayer, you may want to know more about how the debt ceiling relates to the national debt and annual budget deficits.

Government in the Red

Put simply, the federal government runs a deficit when tax revenues are not sufficient to meet spending obligations. Federal spending has outpaced revenue over the last 50 years, except in FY 1969 and 1998-2001.[1] Annual budget deficits add to the national debt, which stood at $19.846 trillion on March 15, 2017. As required by the Bipartisan Budget Act, this became the new debt limit until it is adjusted by further legislation.[2]

There are two categories of federal debt: (1) funds the government has borrowed, primarily through Treasury securities, from individuals, corporations, state or local governments, foreign governments, and other non-federal entities; and (2) funds borrowed from government accounts, such as the Social Security, Medicare, and Civil Service Retirement trust funds. Almost all federal debt is subject to the statutory debt limit.[3]

The debt ceiling is a stop sign for federal borrowing, which means the Treasury can no longer issue securities that would put the government above the limit (though it may issue new securities to replace redeemed securities). The ceiling only stops spending that requires additional borrowing; raising the ceiling only allows borrowing for spending that has already been authorized or incurred. However, failing to raise the debt limit could ultimately result in the United States defaulting on its legal obligations. Although this is unlikely to happen, it might result in cutbacks to government services, layoffs of government employees, and disruption of financial markets.[4]

Extraordinary Measures

The Treasury can buy time through "extraordinary measures," which could include suspending issuance of special securities to state and local governments, suspending investment of three federal pension funds and another government fund, and redeeming securities held by two of the pension funds. By law, the pension funds must be made whole with interest after the debt limit is raised.

On March 16, 2017, Treasury Secretary Steve Mnuchin informed congressional leaders that he had instituted most of these measures and urged Congress "to protect the full faith and credit of the United States by acting to increase the statutory debt limit as soon as possible."[5]

The Congressional Budget Office estimates that extraordinary measures would allow the government to continue borrowing and making usual payments until the fall of 2017.[6]

Mounting Debt

Since 1960, Congress has addressed the debt ceiling 78 separate times by permanently raising the limit, temporarily extending it, or revising its definition.[7] Most actions occurred with little or no conflict; however, this has changed in recent years due to a bitterly divided Congress and the mounting national debt.

Over a five-year period during and after the Great Recession — from Q4 2007 to Q4 2012 — the federal debt rose as a percentage of gross domestic product (GDP) from 63% to 101%, a level not seen since the years immediately following World War II. This dramatic increase was due to a combination of slow GDP growth, reduced federal tax revenues, and increased spending on economic stimulus measures. Deficit spending has slowed during the last four years, but any deficit adds to the debt, and GDP growth has remained low. At the end of 2016, debt was equivalent to about 106% of GDP.[8]

The Battle to Come?

The debt ceiling will almost certainly be raised. The question is what will be required to raise it. In a March 16 interview, House Speaker Paul Ryan said he did not believe Congress would pass a "clean bill" to raise the debt ceiling without additional provisions, but he did not yet know what might be required to gain approval.[9]

With the administration and Congress representing the same party, it would seem that compromise may not be difficult, but budget hawks have expressed a commitment to significant spending cuts in order to support an increase in the debt limit.[10] The Trump administration's budget outline released on March 16 uses budget cuts to increase military spending, but does not reduce overall federal spending.[11] And proposed tax reductions and new infrastructure spending would further increase the deficit and national debt unless they are accompanied by a large increase in GDP growth.

Although these differences may be resolved in a timely fashion, recent battles and current legislative priorities suggest they might not come to a head until late summer or early fall, when the Treasury's extraordinary measures run their course and the debt ceiling becomes an imminent crisis.

U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest. The principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid.

1, 6) Congressional Budget Office, 2017

2, 4-5, 7) U.S. Treasury, 2017

3) Congressional Research Service, 2015

8) Federal Reserve, 2015-2017

9) Bloomberg, March 16, 2017

10) The Hill, March 16, 2017

11) CNNMoney, March 16, 2017

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