

POLICY ESSAY

MANAGING OUR NATIONAL DEBT RESPONSIBLY: A BETTER WAY FORWARD

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INTRODUCTION

The Constitution gives Congress the power to borrow money for the United States to meet our obligations. For 227 years, we have been a nation that consistently pays our bills and our creditworthiness is one of our greatest strengths. From our earliest days, fulfilling a strategy for financial strength developed by Alexander Hamilton, honoring our financial obligations and preserving the full faith and credit of the United States have been sacrosanct responsibilities that must never be abandoned. In short, when the bills for expenditures already authorized by Congress come due, they must be paid, and these bills are not an abstraction; they are the salaries of our troops, benefits for our veterans and retirees, and payments to hospitals for providing care, not to mention turning on the lights for the federal government.

At the same time, Congress sets a statutory debt limit that restricts the ability of the Treasury Department to issue new debt. Raising the debt limit does not authorize any federal spending; it simply allows the government to pay bills already incurred. For decades, raising the debt limit has been a recurring issue in Congress. Importantly, every debt limit debate has concluded with an increase to the statutory limit, thereby avoiding an unprecedented and catastrophic default on our national debt. However, in recent years, the unthinkable has too often come too close for comfort. What once was a deadline that drove debates on the budget has transformed into a nihilistic platform for some in Congress to promote the very real risk of a default to advance narrow partisan agendas.

Ironically, the debt limit was instituted almost 100 years ago as a way to simplify our borrowing process to meet our nation's financial obligations, and to reduce the burden on Congress to authorize each debt issuance. Congressional increases in the newly-instituted debt limit would allow the executive branch to issue debt to meet its congressionally-mandated obligations as needed, so long as it stayed below that limit.

As the process evolved over time, by the 1980s and into the 1990s, raising the debt limit began to be accompanied by debates on budgetary policy. During these debates, Members of Congress used the deadline of a debt limit to negotiate fiercely over budget policy, but threats of default were treated as extreme. The universal expectation was that Congress would continue to pay the nation's bills, and assertions to the contrary were deemed radical or purely posturing. In recent years, however, some in Congress have become increasingly aggressive in

promoting what was once deemed off the table. The new rhetoric is more strident, with the threat of default employed as an affirmative bargaining chip in a way that is unprecedented and dangerous. That is why since 2011 the position taken by President Obama, Secretary Geithner, and myself is that there can be no negotiations over the debt limit. Congress must simply do its job to avoid default.

The willingness of Congress, in recent years, to create a real risk of default has helped demonstrate the actual and potential harm that comes from debt limit brinksmanship. These impasses have been central to a downgrade of the U.S. credit rating, and have contributed to declines in stock prices, increased financial market volatility, and widened credit spreads—all of which can translate into very real problems for the American public by lowering household wealth and increasing borrowing costs for businesses, consumers, and the Federal government at large. An unprecedented default on our obligations could precipitate a financial crisis, wreak havoc on our economy, and, in turn, damage our standing as a nation.

The most recent debt limit suspension is set to expire in March. The responsible course for the new Congress would be to raise the debt limit without drama or brinksmanship. Unfortunately, if recent history is any indication, we may once again hear calls to block raising the debt limit, with the dangerous misinformation and rhetoric that has surrounded the issue in recent years.

This paper explains how the debt of the United States is managed, explores the history of the debt limit, leading to the recent dangerous impasses that it has caused, and examines the costs to our country that these impasses have and could again impose. In my view, the current system presents grave risk and no longer serves the United States well. I am hopeful that a careful review of our experience, and the often extraordinary steps taken by the Department of the Treasury in recent years to navigate debt limit disruptions, can contribute to a more productive dialogue and, ultimately, lead to reform so this self-inflicted—and potentially catastrophic—harm can be avoided in the future.

MANAGING THE DEBT OF THE UNITED STATES

A Division of Labor Between the Legislative and Executive Branches The Constitution vests in the Congress the power to spend and to tax. When Congress exercises its spending power, it creates national obligations. For example, Congress enacts appropriations every year to pay for expenses like our military and federal workforce. On the other side of the ledger, the revenue laws that Congress enacts determine how much money comes into the Treasury. To the extent that incoming receipts are not sufficient to pay the nation's many periodic obligations, the nation must borrow to make up the gap, since decisions on expenditures are already locked in.

The Constitution also vests in Congress the power to borrow money on the credit of the United States.¹ The Executive Branch, through its Constitutional role

¹ U.S. CONST. art. I, § 8, cl. 2.

to “take care that the laws are faithfully executed,”² is then responsible for carrying out Congressional decisions by spending as required, by collecting tax revenue, and by issuing debt on behalf of the United States. Within the Executive Branch, the Department of the Treasury is the agency responsible for borrowing amounts necessary for financing the government.³

The Treasury issues debt, borrows money, to make sure that the government can make the payments to the public that other laws mandate. These obligations include payments to Social Security retirees, defense contractors, and disabled veterans, to name a few. If incoming revenue falls short and the Treasury fails to issue debt, it would be unable to make its legally required payments. The result is a potential conflict, in which one set of Congressional mandates requires the Treasury to make payments, but having reached the debt limit the borrowing needed to make those required payments is prohibited.

For a significant part of our country’s history, until 1917, each issuance of debt by Treasury required specific congressional approval. The idea of the debt limit was first implemented to simplify the borrowing process by providing some form of blanket authorization for Treasury to borrow as needed, as long as the total amount of outstanding debt did not exceed the limit.

Regardless of the precise contours of the limits Congress places on Treasury’s ability to issue debt, one simple fact is true in all instances: in no case does Treasury’s issuance of debt incur or authorize new spending; rather, Treasury is merely financing pre-existing spending commitments that Congress has already authorized.

Treasury Manages U.S. Debts to Meet All of Our Obligations

The U.S. Treasury market is the deepest and most liquid government securities market in the world. Treasury securities play a unique role in the global economy, serving as the primary means of financing the U.S. federal government, a critical store of value for global investors and savers, the key risk-free benchmark for other financial instruments, and an important conduit for the Federal Reserve’s implementation of monetary policy.

To determine the amounts it needs to borrow, Treasury first forecasts the amount of money the government will take in (receipts) and the amount of money the government is obligated to spend in a given period (outlays). To the extent that outlays exceed receipts, there is a deficit, and Treasury issues obligations, such as bills, notes, and bonds, to raise the cash necessary to make up the difference. Treasury borrowing also reflects other financing requirements, such as requirements for operating cash balances and disbursements for federal credit programs. This practice allows the government to continue operating smoothly and efficiently and enables the U.S. to fulfill all of its existing obligations.

² U.S. CONST., art. II, § 3, cl. 5.

³ See 31 U.S.C. §§ 3102–3104 (2012).

The risk of the debt limit expiring works against the most fundamental principles that govern federal debt management: maintaining level and low costs through regularity and clarity about the time and quantities of Treasury offerings.

Treasury strives to finance federal borrowing at the lowest cost to taxpayers over time, through a policy of issuing securities on a regular and predictable basis—not only in size, but in frequency of distribution as well. This certainty gives investors confidence in the guidance Treasury provides about its debt issuance strategy – a critical consideration for investors making portfolio management decisions. It provides assurance that debt issuance will not unexpectedly change in a way that might cost them money. As such, this certainty lowers the U.S. government’s borrowing costs, and saves taxpayers money because interest rates have virtually no risk premium. For example, 52-week bills, a type of Treasury security, are generally auctioned every four weeks;⁴ nearly all types of marketable Treasury securities are similarly auctioned on a regular cycle, and Treasury announces its upcoming borrowing needs on a quarterly basis,⁵ which helps the market forecast the volume of securities that will be auctioned in the upcoming quarters.

Beyond being regular and predictable, we must also have in place prudent risk management measures to help us better mitigate real, unforeseen risks. The two most significant improvements on this front during my tenure as Secretary were enhancements to our operational redundancies to ensure uninterrupted operations and increasing the amount of cash on hand that Treasury carries at any given moment.

While the Treasury Department has the infrastructure and contingency plans to operate auctions through significant events, including the ability to conduct auctions from four geographically diverse locations, it is unlikely that all major Treasury auction participants have systems that are similarly robust. We have learned that events such as September 11th or Hurricane Sandy can, at least for a short period of time, inhibit investor ability to participate in a Treasury auction, and we need to have the resilience to make certain that Treasury has access to necessary levels of cash in a timely manner. To avoid this risk, we changed Treasury’s cash balance policy in May 2015, announcing that we would hold a level of cash generally sufficient to cover one week of outflows in the Treasury General Account, subject to a minimum balance of roughly \$150 billion, however given the day to day swings in cash flow, we regularly have a balance greater than that amount.⁶ Treasury’s cash balance is now regularly more than

⁴ See *Treasury Bills*, TREASURY DIRECT (last accessed Nov. 7, 2016) <https://treasurydirect.gov/instit/marketable/tbills/tbills.htm> [<https://perma.cc/Y87B-XQY2>].

⁵ See *Quarterly Financing Estimates by Calendar Year*, U.S. Dept. Treasury (last accessed Nov. 7 2016) <https://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Pages/Quarterly-Financing-Estimates.aspx> [<https://perma.cc/5UEC-Q4CS>].

⁶ See *Quarterly Financing Estimates by Calendar Year*, U.S. DEP’T OF THE TREASURY (last updated Aug. 1, 2016).<https://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Pages/Quarterly-Financing-Estimates.aspx> [<https://perma.cc/KFJ8-NZKX>]

\$300 billion,⁷ which is enough to protect the U.S. government from potential default for about one week, should a catastrophic event ever inhibit the Treasury's ability to market debt.

Notwithstanding Treasury efforts to be regular and predictable and to mitigate potential risk, a historical survey makes clear that the debt limit, while perhaps originally conceived of as consistent with these goals, has been distorted over time into a tool to create uncertainty that exposes our financial system to needless risks that Treasury cannot meaningfully mitigate.

A HISTORY OF THE DEBT LIMIT

Debt limit standoffs have dominated headlines in recent years, but debt limit negotiations in one form or another went on for more than half a century, during the Eisenhower, Carter, Reagan, Clinton, and both Bush administrations.⁸ Because Congress sometimes waited until the last minute to raise the debt limit, Treasury has had to delay or cancel auctions, as well as operate with only cash on hand on several occasions. As any business knows, operating on cash only is profoundly dangerous. Given the uncertainty around government cash flows, Treasury could quickly face significant payments and have no money to make them. The Treasury's need for cash on a single day can range from a few billion dollars to more than \$50 billion, just to make required payments to beneficiaries, contractors, and employees, to well over \$150 billion if a significant amount of Treasury securities also mature on that day.

With increasingly frequent debt limit impasses, Congress authorized the use of certain "extraordinary measures" to buy a little time before an actual default.⁹ These tools enable the government to suspend new investment and redeem some existing investments of in certain funds of the government, and thus continue borrowing to pay the country's obligations during brief periods when Treasury would otherwise lack borrowing authority. These measures give Congress additional time to enact an increase or extension of borrowing authority.

Over my career, I have been involved in debt limit debates from many different vantage points throughout the Reagan, Clinton and Obama Administrations. I saw firsthand how the rhetoric and strategy involving the debt limit has evolved and spiraled beyond an acceptable level of risk. During the

⁷ Treasury's cash balances are reported at *Daily Treasury Statement*, BUREAU FISCAL SERV. (last accessed Nov. 11, 2016) <https://www.fms.treas.gov/dts/index.html> [<https://perma.cc/M56X-ZC2C>].

⁸ See THE DEBT LIMIT: HISTORY AND RECENT INCREASES CONG. RESEARCH SERV., (Nov. 2, 2015); INFORMATION ON DEBT CEILING LIMITATIONS AND INCREASES GOV. ACCOUNTABILITY OFFICE; "Debt Limit Extensions," in CQ Almanac 1980, 36th ed., 301-3; DEBT CEILING: ANALYSIS OF ACTIONS TAKEN DURING THE 1995-1996 CRISIS GOV. ACCOUNTAILITY OFFICE; DEBT CEILING: ANALYSIS OF ACTIONS TAKEN DURING THE 2002 DEBT ISSUANCE SUSPENSION PERIODS, GOV. ACCOUNTAIBLITY OFFICE.

⁹ Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 6002(a)-(c), codified at 5 U.S.C. 8348(j)-(k); Thrift Savings Fund Investment Act of 1987, Pub. L. No. 100-43, codified at 5 U.S.C. 8438 (g)-e(h).

1980s and 1990s, Congress often viewed the debt limit as a deadline, where one or another faction would try to force debate on fiscal policy goals and spending priorities. The idea of actually defaulting was never a credible threat, and for very few was it even an acceptable prospect to raise. In the rare instances when default was raised as an option, it was considered either extremely radical or transparent posturing.¹⁰ It may have been an unwise way to create bargaining leverage, but default was not entertained as a responsible option. In contrast, in recent years, some in Congress have pushed the threat of default into the mainstream where it cannot be tolerated as an option.

For example, during the Reagan Administration a series of impasses were resolved with the enactment of a two-part large scale budget deal, collectively known as Gramm–Rudman. In 1985, after several months of negotiations between the Democratic-controlled House and the Republican-controlled Senate, Congress passed the Gramm–Rudman–Hollings Balanced Budget and Emergency Deficit Control Act, or Gramm-Rudman I.¹¹ This deal raised the debt limit while implementing budget targets aimed at gradually reducing budget deficits to zero over a six-year period. After Democrats gained control of both houses in Congress in 1987, the deal was revised with the passage of Gramm-Rudman II, and then again with the passage of bipartisan deficit-reducing legislation in 1990.¹²

During the 1980s, in contrast to recent debt limit episodes, neither party raised defaulting on the debt as a serious option. While Republicans and Democrats engaged in intense negotiations over the budget, members of both parties ultimately understood that preventing default was a mutual responsibility. That meant that the threat of default was not used to extract one-sided partisan demands – allowing for genuinely bipartisan budget negotiations. As conservative columnist Ross Douthat pointed out when speaking about Gramm Rudman II, while the White House objected to the deal, it was negotiated by a Democratic Congress and enjoyed bipartisan support. He wrote: “The Democrats controlled both houses of Congress, not one, they passed a modest bill that didn’t require total ideological surrender from the Reagan White House, and — note well — they did all this, as [Kevin] Glass writes, with ‘significant amounts of moderate Republican support.’ ... ‘Whereas the House Republicans [in 2013] are operating from a weaker position, making demands that haven’t yet cracked the wall of the Democratic unity, and putting Obama in a position, thus far, where he

¹⁰ See David E. Sanger, *Gingrich Threatens U.S. Default if Clinton Won’t Bend on Budget*, N.Y. TIMES, Sept. 22, 1995, <http://www.nytimes.com/1995/09/22/business/gingrich-threatens-us-default-if-clinton-won-t-bend-on-budget.html> [<https://perma.cc/BP9K-SDL9>]; Kara Brandeisky, *How Clinton Handled His Debt Ceiling Crisis Better Than Obama*, NEW REPUBLIC (Aug. 2, 2011), <https://newrepublic.com/article/93043/obama-clinton-debt-ceiling-crisis> [<https://perma.cc/TRZ8-4QJ3>].

¹¹ Megan Suzanne Lynch, *Statutory Budget Controls in Effect Between 1985 and 2002*, CONG. RESEARCH SERV. (July 1, 2011).

¹² *Id.*

can't move to meet them without essentially cutting the heart out of his presidency.”¹³

The debt limit debate intensified during the Clinton Administration. For nine months during 1995 and 1996, the Administration and the Republican Congress were at loggerheads when Republicans used the debt limit as a high-stakes bargaining chip to press their “Contract with America,”¹⁴ including large tax cuts and deep program cuts. House Speaker Newt Gingrich openly threatened the possibility of default unless Republican tax and budget demands were met,¹⁵ and both Moody's and Standard and Poor's warned that the United States' credit rating was at risk.¹⁶

Ultimately, two partial government shutdowns during this period left Republicans without the public support to condition significant concessions on an increase in the debt limit. The debt limit was increased in March 1996 alongside relatively modest policy changes - enacting initiatives to ease small business regulatory requirements and adjustments to the tax structure for Social Security recipients. Despite threats of the default during this time, the conventional wisdom was that default was never actually on the table. Alice Rivlin, director of the Office of Management and Budget during this period, told the New Republic “It was essentially unthinkable... There was nobody in the Congress who really contemplated forcing a default.”¹⁷

In contrast to the idea that default was “unthinkable,” during the past few years, some in Congress have openly advocated defaulting on our obligations during the debt limit impasses.¹⁸ During the debt limit impasses of 2011 and 2013, some members of Congress also began advocating for the prioritization of debt payments over other payments as an alternative to raise the debt limit.¹⁹ Prioritization incorrectly suggests that the only default that matters is a missed payment on our debt instruments, payments of principal and interest on Treasury bills, notes, bonds, and similar obligations.²⁰ Advocates of this view asserted that so long as we are able to make payments on our debt, there will be no major repercussions if other payments are missed. However, any plan to make some payments but not others already mandated by Congress is simply default by

¹³ Ross Douthat, *Debt Ceiling 'Blackmail,' Then and Now*, N.Y. TIMES: EVALUATIONS (Oct. 8, 2013), http://douthat.blogs.nytimes.com/2013/10/08/debt-ceiling-blackmail-then-and-now/?_r=0 [<https://perma.cc/8AZZ-4H7V>].

¹⁴ See Sanger, *supra* note 10.

¹⁵ *Id.*

¹⁶ See David E. Sanger, *A Default Threat is Hinted As Way to Settle Budget*, N.Y. TIMES, January 22, 1996.

¹⁷ Brandeisky, *supra* note 10.

¹⁸ See Full Text: *Geithner Letter Responding to Republicans on Debt Limit*, WALL ST. J.: REAL TIME ECONOMICS (Jun. 29, 2011), <http://blogs.wsj.com/economics/2011/06/29/full-text-geithner-letter-responding-to-republicans-on-debt-limit> [<https://perma.cc/ML77-LMWT>].

¹⁹ See, e.g., Full Faith and Credit Act, S. 1963, 112th Cong. (2011).

²⁰ See Tim Alberta & Michael Catalini, *Republicans Downplay 'Default,' Dismiss Debt Deadline*, NAT'L J. (Oct. 6, 2013), <https://www.nationaljournal.com/s/69176/republicans-downplay-default-dismiss-debt-deadline?mrefid=HomepageRiver>.

another name.²¹ Failure to pay beneficiaries, medical providers, or contractors would constitute a breach in the vital certainty that the full faith and credit of the U.S. is absolute. And adding payment risk to federal transactions would introduce uncertainty and cost into a system that is seen worldwide as the gold standard for risk free terms.

After protracted brinksmanship in 2011, the United States credit rating was downgraded for the first time in its history. In its decision, credit rating agency Standard & Poor explained that “[t]he 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.”²² Clearly, the rhetoric around default had reached such a level that financial markets were considering the threat to be real.

Nevertheless, these reckless proposals have endured. In 2013 the Republican-led House of Representatives approved prioritization legislation, the Full Faith and Credit Act (H.R. 807),²³ and during and shortly after the most recent debt limit impasse in 2015, the Republican-led U.S. House of Representatives passed two bills, the Default Prevention Act (H.R. 692) and the Debt Management and Fiscal Responsibility Act of 2015 (H.R. 3442), which would direct the Treasury Department to prioritize principal and interest over other payments.²⁴ The Administration threatened to veto each of these bills, and none was ever considered by in the Senate.²⁵

THE EFFECTS OF DEBT LIMIT BRINKSMANSHIP DURING THE OBAMA ADMINISTRATION

The escalating brinksmanship associated with debt limit crises during this Administration have had real impacts. We saw Treasury’s borrowing costs increase during these periods, directly costing taxpayers money and adding to the deficit. We have also seen indications that this irresponsible behavior threatens to impair the world’s confidence in the U.S. financial system. And, while we thankfully have not had to learn firsthand what would happen in the event Congress purposely allowed the country to default, we expect that the effects would be extremely damaging if not catastrophic.

²¹ Daniel Watson, *There is Only One Solution to the Debt Limit*, U.S. DEPT. TREASURY: TREASURY NOTES (Oct. 16, 2015) <https://www.treasury.gov/connect/blog/Pages/one-solution-debt-limit.aspx> [<https://perma.cc/7DXU-ANU3>].

²² Charles Riley, *S&P downgrades U.S. credit rating*, CNN: MONEY (Aug. 6, 2011), http://money.cnn.com/2011/08/05/news/economy/downgrade_rumors [<https://perma.cc/QZ5B-GRRC>].

²³ See, e.g., Full Faith and Credit Act, S. 1963, 112th Cong. (2011).

²⁴ See, e.g., Default Prevention Act, H.R. 692 (114th Congress); Debt Management and Fiscal Responsibility Act of 2015, H.R. 3442 (114th Congress).

²⁵ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATION POLICY: H.R. 692 – DEFAULT PREVENTION ACT, (Oct. 20, 2015); OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATION POLICY: H.R. 3442 – DEBT MANAGEMENT AND FISCAL RESPONSIBILITY ACT OF 2015. (Fed. 9, 2016).

Direct Costs of Debt Limit Crises

Debt ceiling impasses reduce Treasury's ability to be regular and predictable in its debt management. As one would expect with an over \$18 trillion economy, the daily cash flows in and out of Treasury are very large, highly irregular, and very difficult to predict. Therefore, as the debt approaches the limit, Treasury's regular and predictable issuance schedule must be radically reworked to ensure that the debt outstanding does not exceed the limit. Treasury has had to resort to much more volatile issuance sizes and increase the use of more costly funding options called cash management bills (CMBs), securities that the Government Accountability Office (GAO) has specifically identified as being a more expensive source of funding and recommended limiting their issuance as much as possible.²⁶ On several occasions, Treasury even postponed regularly scheduled auctions. Each of these maneuvers are out-of-the-ordinary, create a significant uncertainty around Treasury's debt issuance, and increase costs for the taxpayer.

While some of these debt management practices may seem esoteric, the costs to taxpayers are very real. Managing through the most recent impasse in 2015, we were forced to choose between bad and worse outcomes, postponing the auction and issuance of the October 2-year note, the first time such a postponement was necessary since the 1995 impasse.²⁷ And when we were able to hold the postponed auction, we drew the weakest demand for any 2-year auction since 2010 and yields jumped to a 4-year high.²⁸ The GAO has studied the impact of recent debt limit crises. For example, GAO estimated Treasury's borrowing costs increased by between \$1 billion and \$1.7 billion as a result of the debt ceiling impasse in 2011.²⁹ When Treasury's borrowing costs increase, those costs are ultimately borne by the taxpayer because Treasury will be making higher interest payments, which ultimately must be funded through higher taxes.

Moreover, it should surprise no one that these extra costs, and the broader harms that a debt limit crisis can cause, are likely to become more severe and flow through the nation's financial system more quickly should Congress repeatedly entertain the possibility of defaulting. Improvements in technology and the increased interconnectedness of global financial markets allow investors, both sovereign and private, to watch in real time as politicians suggest that the U.S.

²⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-269, TREASURY HAS REFINED ITS USE OF CASH MANAGEMENT BILLS BUT SHOULD EXPLORE OPTIONS THAT MAY REDUCE COST FURTHER (2006).

²⁷ Press Release, U.S. DEPT. TREASURY, *Treasury Announces Postponement of 2-Year Auction* (Oct. 22, 2015).

²⁸ Jennifer Surane & Daniel Kruger *Demand Falters at Two-Year Treasury Auction as Fed Bets Mount*, BLOOMBERG (Nov. 4, 2015), <http://www.bloomberg.com/news/articles/2015-11-04/treasury-yields-near-six-week-high-signal-climbing-bets-on-fed> [<https://perma.cc/HC69-B47P>].

²⁹ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-701, ANALYSIS OF 2011-2012 ACTS TAKEN AND EFFECT OF DELAYED INCREASE ON BORROWING COSTS (2012).

government should default, as large investors publicly announce that they are avoiding Treasury securities, and as the interest rate that Treasury must pay to issue debt rises in response. The more this happens, the more investors will expect it to happen, and the sooner they will begin to manage their portfolios accordingly – avoiding certain Treasury securities and increasing Treasury’s costs.

Increasing the Risk of Default

While the direct costs of debt limit brinksmanship can be significant and damaging to our economy, the potential indirect costs to our financial system and economy are even greater. Repeated debt limit impasses and the perception that the U.S. government may default would create cracks in the very core of financial markets and add to the risk that the negative consequences of the next debt limit impasse will be larger than they were before.

A long-held belief undergirding the financial markets is that there are no conditions that would or could ever lead to a situation in which the Treasury would not pay its obligations. If investors start to lose confidence that a debtor will pay them back, they will demand higher interest rates. As we have learned during prolonged debt limit debates, even a debtor as creditworthy as the U.S. government will face these realities if investors lose enough confidence. Over a four-week interval at the height of the 2013 debt limit crisis, the interest rate demanded at auctions of 1-months bills increased from 0 to 35 basis points.³⁰ And there is a real risk that ultimately, some creditors may simply stop lending. For example, there was a significant reduction in demand to purchase 4-week debt from the Treasury during the debt limit impasse in October 2015. In that auction, the total volume of bids that Treasury received, relative to the amount of debt that was being issued (the bid-to-cover ratio), dropped by nearly 50 percent, indicating that significantly fewer investors wanted to purchase the security at *any* interest rate.³¹

At one point in 2013, Fidelity Investments even announced that it had sold all Treasury holdings with maturities in late October or early November, when the market anticipated we would reach the debt ceiling absent congressional action to raise it.³² While Fidelity’s actions may be perceived by some as extreme, these actions reflect an environment that exists during debt limit standoffs, one in which other institutions may decide to sell Treasury holdings with the same maturity date, to avoid the risk of not being perceived as good fiduciaries. A scenario like this could lead to higher and higher costs and ultimately the possibility that Treasury would not be able to borrow at any cost. Without the ability to raise

³⁰ See *Today’s Auction Results*, TREASURY DIRECT (last accessed Nov. 7, 2016) http://treasurydirect.gov/instit/annceresult/press/press_auctionresults.htm [<https://perma.cc/V8YE-7V7Q>].

³¹ *Id.*

³² Associated Press, *Fidelity sells off short-term US debt ahead of ceiling*, CNBC, (Oct. 9, 2013) <http://www.cnbc.com/2013/10/09/fidelity-investments-says-it-has-sold-off-all-us-debt-maturing-around-debt-ceiling.html> [<https://perma.cc/H68Q-YHRN>].

money by issuing new debt, Treasury's cash balance would rapidly decline and quickly, leading swiftly to default.

In this regard, it is critically important to note that during prolonged debt limit impasses, Treasury is unable to maintain a prudent level of cash consistent with its cash balance policy.³³ For example, in 2015, Treasury had to abandon its prudent cash management policy beginning in late-summer, due to the extended debt limit debate. Starting in mid-August and continuing through mid-November, Treasury was consistently well below our current policy of holding approximately \$150 billion in cash, generally equal to five days of liquidity needs.³⁴ This means that Treasury was at nearly immediate risk of default if investors became unwilling or unable to purchase our securities, or if there was an unexpected turbulence in cash flow, making the U.S. financial system more vulnerable to crisis.

The Potential Costs of an Actual Default

We do not know the extent of the economic damage that would be caused by defaulting on our obligations and it should be unthinkable that we ever find out. But there is one small-scale incident from our history that, while not a parallel example, provides some insight. In 1979, after Congress had again gone to the brink before raising the debt limit, Treasury missed payments on about \$120 million worth of bills due to a technical glitch. To be clear, this was not a conscious choice to miss a payment; it was an error that was quickly corrected. This is very different from choosing to miss payments, which is what some in Congress suggested during recent years. Nonetheless, the incident caused an increase in Treasury interest rates of more than 50 basis points, increasing interest payments by billions of dollars over time.³⁵

The 1979 incident is useful to consider against the recent suggestion that missing payments would be both acceptable and workable. First, it shows that even small accidents can cause real, negative consequences. Surely a decision by Congress to miss payments on a much larger scale, and the market's reaction to this new uncertainty in U.S. debt, would result in much graver consequences. Second, it reminds us that our payment systems are not infallible. While some have suggested that Treasury can and should prioritize certain payments and miss others, Treasury's payment systems are designed to pay all of our bills on time and in full—not to pick and choose which bills to pay. It would be technologically feasible to continue to make principal and interest payments; however, attempting to manually prioritize among more than 80 million payments

³³ U.S. Dept. Treasury, Secretary Lew Sends Debt Limit Letter to Congress, (September 10, 2015).

³⁴ *Daily Treasury Statement*, U.S. DEPT. TREASURY (Aug. 19, 2015) <https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=a&fname=15081900.pdf> [<https://perma.cc/DF5K-787W>].

³⁵ The Day the United States Defaulted on Treasury Bills, Fin. Rev. (1989)

made by the federal government each month would be fraught with risk. We have seen the damage from even accidentally missing a small payment.

Even if threats to default are just that, my great fear is that one day congressional miscalculation and inaction will result in an accidental default of the U.S. government, which in and of itself could have major consequences. The immediate impact of a default on our obligations would of course be that someone who is owed money by the United States would not get paid on time and in full. And the parties in question are not just sophisticated financial institutions and sovereign wealth funds. They are also soldiers who are owed their salaries, retirees who are owed their Social Security benefits, hospitals that are owed Medicare reimbursements, and government contractors, many of whom are small businesses. In other words, a government default would quickly disrupt the lives of many Americans, who rely, in some fashion, on timely payments from the government.

There would likely be many other repercussions to even a single default. As observed above, in 2011, S&P downgraded the credit of the U.S. government from AAA to AA+, for the first time in 70 years, due in part to the severity of congressional gridlock, even though there were no missed payments. If the United States actually defaulted, it seems almost certain that the credit-rating agencies would further downgrade the United States and that investors would demand even more compensation when lending, given the new risk that they may not be paid on time. This would compound all of the problems described previously, such as directly increasing costs to U.S. citizens and weakening the U.S. government's ability to weather crises.

PAST APPROACHES TO MINIMIZING THE IMPACTS OF THE DEBT LIMIT

The history of the debt limit reveals a patchwork of attempts to manage our nation's borrowing authority. When an approach has proven unsatisfactory, new directions have been explored. There are several examples from our recent history, as detailed in a recent GAO report.³⁶

One past approach is to link debt limit increases directly to the congressional budget process. Currently, decisions to tax and spend are made in isolation from decisions as needed in order to finance those spending commitments. The so-called "Gephardt Rule," named for former Representative Richard Gephardt and adopted in 1979, provided that whenever the House of Representatives passed a budget resolution, the House would automatically be deemed to have also passed legislation to adjust the debt limit to the level specified in the budget. The rule was repealed between 2001 and 2002, and ultimately repealed again in 2011.³⁷

³⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-476, DEBT LIMIT: MARKET RESPONSE TO RECENT IMPASSES UNDERSCORES NEED TO CONSIDER ALTERNATIVE APPROACHES (2015).

³⁷ Joshua Green, *How Dick Gephardt Fixed the Debt-Ceiling Problem*, ATLANTIC (May 9, 2011) <http://www.theatlantic.com/politics/archive/2011/05/how-dick-gephardt-fixed-the-debt-ceiling-problem/238571/> [<https://perma.cc/SY7E-6QLA>].

The so-called “McConnell Provision” is another past approach, offered by Senator Mitch McConnell (R-KY) as part of the Budget Control Act of 2011 and signed into law by President Obama.³⁸ Under this arrangement, the President was authorized to twice notify Congress that the outstanding debt was approaching the debt limit and that further borrowing was necessary. Congress then would have the opportunity to express its views on the merits of a debt limit increase through a joint resolution of disapproval. If that resolution came to the President’s desk, the President could veto it. Accordingly, if the resolution of disapproval was not enacted, a debt limit increase would take effect. This procedure expired in 2012 after the two debt limit increases that were contemplated by the Budget Control Act, but an extension was supported by my predecessor as Treasury Secretary, Tim Geithner.³⁹

While these approaches may have helped to mitigate the impacts of the debt limit over the short term, they did not provide lasting solutions. The debt limit persists and along with it, the unnecessary threat of default.

IT IS TIME TO ELIMINATE THE RISK OF DEFAULT

Today, we have a broken, outdated system that no longer meets our country’s needs. We must change course. If this were an external threat to our national security, we would bolster our national defense. If this were a foreseeable natural disaster, we would harden our infrastructure to mitigate that risk. Similarly, the current process for addressing the debt limit is a clear risk that could result in an unacceptable threat to the health of our financial system. While we must respect the ultimate power of Congress over governmental borrowing, it is time for Congress to reduce the unnecessary risk associated with the debt limit and reform the current system.

As an economic principle, the existence of the debt limit is hard to defend; it is a purely political construct. Increasing the debt limit does not authorize or create additional spending, and long before any debt limit impasse, legislators have already made the budgetary decisions that direct federal spending and revenue, and hence the trajectory of the national debt.

In terms of effects on the economy, there is only a downside to the idea of a debt limit. While it is important for the government to manage its finances such that its debt-to-GDP ratio is sustainable, decisions on how much to borrow should be made when spending and revenue laws are enacted, not when bills are waiting to be paid.

It is for this reason that, as the GAO reported in 2011, most countries have abandoned the concept of a debt limit for budgetary practices that better link

³⁸ See Budget Control Act of 2011, S. 365 (112th Congress).

³⁹ Jenni LeCompte, *Taking the Threat of Default Out of the Debt Limit*, U.S. DEPT. OF TREASURY: TREASURY NOTES (Dec. 5, 2012), <https://www.treasury.gov/connect/blog/Pages/mcconnell-provision.aspx> [<https://perma.cc/3UGR-59LN>].

policy decisions with their impact on the debt.⁴⁰ The United States is, in fact, one of the few countries in the world that still employs a debt limit.⁴¹

While the United States differs from many of our international counterparts in that the Constitution vests in the Congress the power to borrow money, the debt limit is not itself required by the Constitution—the precise manner in which we implement the prerogative of Congress to borrow money is far from immutable.

The debt limit can no longer be a topic for negotiation, and Congress should take action to eliminate this risk of periodic crisis. No longer a tool for simplifying the borrowing process, the debt limit has morphed into a weapon that irresponsible actors in Congress can wield against our economic well-being. However Congress chooses to exercise its Constitutional role with regard to our nation's debts, whether to abandon the debt limit entirely or to adopt a new course that addresses the current risks, one thing is clear: the current debt limit regime has outlived its usefulness.

CONCLUSION

On March 15, 2017, the current suspension of the statutory debt limit will expire. At that point, absent action by Congress, my successor will have to take extraordinary measures to avoid default and enable the United States to temporarily continue borrowing without exceeding the debt limit. This could be an early challenge in a new administration and a new Congress.

There is an alternative path. Rather than perpetuating a cycle of debt limit impasses that push us closer and closer to the unthinkable, Congress should chart a path that removes unnecessary threats to our economy and our security.

⁴⁰ Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market, Gov. Accountability Office (Feb. 2011) <http://www.gao.gov/assets/320/315843.pdf> [<https://perma.cc/TC48-SBAS>].

⁴¹ See testimony of Chad Stone, Chief Economist at the Center on Budget and Policy Priorities, February 2, 2016:

To my knowledge, only one other developed country, Denmark, has a statutory debt limit anything like ours. Both countries have put a dollar limit on how much debt the government can issue. There's a crucial difference, however, between our debt limit and Denmark's: the Danes do not play politics with theirs, as Jacob Funk Kirkegaard of the Peterson Institute for International Economics explains:

The Danish fixed nominal debt limit — legislatively outside the annual budget process — was created solely in response to an administrative reorganization among the institutions of government in Denmark and the requirements of the Danish Constitution. It was never intended to play any role in day-to-day politics.

When the financial crisis caused a sharp increase in government debt in 2008-2009, the Danes raised their debt ceiling — a lot. The 2010 increase doubled the existing ceiling, which was already well above the actual debt, to nearly three times the debt at the time. As Kirkegaard reports, “The explicit intent of this move — supported incidentally by all the major parties in the Danish parliament — was to ensure that the Danish debt ceiling remained far in excess of outstanding debt and would never play a role in day-to-day politics.”

I have been deeply involved with debt limit decisions our country has faced over three decades and during administrations of both parties. More times than I care to count, I have testified before, written to, and engaged in discussions with Congress about the debt limit.⁴² And I will never forget sitting in the Oval Office and discussing nightmare scenarios with the President. I hope that my experiences and the experiences of my predecessors can serve as a warning of the danger of coming to the brink of default. Congress should avoid a return to brinksmanship that causes grave risk to our nation. The actions of the past eight years have proven that extending the debt limit cannot be negotiated.

⁴² *Debt Limit*, U.S. DEP'T OF THE TREASURY (last accessed Nov. 7, 2011) <https://www.treasury.gov/initiatives/Pages/debtlimit.aspx> [<https://perma.cc/NEA2-EZHX>].