CBO TESTIMONY

Statement of
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on
Debt Subject to Limit

before the
Committee on Finance
United States Senate

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NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EDT), Friday, July 28, 1995.

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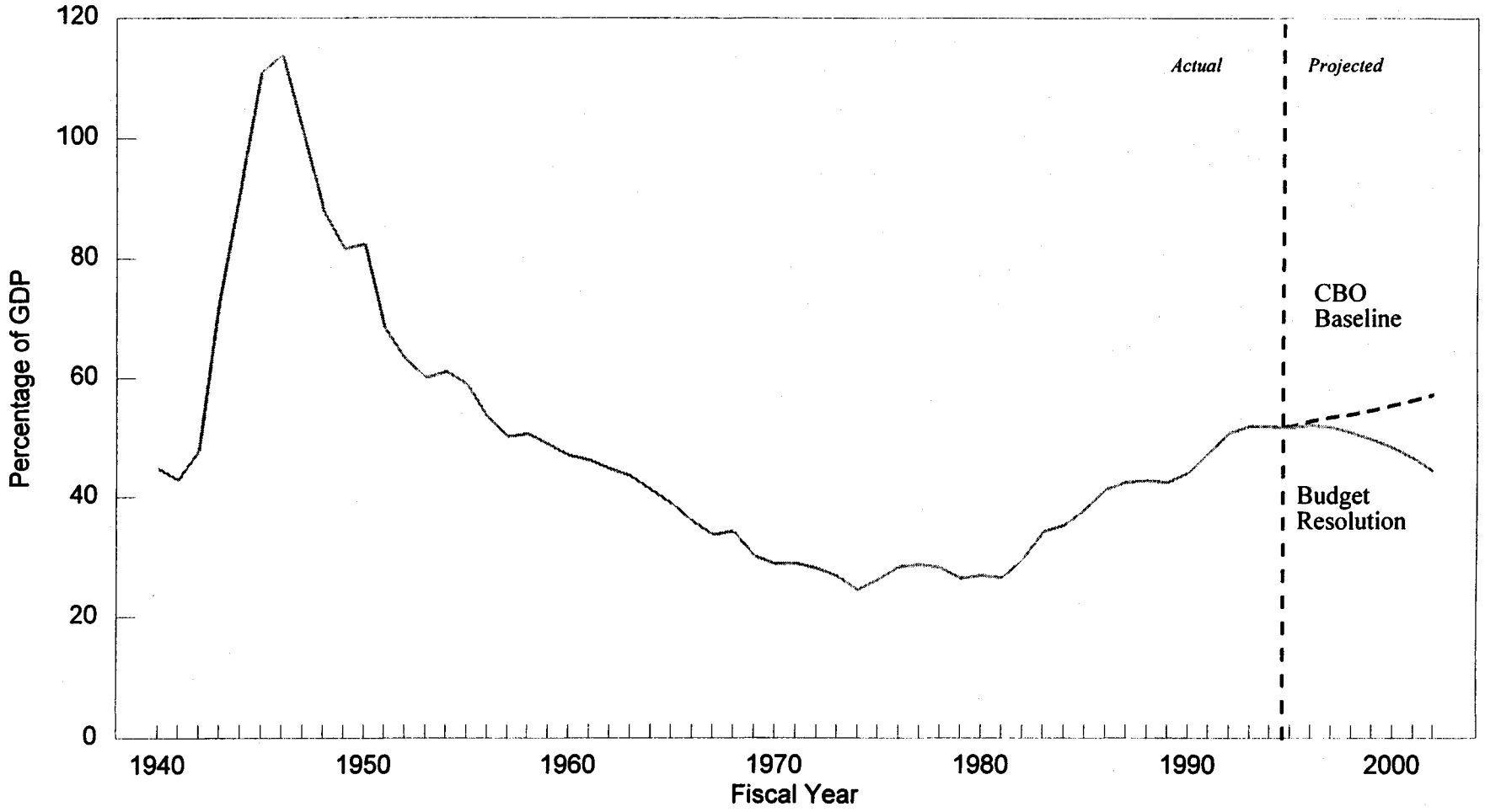
Mr. Chairman, I am pleased to appear before this Committee to discuss the federal debt limit. In my statement today, I will give some background information on the debt limit, including its relation to the deficit and its impact on financial markets. I will also discuss the Congressional Budget Office's (CBO's) projections of when we will reach the current debt ceiling; describe the pertinent dates regarding federal borrowing, cash inflows, and cash outlays that debt watchers should be concerned with; and outline potential Treasury action to cope with a borrowing crisis.

FEDERAL DEFICITS AND DEBT HELD BY THE PUBLIC

The large budget deficits of the 1980s and early 1990s have caused the federal debt to soar, a trend that would continue under current laws and spending practices. At the end of this fiscal year, debt held by the public will be $3.6 trillion. If there are no changes in federal taxing and spending policies, CBO estimates that debt held by the public will amount to $5.6 trillion by 2002. As a share of gross domestic product (GDP), it will rise to nearly 57 percent, up from 51 percent at the end of fiscal year 1995 and a post-World War II low of 24 percent in 1974 (see Figure 1).

The budget resolution adopted by the Congress in June seeks to reach balance by 2002 and stem the rise in borrowing from the public. In the meantime, there would be deficits, so debt held by the public would continue to grow, reaching $4.4

FIGURE 1.
DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GDP



SOURCES: Office of Management and Budget for 1940-1994; Congressional Budget Office for 1995-2002.
NOTE: Projections based on June 1995 conference resolution and CBO April 1995 baseline.

trillion by the end of 2002. Debt held by the public relative to GDP, however, would decline to 44 percent.

WHAT IS THE DEBT LIMIT AND WHY DO WE HAVE ONE?

Since the Second Liberty Bond Act was passed in 1917, the Congress, by statute, has set an overall dollar ceiling on the amount of debt that the Treasury can issue. The limit applies to nearly all debt of the federal government, including the special securities (Government Accounts Series) issued to trust funds and other government accounts. That internally held debt has grown quite rapidly in recent years as Social Security and other trust funds have run large surpluses. At the end of fiscal year 1995, CBO estimates, government-held debt will amount to $1.3 trillion compared with only $200 billion in 1980.

With rare exceptions, the limit on debt does not apply to debt issued by other federal agencies, which the Treasury does not control. However, few federal agencies have authority to conduct their own borrowing. The statutory limit also does not apply to debt issued by the Federal Financing Bank, which used its full authority during an interruption in the debt ceiling in 1985.

Debt subject to limit generally counts the face value of federal debt. Special rules, however, apply to securities that are sold at a discount. Savings bonds, Treasury bills, and zero-coupon bonds are all discount securities, meaning that holders of those securities collect no income at all from them until maturity, when they receive the face amount that reflects the initial purchase price plus accrued interest. If maturity is far in the future, the face amount of those securities greatly exaggerates their current worth. Hence, such securities are included in the debt subject to limit at their purchase price when they are first sold and then at gradually greater amounts until they mature.

Together, the deficit and the trust fund surplus easily explain most of the growth in debt subject to limit (see Table 1). The deficit largely determines what the Treasury must borrow in credit markets. The trust fund surplus drives the issuance of debt to federal government accounts. Because the income--mostly earmarked revenues (such as Social Security taxes) and interest--of trust funds is likely to continue to exceed their outlays, debt subject to limit will continue growing even after the budget is brought into balance. Under the budget resolution, the debt subject to limit would rise from its current ceiling of $4.9 trillion to nearly $6.7 trillion at the end of 2002.

At one time, the debt ceiling may have been an effective control on the budget when most spending was subject to annual appropriations. But

TABLE 1. PROJECTIONS OF DEBT SUBJECT TO LIMIT UNDER THE BUDGET RESOLUTION (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002
Debt Subject to Limit, Start of Year	4,890	5,197	5,497	5,767	6,026	6,276	6,490
Changes							
Deficit	170	152	116	100	81	33	-6
Trust fund surplus	121	127	134	139	151	162	173
Other changes[a]	17	20	20	20	18	19	19
Total	308	299	270	259	250	215	185
Debt Subject to Limit, End of Year	5,197	5,497	5,767	6,026	6,276	6,490	6,675

SOURCE: Congressional Budget Office.

NOTES: The current statutory ceiling is $4,900 billion. Numbers may not add up to totals because of rounding.

The figures shown here are based on the outlay and revenue levels reported in the budget resolution. Those reported levels do not include the effects of a contingent tax cut the resolution provides for or the effect of the so-called fiscal dividend that CBO estimates would result from balancing the budget.

a. Mostly investments by government accounts that are not trust funds and net outlays of credit financing accounts.

discretionary spending is now a much lower proportion of total spending, amounting to only 36 percent in 1995. Under the recently adopted budget resolution, discretionary outlays will continue to fall further to 27.5 percent by 2002. The rise in mandatory spending and growth of the trust fund surplus has turned the statutory limit on federal debt into an anachronism. Through its regular budget process, the Congress already has ample opportunity to vote on overall revenues, outlays, and deficits. Voting separately on the debt is ineffective as a means of controlling deficits because the decisions that necessitate borrowing are made elsewhere. By the time the debt ceiling comes up for a vote, it is too late to balk at paying the government's bills without incurring drastic consequences.

As a result, the debt limit in recent years has served mainly as a vehicle for other budgetary and unrelated legislation because raising the ceiling is considered to be "must pass" legislation. The debt limit is frequently used as a device to force action to obtain some other legislative goal. For example, in 1990, the Congress voted seven times on the debt limit between August 9 and November 5 as the budget summit meetings progressed and the Congress considered the resulting budget resolution and reconciliation bill.

WHAT ARE THE CONSEQUENCES OF NOT RAISING THE DEBT LIMIT?

Financial markets find the debt limit a periodic source of anxiety. The government has never defaulted on its principal and interest payments, nor has it failed to honor its other checks. However, even a temporary default--that is, a few days' delay in the government's ability to meet its obligations--could have serious repercussions in the financial markets. Those repercussions include a temporary rise in the overall level of U.S. interest rates relative to foreign rates, a temporary decline in the value of the dollar, and a permanent increase in federal borrowing costs relative to yields on other securities as investors realize that Treasury instruments are not immune to default.

Failing to raise the debt ceiling will not bring the government to a screeching halt the way that not passing appropriation bills would. Employees would not be sent home, and checks would continue to be issued. If the Treasury is low on cash, however, there could be delays in honoring checks and disruptions in the normal flow of government services. Carried to its ultimate conclusion, defaulting on payments would have much graver economic consequences--such as loss of confidence in government and a higher risk premium on Treasury borrowing--than failing to pass a continuing resolution for discretionary appropriations.

CURRENT PROJECTIONS OF DEBT SUBJECT TO LIMIT

As of the end of June, debt subject to limit was $4.861 trillion, narrowly close to the current ceiling of $4.9 trillion. However, redemptions of some Government Account Series and State and Local Government Series debt have brought debt subject to limit down to $4.85 trillion today.

So when will the Treasury hit the ceiling? It is still too early to determine the particular week that the debt ceiling will be reached, much less a specific day. With the 1995 deficit now expected to total between $160 and $165 billion, the federal government should be able to squeak through September with a small amount of borrowing authority remaining.

After that point, when exactly the Treasury uses up its available authority will depend on the size and timing of upcoming cash drains and on the Treasury's cash balance at the beginning of the fiscal year. Normally, the Treasury enters a new fiscal year with a cash balance of $40 billion or so. Drawing on those cash reserves and using any remaining borrowing authority, the Treasury should be able to hold out until mid-October. Note, however, that those projections do not presuppose any unusual action by the Treasury. With a little ingenuity, the Treasury may even be able to hold out into early November.

The date on which the debt ceiling is reached depends on the Treasury's borrowing schedule, which in turn is based on the government's cash outflows and cash inflows. The Treasury tries to maintain a predictable borrowing calendar to minimize uncertainty in the market and help reduce costs. Many receipts and outlays also follow a predictable pattern, which helps in projecting the Treasury's cash needs.

Borrowing

Treasury securities are generally issued according to a regular schedule, except cash management bills, which are issued when needed to temporarily cover shortfalls in cash balances (see Table 2 for expected issue dates from September through November). Three-month and six-month bills are auctioned on a weekly basis, with 52-week bills offered every four weeks. As for longer-term securities, two-year and five-year notes are sold at the end of each month, with three-year and 10-year notes auctioned quarterly and 30-year bonds sold twice a year.

The sizes of note and bond auctions are generally stable from one issuance to the next, usually varying in size by no more than $0.5 billion, if they change at

TABLE 2. CALENDAR OF TREASURY BORROWING, SEPTEMBER TO NOVEMBER 1995

Auction Date	Type of Issue	Settlement Date[a]
September 5	3-month bills	September 7
September 5	6-month bills	September 7
September 11	3-month bills	September 14
September 11	6-month bills	September 14
September 14	52-week bills	September 21
September 18	3-month bills	September 21
September 18	6-month bills	September 21
September 25	3-month bills	September 28
September 25	6-month bills	September 28
September 26	2-year notes	October 2
September 27	5-year notes	October 2
October 2	3-month bills	October 5
October 2	6-month bills	October 5
October 10	3-month bills	October 12
October 10	6-month bills	October 12
October 12	52-week bills	October 19
October 16	3-month bills	October 19
October 16	6-month bills	October 19
October 23	3-month bills	October 26
October 23	6-month bills	October 26
October 24	2-year notes	October 31
October 25	5-year notes	October 31
October 30	3-month bills	November 2
October 30	6-month bills	November 2
November 6	3-month bills	November 9
November 6	6-month bills	November 9
November 7	3-year notes	November 15
November 8	10-year notes	November 15
November 9	52-week bills	November 16
November 13	3-month bills	November 16
November 13	6-month bills	November 16
November 20	3-month bills	November 23
November 20	6-month bills	November 23
November 21	2-year notes	November 30
November 22	5-year notes	November 30
November 27	3-month bills	November 30
November 27	6-month bills	November 30

SOURCE: Congressional Budget Office based on regularly announced schedule of the Department of the Treasury.

NOTE: Does not include cash management bills.

a. Date when debt is actually issued and the Treasury collects money.

all. Fluctuations in financing requirements are therefore made up through bill auctions. The predictability of Treasury issues, as well as the market's liquidity, helps the Treasury to borrow at the lowest cost possible.

Debt issued to trust funds plays an important role in calculating the debt limit. As shown in Table 3, debt held by government accounts represents over one-quarter of all outstanding debt subject to limit. Social Security, Medicare, and federal retirement trust funds account for the bulk of those holdings.

Purchases and sales of debt by trust funds are handled within the Treasury and do not flow through credit markets. Similarly, interest on those securities is simply an intragovernmental transfer: it is paid by one part of the government to another part and adds nothing to the deficit. Thus, participants in the financial markets view those investments accurately enough as a bookkeeping entry, an intragovernmental I.O.U. Nevertheless, transactions in Government Account Series debt accrue against the debt ceiling. Moreover, continued investment of trust fund surpluses may cause the Treasury to bump against the debt limit even without a major payment to the public or auction scheduled on that day. Indeed, a Civil Service Retirement lump sum payment of around $20 billion on September 30 and a Military Retirement lump sum payment of around $11 billion on October 1 will involve large issuances of Government Account Series debt.

TABLE 3. RELATIONSHIP BETWEEN DEBT HELD BY THE PUBLIC AND DEBT SUBJECT TO LIMIT (End of fiscal year, in billions of dollars)

	Actual			Projected
	1980	1985	1990	1995
Debt Held by the Public	710	1,500	2,411	3,605
Trust Funds				
Social Security[a]	31	37	215	489
Medicare[b]	19	32	110	143
Civil Service Retirement	74	127	236	375
Military Retirement	0	12	65	110
Unemployment Insurance	13	17	51	48
Highway	11	12	17	17
Airport and Airways	5	7	14	12
Railroad Retirement	3	4	9	13
Federal Deposit Insurance Corporation[c]	10	16	c	c
Other	14	23	39	51
Subtotal	180	287	755	1,258
Other Government Accounts				
Deposit insurance agencies[c]	5	7	11	29
Other[d]	14	24	29	38
Subtotal	19	31	41	67
Total	199	318	796	1,325
Gross Federal Debt	909	1,818	3,207	4,930
Exclusions from Debt Limit[e]	f	6	-45	-40
Debt Subject to Limit	909	1,824	3,161	4,890

SOURCE: Congressional Budget Office based on information from the Department of the Treasury and the Office of Management and Budget.

NOTE: Numbers may not add up to totals because of rounding.

a. Old-Age and Survivors Insurance and Disability Insurance.

b. Hospital Insurance (Medicare Part A) and Supplementary Medical Insurance (Part B).

c. Until August 1989, the Federal Deposit Insurance Corporation Fund was classified as a trust fund. Its successor, the Bank Insurance Fund, is not a trust fund and is thus included in "other government accounts." Other deposit insurance funds include the Federal Savings and Loan Insurance Corporation (FSLIC) Fund and its successor, the FSLIC Resolution Fund; the Savings Association Insurance Fund; and the Credit Union Share Insurance Fund.

d. Beginning in 1989, includes Treasury securities purchased in the open market by the Tennessee Valley Authority.

e. Mostly debt issued by the Federal Financing Bank and debt issued by federal agencies other than the Treasury.

f. Less than $500 million.

Cash Inflows

If the Treasury is barred from borrowing, it can count only on taxes and other current receipts to replenish its cash balances. Withheld income and employment taxes are the backbone of the Treasury's deposits, accounting for the majority of all non-debt-related deposits. Withheld taxes flow in fairly smoothly at about $3 billion to $4 billion per day. By contrast, corporate income taxes are concentrated around four major payments dates: April 15, June 15, September 15, and December 15. Given today's large budget deficits, though, the Treasury cannot count on such inflows to cover its cash drains for very long.

Cash Outflows

Two large drains on the Treasury--cash benefit payments and cash interest payments--are particularly noteworthy. Nearly all cash benefit payments for Social Security and other retirement and disability programs go out between the first and third of the month. Currently, those programs drain the Treasury's cash by about $37 billion in the first week of the month.

Cash interest payments to owners of Treasury notes and bonds take place on fixed dates. The biggest spikes occur on midquarter refunding settlement dates:

February 15, May 15, August 15, and November 15. Interest payments on those dates total around $25 billion. Smaller spikes (of $4 billion to $5 billion or so) occur on other semiannual cycles, mostly at the end of each month.

Other cash withdrawals for purposes as varied as federal employees' pay, defense contracts, grants to states and localities, and Medicare are less lumpy and average about $4 billion to $6 billion per day.

The November 15 interest payment date will present a very high hurdle for the Treasury to jump and may turn out to be the actual day of reckoning. October and November are both low-revenue--and therefore high-deficit--months. The Treasury borrowed more than $27 billion in the market last October and almost $37 billion in November to meet cash needs. Even if the Treasury manages to avoid cash flow problems into early November, it is unlikely to be able to raise enough money to pay note and bond holders their interest without an increase in the debt limit before November 15.

TREASURY OPTIONS TO COPE WITH INTERRUPTIONS IN BORROWING AUTHORITY

During an interruption in borrowing authority, the Treasury's main objectives are to avoid default, honor government obligations, and keep operations running. To do so, in the past the Treasury has adopted various tactics to cope with interruptions in the debt ceiling (see Table 4). Among the most common responses have been:

- *Suspending Sales of Nonmarketable Debt.* Suspending the sales of savings bonds, state and local government series, and other nonmarketable debt for the duration of the interruption is a more or less routine response.

- *Trimming or Delaying Auctions of Marketable Securities.* If the Treasury is unsure whether it can legally issue bills, notes, and bonds on the settlement date, it will not auction them.

- *Underinvestment of Government Trust Funds.* This practice has frequently proved unavoidable. In many cases, the Treasury could not invest trust fund receipts fully when it was up against the debt limit. The trust funds were properly credited, but they simply held

TABLE 4. RECENT INCREASES IN THE DEBT LIMIT

Enactment Date[a]	Amount of Limit (Billions of dollars)	Expiration Date	Treasury Actions at Close[b]
Sept. 30, 1982	1,290.2	Sept. 30, 1983	Deteriorated budget outlook necessitated action well before expiration. Increase enacted in May 1983 as a consequence of Social Security rescue package.
May 26, 1983	1,389.0	Permanent	Beginning late October 1983, delayed auctions; underinvested trust funds.
Nov. 21, 1983	1,490.0	Permanent	Beginning late April 1984, trimmed auctions; underinvested Social Security.
May 25, 1984	1,520.0	Permanent	Beginning late June 1984, trimmed auctions; underinvested Social Security.
July 6, 1984	1,573.0	Permanent	Delayed auctions (beginning late September 1984); underinvested trust funds (beginning early September); cash situation not critical.
Oct. 13, 1984	1,823.8	Permanent	Prolonged interruption associated with debate over Balanced Budget and Emergency Deficit Control Act (commonly known as Gramm-Rudman). Underinvested trust funds beginning early September 1985; cut late-September auctions, worsening cash situation; issued debt through FFB in October; actively disinvested trust funds in order to pay benefits in early November.
Nov. 14, 1985	1,903.8	Dec. 6, 1985	More or less timely increase.
Dec. 12, 1985	2,078.7	Permanent	Used FFB temporarily to credit Social Security and preserve regular auctions August 1-15, 1986; otherwise timely.
Aug. 21, 1986	2,111.0	Permanent	Used FFB authority; underinvested trust funds beginning September 30, 1986; delayed or cut auctions beginning late September; cash situation not critical.
Oct. 21, 1986	2,300.0	May 15, 1987	Timely increase at expiration.
May 15, 1987	2,320.0	July 17, 1987	Postponed some auctions beginning July 20, 1987; cash situation not critical.
July 30, 1987	2,320.0	Aug. 6, 1987	Postponed auctions normally held in early August but settling on August 15, 1987 (midquarter refunding).
Aug. 10, 1987	2,352.0	Sept. 23, 1987	Part of Balanced Budget and Emergency Deficit Conrol Reaffirmation Act (commonly known as Gramm-Rudman II) package. Rescheduled auctions normally held September 21-24, 1987; otherwise timely.
Sept. 29, 1987	2,800.0	Permanent	More or less timely increase associated with savings and loan bill.
Aug. 7, 1989	2,870.0	Oct. 31, 1989	Boosted auction sizes and accelerated settlements to build up cash balances in late October.
Nov. 8, 1989	3,122.7	Permanent	More or less timely increase before Congressional recess.
Aug. 9, 1990	3,195.0	Oct. 2, 1990	Very short term increase associated with 1990 budget summit's conclusion.
Sept. 30, 1990	3,195.0	Oct. 6, 1990	Very short term increase as 1990 budget summit agreement underwent modifications.
Oct. 9, 1990	3,195.0	Oct. 19, 1990	Borrowed up to limit on October 19 while awaiting next increase.
Oct. 19, 1990	3,195.0	Oct. 24, 1990	Delayed several auctions normally held October 18-22, 1990, but settling after scheduled expiration of ceiling.
Oct. 25, 1990	3,195.0	Oct. 27, 1990	Compressed auctions and settlements into the period between October 25 and 27, 1990.
Oct. 28, 1990	3,230.0	Nov. 5, 1990	Temporary limit until reconciliation bill (including Budget Enforcement Act) was signed.
Nov. 5, 1990	4,145.0	Permanent	Postponed several acutions pending last-minute increase before Congressional recess.
April 6, 1993	4,370.0	Sept. 30, 1993	Next increase enacted August 1993, comfortably before expiration, as part of OBRA-93.
Aug. 10, 1993	4,900.0	Permanent	Not yet expired.

SOURCE: Congressional Budget Office based on information from the Department of the Treasury and various news items.
NOTE: FFB = Federal Financing Bank; OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

a. Date signed into law, typically one to seven days after passage by the Congress.

b. Actions listed do not include suspension of sales of savings bonds and state and local government series, which are more or less routine responses to an interruption in the debt ceiling (especially after expiration of a temporary ceiling). From 1983 through 1990, the Social Security trust funds enjoyed a special arrangement under which they were credited on the first of the month with all revenues expected during that month. If fully invested, that credit caused the debt subject to limit to spike between $15 billion and $20 billion. On occasion, when constrained by the debt limit, the Treasury credited the trust funds as required but was unable to invest the resulting balances fully.

large amounts of so-called uninvested balances. Upon the passage of a new debt ceiling, the Congress has routinely voted to invest those balances and replenish any trust funds that lost interest income as a result of the interruption.

Only once did the underinvestment of trust funds go a step further: in November 1985, the Treasury redeemed trust fund securities a few days early to create room under the debt ceiling to auction regular, marketable securities. The money raised in those auctions permitted the payment of benefits to Social Security recipients, otherwise imperiled by the Treasury's razor-thin cash balances. During a period when issuing debt has been suspended, the Treasury retains the option to disinvest particular trust funds.

CONCLUSIONS

Limiting the Treasury's borrowing authority is not a productive method of achieving deficit reduction. Significant deficit reduction can best be accomplished by legislative decisions that reduce outlays or increase revenues. Failing to raise the debt limit in a timely manner, while perhaps bringing a difficult vote on legislation to a head, only serves to make the Treasury's job of paying the government's bills

more difficult. An extended delay could have a significant effect on the government's credibility and the interest rates that it must pay on future borrowing.