

FEDERAL DEBT LIMIT IN THE UNITED STATES: THE PERVERSE IMPACT OF AN OUTMODED CONTROL MECHANISM

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Abstract. The federal government of the United States imposes a legal limit on its debt under an old system of fiscal control. Because the government operates close to that limit and also has been operating with a sizable deficit, this statutory limit must be regularly raised. Although Congress approves the spending programs and revenue structure that produces the deficit, in recent years some members of that body have chosen to use the debt limit as a method of controlling deficit increases. However, constraining debt increases does not constrain spending, but rather only constrains the ability to pay the bills for the spending. That constraint, after spending has occurred, creates the prospect of default and endangers the national credit rating.

Keywords: debt limit, deficit, credit rating, US government, budget, appropriations.

JEL classification: H11, H63

Introduction

The expected capacity to service debt on a timely basis provides an economic limit to government borrowing. If prospective lenders believe that service is subject to considerable risk, then interest rates required by lenders will rise, possibly to unsupportable levels, or, in the worst case, lenders will not make loans at any interest rate. That has been, of course, the fate of Greece in 2011 and 2012, when its sovereign debt reached levels that challenged the nation's capacity to pay interest and meet scheduled repayments of principle. Voluntary loans to the country ceased, bringing severe austerity to the government and considerable suffering to much of the population. The economic limit to debt is harsh and not forgiving.

The government of the United States, however, has established a statutory limit on its outstanding debt, a limit that falls far earlier than any economic limit driven by willingness of lenders to lend or by skyrocketing interest rates required to cover the risk

of potential default.¹ Historically, the debt of the United States government was internationally regarded as economically and politically secure, certain to pay the promised return as it came due. The debt was an international safe haven and the United States was one of the few countries whose sovereign debt enjoyed the highest rating for absence of credit risk. The debt was all denominated in the national currency, preventing exchange rate risk as a problem for debt service, and the national government had power to print its own currency as a last resort for debt service, two advantages not shared by all debtor nations. However, in late summer 2011, this credit rating fell from AAA to AA+ with the international rating firm Standard & Poor, not simply because of high debt. The debt to gross domestic product ratio is high, but not as high as with some other AAA-rated nations and American tax burdens are relatively low and tax compliance is relatively high, suggesting unused debt service capacity. Rather, the source of the problem was the statutory limit that the national government had established for itself and the political argument in the U. S. Congress about increasing that limit. And other rating agencies appear poised to reduce their evaluations in the early months of 2012 as another debt ceiling dispute looms and, given the fiscal path the government is following, more ceiling problems are probable for some time into the future. This perverse and surprising impact may appear confusing. A debt limit would seem to make debt service more secure, not less. The article that follows explains how this strange downgrade of an economically strong nation emerged.

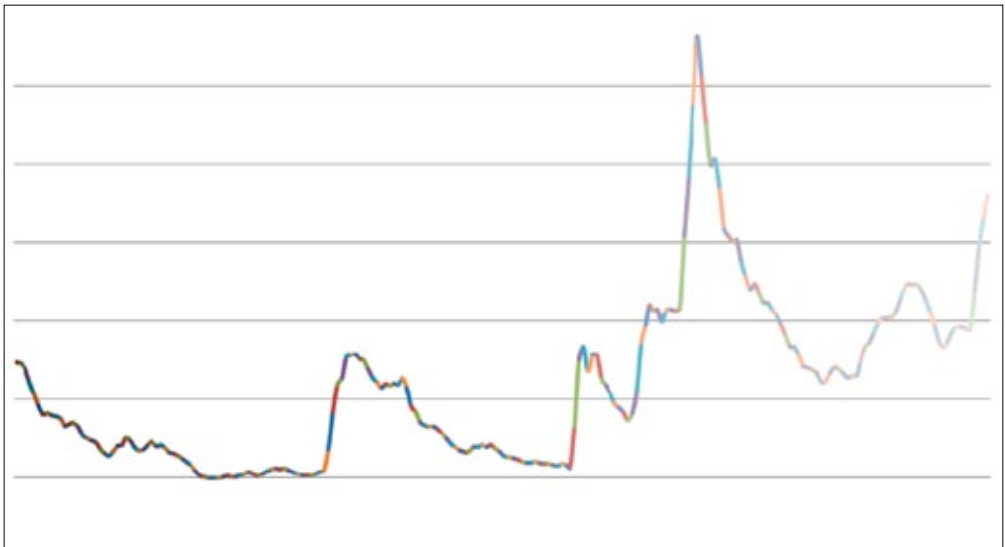
American federal debt

The American national government has almost never been out of debt. At independence, it had considerable debt incurred in fighting the revolutionary war and it also assumed the debts that its states had incurred in fighting that war, so it did not start with a clean sheet. For a few months in early 1835, the federal government did have no debt outstanding, having managed to repay all debts incurred from the revolutionary war, the war of 1812, and other deficits (Dewey, 1936). However, the debt-free status ended quickly and from that time forward, the American national government had always had debt. With the exception of previously-noted debt to finance the revolutionary war and the war of 1812, it has not been American practice to actually repay federal government debt issued to deal with wars and substantial crises. In point of fact, the debt issued to finance the Civil War in the 1860s was never retired, the debt issued to finance World War I was never retired, the debt issued in the Great Depression of the 1930s was never retired, and the debt issued to finance World War II was never retired. In all these instances, when the substantial debt issued to deal with the crisis matured, it was replaced by new borrowing and the level of debt outstanding never returned to its level before the crisis being financed. In all instances, economic growth served to make the significance of those debt levels decline to relative economic unimportance.

¹ Denmark also has a legal debt limit, but the general practice among developed countries is to authorize whatever new borrowing is associated with the budget that has been approved, either explicitly or implicitly.

To understand the economic significance of debt outstanding, it can usefully be compared to the size of the national economy and the history of United States debt shows that this debt to gross domestic product ratio has varied substantially over the years, particularly increasing in periods of major war or economic crisis. Thus, Figure 1 reports that history, showing the considerable spikes for major wars (the Civil War in the 1860s, World War I in the 1910s, and World War II in the 1940s) and during the Great Depression of the 1930s. In each case, although the debt issued to provide funds for the event was never retired on net, growth of the economy served to cause a fall in the burden ratio over time.

Figure 1. Federal Debt Held by the Public as % GDP, 1790-2011 (end of calendar year)



Sources: U. S. Congressional Budget Office, Bureau of Economic Analysis, and Federal Reserve Bank of St. Louis Source

The nature of this borrowing has changed over the years. In general, the Department of Treasury borrows to accommodate cash requirements of the federal government, whatever the source of those requirements. Historically, debt was issued for particular purposes. For example, debt issued through the Spooner Act of 1902 (32 Stat 481; Public Law 57 – 183) financed construction of the Panama Canal and the 1898 War Revenue Act (30 Stat. 448-470) financed the Spanish-American War. Congress thus maintained individualized issue control over debt. However, in modern times, borrowing has not been done to finance any particular project or task but rather to provide cash to support expenditure in a period that it exceeds the amount of revenues collected. In other words, borrowing occurs to cover the deficit and the accumulation of this borrowing, netted against any surpluses that have occurred since the start of the nation, equals the amount of debt outstanding. In other words, the Treasury now issues debt, not to support projects, but to cover the difference between spending and revenue. Constraining

the growth of debt means reducing the size of the deficit but reducing the level of debt requires running a surplus. When the statutory debt limit is reached, the Treasury loses the capacity to borrow to cover the difference between spending and revenue. It ultimately runs out of funds to pay the bills for purchases and obligations already made. As will be discussed in a later section, the government can continue to make purchases but the Treasury cannot pay for them.

Origins of the statutory debt limit

The first statutory debt limit was enacted during World War I. Prior to that time, Congress had to approve each individual debt issuance and the debt limit was intended to provide the Treasury with greater flexibility in its financing operations. Rather than come to Congress with a request to borrow in order to cover financing needs, the borrowing could be done as necessary, so long as the total debt outstanding – debt held by the public plus debt held by government accounts -- was less than the total amount that Congress had approved. The debt limit also was intended to provide some general control over the pace of government spending (Cooke and Katzen, 1954). In that era, there was no regular budget process in place and agencies came to Congress to request additional funds as they exhausted funds that had previously been approved. The limit served as something of a control over the pace of overall government spending, a control that was nowhere else in place in the federal system.

Government debt limits were not unique to the federal government in the United States. Both state and local governments characteristically operate with debt limits, often included in their constitutions rather than in statutory law. Many of these constraints emerged in constitutions written or re-written in the second quarter of the nineteenth century, in the aftermath of defaults and even repudiations of state debt that was issued to construct systems of roads, canals, and railroads in the process of infrastructure development in the 1830s. While the Erie Canal in New York State successfully linked Lake Erie in the Great Lakes with the Hudson River and ultimately New York harbor and was a great factor in opening commerce from the American Midwest to the world, many of these state-developed or underwritten projects were great commercial failures and the state debt issued to finance the projects went to default. Revised state constitutions and new state statutes responded by constraining state borrowing (and also limiting local borrowing as well). These limits were created to prevent the kind of careless use of state credit that had emerged in the past. Only eight of the fifty states – Alaska, California, Georgia, Minnesota, Montana, North Carolina, Oklahoma, and Vermont – now lack a constitutional or statutory limit to authorized debt – either an absolute dollar limit, a limit linked to another economic magnitude (the value of taxable property, total general fund revenue, state personal income, etc.), or referendum or other extraordinary controls (National Association of State Budget Officers, 2008). They are, however, not elements of aggregate fiscal control on the state but are controls on the use of state credit. Furthermore, state and local governments have created various means of borrowing for infrastructure projects in ways not constrained by the legal limits – normally by creating public authorities that are legally not instru-

ments of the government but that act on behalf of the government to finance, build, and operate facilities. Even states that forbid state debt entirely use public authorities associated with state government (a state university or a state toll road commission) to borrow for construction of infrastructure.

At the federal level, a national budget process was created by the Budget and Accounting Act of 1921. The process established a regularized system by which a total budget was presented on a standard schedule, thus allowing Congress to see how much total spending was being proposed for a budget year and permitting attention to the comparison of total spending against revenues being received. The control on spending would thus become the appropriation process and not the ultimate constraint from a debt limit.

The budget process and expenditure control in the American system

As is the case in all modern public expenditure control systems, American federal agencies do not have their own bank accounts and do not directly spend the money they have been legally allowed to use for the purchase of goods and services. Discretionary federal spending (37.4% of outlays in fiscal year 2011) is controlled through appropriation accounts that are established by the Congress in appropriation laws. Each year, Congress is expected to pass separate appropriation laws for provision of government services, signed by the President, that include provision of resources to executive agencies so that they may provide services through the budget year. The titles of these laws roughly follow the administrative organizations of the government: Agriculture; Commerce/Justice/Science; Defense; Energy & Water; Financial Services; Homeland Security; Interior & Environment; Labor/Health and Human Services/Education; Legislative Branch; Military Construction/Veterans Affairs; State/Foreign Operations; Transportation/Housing and Urban Development. However, Congress may reorganize its operations and change the number of laws and what operations are included in each. What the appropriation laws provide each agency is called budget authority, not direct funds, and the agency may then use this obligation authority to enter into contracts with private entities for delivery of goods or services. The Government Accountability Office explains: "Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation act; they represent amounts that agencies may obligate during the period of time specified in the respective appropriations acts." (US GAO, 2005, p.21). Agencies receive authority to incur financial obligations (essentially, enter into contracts for delivery of resources), but after the purchases have been delivered, the Treasury of the United States pays the amounts contracted by the agency.² The agency purchases so long as it has unused obligation authority. It is not involved in the payment for the services it has acquired. The Treasury handles the money. The appropriation laws passed by Congress control this spending.

Another portion of federal spending is legally regarded as mandatory and does not flow through the annual appropriation process (a permanent appropriation law provides the basis for the spending). Most of this spending is for the national social insur-

² The system refers to these payments as outlays.

ance system and includes spending for Social Security benefits (support for the elderly, disabled, and dependent survivors), Medicare (health insurance for the elderly), and Medicaid (medical care for poor people). It also includes interest payments on national debt and some other individual benefit programs (like unemployment compensation). Mandatory spending plus net interest paid equaled 62.6% of federal outlays in the fiscal year 2011. This spending is done according to a formula, rather than through annual appropriation. Congress enacts a set of rules that determine who is eligible for payments and what benefits those eligible will receive and spending thus flows automatically through the year according to the data entering into the formula. Congress controls this spending, not by annual appropriation, but by altering the various formulae to make them more or less generous. Here again, payments come from the Treasury, not from any agencies that are responsible for administering the programs. The rules passed by Congress determine the amount of spending.

What this means is that the control point for government spending on programs is the annual appropriation laws that create obligation authority for the operating agencies and for mandatory spending is the various entitlement formulae. So long as the agency has obligation authority, it can spend and without obligation authority, the agency cannot spend or, in fact, operate. Appropriation legislation typically provides obligation authority for one year at a time and unused obligation authority in one year cannot be carried forward for use in a later year. The obligation authority expires and may or may not be appropriated later.

The presumption is that new appropriation laws will have been passed before the start of the new budget year (federal budget years start each October 1). That gives operating agencies obligation authority for use as soon as the year starts and that is necessary because, in the absence of obligation authority, the agency cannot operate. However, the American practice has been for these laws to not have been passed before the new budget year starts. In the fiscal years from 1948 through 2013, all appropriation acts were signed into law by the first day of the new fiscal year only in 1989, 1995, and 1997, but the system provides an accommodation (Mikesell, 2013, p.122). Although there have been a few years in which at least portions of the national government have closed for absence of the required appropriation, it is normally the case that the Congress will pass what is called a continuing resolution, effectively an agreement between Congress and the executive branch that will allow agencies to continue their pace of operations as if the required appropriation legislation has been passed. Indeed, it is now usually the case that appropriation laws will not have been passed on time and great portions of the national government will operate on the basis of a continuing resolution for weeks or months into the new budget year. In fact, it is sometimes the case that appropriations will never get adopted and agencies will function through the entire year on the basis of a continuing resolution.

The important point to recognize is that it is obligation authority that controls the pace of government spending. It is not whether the Treasury has sufficient money to pay the bills incurred by government agencies. Agencies will function and enter into contracts that will necessitate expenditure so long as they have obligation authority, provided either in an appropriation act or in a continuing resolution. Direct expendi-

ture, one part of the determination of deficit or surplus that establishes whether the level of debt increases or decreases, is controlled by the amounts of obligation authority provided by Congressional action. When agencies have no obligation authority, they must shut down operations. They cannot continue to operate and they cannot spend.

Reaching the debt ceiling would not reduce the pace of government spending, at least immediately and probably not until after significant severe consequences to the economy. The Treasury would not be able to issue additional debt to cover the difference between receipts and outlays, so some bills would not be paid as they come due. As described by the Congressional Budget Office, the inability to borrow “would severely strain the Treasury’s ability to manage its cash and could lead to delays of payments for government activities and possibly a default on the government’s debt obligations. Which of the government’s various financial obligations would be paid and which would not would be determined by the Administration.” (Congressional Budget Office, 2012). Government agencies could operate and make purchases. The Treasury would not be able to pay all the bills as they arrived. The Treasury would likely want to pay bond holders first, in order to maintain access to credit markets and avoid a default, but others in the administration might have other agendas (preserving Social Security payments to the elderly, for instance), so the final approach is unknown. It could involve delay of income tax refunds, slowing payments to Medicare and Medicaid providers (hospitals and doctors), slow payment of government contractors, failure to pay government employees, etc. The impacts could be designed to be more painful to Americans than the government shut-downs associated with failure to have appropriations in place at the start of a new fiscal year. The United States government would be in an arrears position, much like some countries of the former Soviet Union found themselves in the 1990s or like the government of Greece now: legitimate payments to pensioners, employees, health services, and suppliers could not be made because the government lacked the funds needed to cover the promises, either from tax revenue or loan proceeds. The countries could not handle their deficits by borrowing because no entity would voluntarily loan them money. As cash became available (tax collections, international assistance, and, as confidence in the country improved, loans), payments would be made, sometimes accordingly to which claimants happened to be trying to be paid at the moment the cash came in. Claimants usually were paid eventually. The difference is that the arrears in the United States would be entirely self-inflicted and entirely avoidable because the United States government is fully capable of borrowing to fill the cash gap.

At least in the short run, running out of ability to pay bills because of the debt ceiling has been reached and new borrowing could not happen would not reduce spending and would not cause government agencies to have to close. So long as agencies had obligation authority, they would still be able to make purchases (i.e., spend), work would continue, and suppliers would continue to seek government business because eventually payments for contracted liabilities would be made. Preventing issuance of new debt is not generally an effective deficit control mechanism. Controlling obligation authority – the appropriation process – is the effective method, but use of that method requires specific action on specific programs that serve specific sectors of the population. Effectiveness requires politically risky actions, not generalized opposition to debt and deficits.

The conflict of paradigms

The Congressional elections of 2010 brought many new legislators, including many who were adherents to the Tea Party movement. (“Tea” stood for “Taxed Enough Already.”) A good number of these members of Congress wanted a smaller national government and lower taxes. Most were suspicious of any government activities, possibly excluding national defense, and many were not much interested in making government function. Because of the fiscal strains of the recession of 2007-2009 and a fundamental fiscal imbalance from wars in Iraq and Afghanistan, a substantial tax reduction in 2001, and expansions of some social programs, the federal government was operating with a substantial deficit. Indeed, current federal revenues covered only 63.9% of federal spending in 2011 and, as a result, the federal debt outstanding as a share of the national gross domestic product had increased dramatically (Office of Management and Budget, 2012). Because spending exceeded revenues, the gap had to be covered by Treasury borrowing and that borrowing rapidly used up the debt ceiling. History had been that Congress would ordinarily raise the debt ceiling whenever an increase was necessary to cover spending programs. From April 1993 through August 2011, the debt limit has increased fourteen times, from \$4,370 billion to \$16,394 billion, so ceiling increases are not unusual and only on one occasion before 2011 did the increase cause controversy in Congress (Austin and Levit, 2012). Increases were necessary to accommodate the appropriation and revenue actions that had already been approved by the lawmakers. But the approval of the increase was not certain as the debt ceiling was approached in late summer of 2011. Objection to the debt ceiling increase became a politically attractive generic objection to increases in federal debt (the natural result of spending more than revenue collections) with the necessity of politically difficult actions to actually reduce the deficit. Members were unwilling to act to reduce specific discretionary appropriations, to modify the formulae driving mandatory spending, or to increase revenues because none of these actions would have been popular. At the time of the 2011 debt ceiling increase, there was no fiscal proposal in Congress that would have reduced the deficit, let alone reduced the level of debt, so debt had to increase to accommodate Congressional actions. That is a clear suggestion of the purely political nature of the debt ceiling paradigm.

Many of the members of Congress newly elected in 2010 were not inclined to permit the debt ceiling increase, but saw this as an opportunity to control federal government spending. If the Treasury could not borrow to meet cash requirements, the federal government could not pay bills for obligations already established. Agencies could make purchases, but the Treasury could not pay all employees, suppliers, or, possibly, interest on loans.³ This uncertainty about debt service, quite rightly, raised questions about high debt rating. None seriously doubted the economic capacity of the federal government to service its debt. Interest rates were historically low and lenders were

³ Because of long-term implications of debt service default, it is likely that payments to bondholders would be a first claim on available funds. Stopping payment of personnel compensation and benefits to federal employees, including military, would not cover much of the problem. In the fiscal year 2011, those payments constituted only around 13% of total federal outlays.

willing to purchase debt as it was issued. Figure 2 shows that there was no evidence of a substantial increase in interest rates faced by the federal government. Indeed, they were lower than they had been in the past forty years.⁴ Capacity to finance the existing and anticipated debt for at least the intermediate term was not in question. The U. S. economy was emerging from a severe recession but economic fundamentals remained strong. What was in question was the political willingness to take the legal actions to meet financial obligations and this was produced exclusively by the debt ceiling.

Figure 2. Ten Year Treasury Constant Maturity Interest Rate, Monthly, 1/1/1970 - 11/1/2012



Source: Federal Reserve Bank of St. Louis

A rating represents an opinion about credit risk and the real danger that debt service will not be paid on time definitely constitutes credit risk. An artifact of an outmoded system for financial control, a control system replaced decades earlier by a regular budget system, created the dilemma that made for the insecurity of the United States government debt – a downgrade created by an historical relic.

Standard & Poor explained its decision to downgrade the debt of the United States government in this way:

“The political brinksmanship of recent months highlights what we see as America’s governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed. The statutory debt ceiling and the threat of default have become political bargaining chips in the debate over fiscal policy. Despite this year’s wide-ranging debate, in our view, the differences between political parties have proven to be extraordinarily difficult to bridge, and, as we see it, the resulting agreement [finally to increase the ceiling] fell well short of the comprehensive fiscal consolidation program that some proponents had envisaged until quite recently.”⁵

⁴ This absence of interest rate increase may be as much an indictment of economic and fiscal policies of other developed nations than it was a dismissal of extra credit risk identified by Standard & Poor. The United States government may be inept, but not so much in comparison with that of other countries.

⁵ Standard & Poor’s, “Research Update: United States of American Long-Term Rating Lowered to ‘AA+’ On Political Risks and Rising Debt Burden; Outlook Negative,” August 5, 2011: 3.

The statutory debt ceiling provided the environment that produced the downgrade because it was the sole reason for the potential of default on the debt obligations. The federal government was not being excluded from the debt market by unwilling lenders, the federal government was able to borrow at extremely low interest rates (an excellent indicator of world-wide confidence in fiscal strength), the United States showed absolutely no evidence of inflationary pressure, and the United States economy was gradually emerging from the severe recession of 2007-2009. The downgrade emerged because the statutory debt ceiling became a political weapon for those wanting to make a statement about deficit reduction who were unwilling to take the politically unpopular actions required to actually reduce the deficit: reduce government spending or increase government revenue.

Conclusion

The debt ceiling represents an old method of financial control. Indeed, by ending the need for the Treasury to obtain Congressional authorization each time debt was issued, it was intended to facilitate borrowing at the same time that it provided some control. As the federal budget process has developed, the debt ceiling and its increases have become an ideal tool for political posturing and that remains its sole remaining function because Congress has more effective means for fiscal control. That posturing caused the loss of the Standard & Poor AAA rating. Indeed, the ceiling votes create an almost perfect mechanism for politicians: the member of Congress may boldly vote against a debt increase, sending a message to constituents that the member is maintaining fiscal constraint – a perfectly generic position – at the same time that the member is unwilling to act to reduce spending or to increase taxes, the way in which deficits can be reduced or even surpluses produced to cut the level of debt – because those actions are virtually certain to be politically unpopular. People like government services provided to them and do not like paying taxes, even as they claim opposition to increases in federal debt. Votes on the debt ceiling are thus political gestures that replace actions that might serve the interests of fiscal sustainability. It is clear that the fiscally responsible action is to eliminate the debt ceiling and trust economic constraints rather than outmoded law. The debt ceiling allows members of Congress to pass appropriation laws, mandatory spending formula, and tax laws that guarantee a large budget deficit and then members of Congress can “boldly” proclaim their opposition to budget deficits by preventing additional borrowing through the debt ceiling constraint.

Refusing to increase the debt ceiling is not the same thing as controlling federal spending, reducing the size of the federal deficit, and certainly not reducing the amount of federal debt. The federal government continues to operate with a considerable deficit because Congress and the President have not revised fiscal laws (appropriations, entitlement formulae, revenue systems) to close the fiscal gap. Furthermore, the debt ceiling remains in place. Barring considerable political restructuring, more ceiling levels will be reached through the future and each episode promises more fiscal drama with the prospect that the federal government, although continuing to operate, will not be able to pay its bills when they come due.

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FEDERALINIS SKOLOS LIMITAS JUNGTTINĖSE AMERIKOS VALSTIJOSE: IŠKREIPTAS ATGYVENUSIOS KONTROLĖS PRIEMONĖS POVEIKIS

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Santrauka. Jungtinių Amerikos Valstijų federalinė vyriausybė naudoja teisinį skolos limitą kaip senos fiskalinės kontrolės sistemos priemonę. Kadangi valstybė vykdo savo finansinę veiklą arti nustatyto limito ir nuolat turi nemažą biudžeto deficitą, limitą reikia reguliariai padidinti. Nors kongresas patvirtina tokio lygio biudžeto išlaidas ir pajamų struktūrą, kad biudžetas būna deficitinis, pastaraisiais metais kai kurie kongreso nariai sumanė panaudoti skolos limitą kaip deficito didėjimo kontrolės priemonę. Tačiau skolos apribojimas nesumažina išlaidų. Skolos limitas tik apriboja galimybę laiku apmokėti sąskaitas. Toks apribojimas po to, kai išlaidos jau padarytos, padidina skolos negražinimo tikimybę ir kelia pavojų valstybės kredito reitingui.

Reikšminiai žodžiai: skolos limitas, deficitas, kredito reitingas, biudžetas, asignavimai, JAV vyriausybė.