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CONGRESSIONAL TESTIMONY

Debt Limit vs. Limiting the Debt

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Congress must soon consider its options as the U.S. government reached its statutory debt limit of $16.4 trillion at the end of 2012, exhausting its authority to borrow from credit markets.[1] Facing a 2013 budget deficit of roughly $1 trillion and unable to finance additional deficit spending by issuing new debt, the Treasury Department has once again resorted to extraordinary measures to pay all its incoming bills. These extraordinary measures, essentially cash and debt management tools, are expected to last into late February. Even augmenting its traditional tools with even more radical measures, Congress and the President will need to decide soon whether and under what conditions to raise the debt limit and thereby permit continued borrowing.[2]

In recent years, President Barack Obama and Congress have squandered multiple opportunities to control federal spending, reform the nation's unsustainable entitlements, and put the nation's fiscal house on a path to balance for the present and for the future. Annual budget resolutions, the 2011 debt ceiling debate, the ensuing "supercommittee" flameout, and most recently the fiscal cliff fiasco all provided such opportunities. Time and again President Obama and Congress have put their faith in processes to force difficult decisions at a later date, and time and again the President and Congress have found a way to maximize political drama while minimizing progress on spending reduction and true fiscal consolidation.

Every recent occasion for constructive action was met with a perfect lack of leadership on the part of President Obama except to achieve the utterly tangential and economically counterproductive accomplishment of raising income tax rates on a few. Consequently, every other recent opportunity to change course met with total failure. The debt ceiling debate now unfolding provides yet another opportunity—perhaps the last, best hope for serious, credible progress toward balancing the budget. Failure ought not be an option. Congress should take a stand in the debt limit debate.

Deficits and Debt on the Rise

In January 2009, as President Obama first took office, the national debt stood at $10.6 trillion. In just the past four years the President has increased the national debt by a stunning $5.8 trillion. Under current policies the total debt will likely to rise by about $1 trillion per year for the next four years.

Of course, a portion of the debt increase over the past four years and the likely increase

[1]The dollar limit on the public debt is set by law. 31 U.S. Code § 3101. The debt limit is also sometimes referred to as the "debt ceiling." The two expressions are entirely synonymous.

[2]One such more radical measure is to operate the government on a cash flow basis after Congress has provided the Administration with the legal authority to prioritize spending, allocating incoming receipts to their highest priorities. See J.D. Foster, "A New, Extra-Extraordinary Debt-Ceiling Tool," Heritage Foundation *Issue Brief* No. 3814, January 3, 2013, http://www.heritage.org/research/reports/2013/01/debt-ceiling-and-extraordinary-measures-to-fund-budget-shortfall.

over the next few years are due to the deep, ongoing weakness in the U.S. economy. President Obama's policies have failed to rejuvenate the economy. Output and employment remain far below normal. Thus, federal tax receipts remain far below normal even with the tax hike from the fiscal cliff legislation. Regrettably, the President's success in raising marginal tax rates, first through the 3.8 percent Medicare surcharge as part of Obamacare and more recently through higher individual income tax rates, will only further delay a full economic recovery.

However, recent deficits are not due solely to weak receipts traced to an underperforming economy. Under President Obama, federal spending has shot up from a normal level of about 20 percent of the economy to about 23.5 percent in 2012. In dollar terms, 2012 federal spending was over a half trillion dollars above what would have been the modern norm. When combined with the revenue shortfall, this meant the federal government had to borrow 30 cents for every dollar spent.

While racking up enormous deficits, President Obama has fiercely resisted even modest efforts to reform and restrain the growth in the nation's major entitlement programs: Social Security, Medicare, and Medicaid. Indeed, the President's health care bill materially worsened the fiscal picture.[3] Yet the underlying facts about the fiscal plight of these programs are not in serious dispute: All of the major entitlement programs are poorly designed to achieve their goal of meeting needs while being grossly unsustainable and unaffordable in their current form.[4] Substantial reforms to improve performance and reduce costs are coming, and the sooner the better. The current debt ceiling debate provides an excellent opportunity to start those reforms.

Consequences of Rising Government Debt

The debt limit applies to the public debt, also known as the "gross debt," which includes debt the government has sold in the credit markets plus debt the federal government has issued internally to record certain intergovernmental transfers, such as transfers from the general fund to the Social Security Trust Fund. Credit markets, naturally enough, are concerned primarily with the "publicly held debt, "debt that is sold to and traded in the markets.

Whether the focus is on public debt subject to limit or publicly held debt sold by the Treasury and traded in credit markets, the amount has soared in recent years and is projected to continue to rise rapidly under current policies. A useful method for depicting the implications of the level of debt is its size relative to the economy because the economy is the ultimate source of government revenues used to pay the interest expense on outstanding debt. The modern norm for publicly held debt is around 40 percent of the economy. In 2013, publicly held debt will reach 76 percent according to the

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[3]See James C. Capretta, "Obamacare Remains a Budgetary and Policy Nightmare," Heritage Foundation *Issue Brief* No. 3689, August 2, 2012, http://www.heritage.org/research/reports/2012/08/obamacare-remains-a-budgetary-and-policy-disaster.

[4]For a comprehensive discussion of these issues, as well as a comprehensive program how to address them, see Stuart M. Butler, Alison Acosta Fraser, and William W. Beach, eds., *Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity*, The Heritage Foundation, 2011, http://savingthedream.org/about-the-plan/plan-details/.

Congressional Budget Office (CBO), rising to near 90 percent by 2022.[5] CBO's long-term projections clearly show this ratio continues to increase in later years under current policies because of rapidly rising costs in Social Security, Medicare, and Medicaid.

This projected increase has profound implications for America's economy and the well-being and economic security of America's workers. At the most basic level, this rapid increase in debt means a rapid increase in government interest expense. According to CBO's baseline projections, federal net interest expense is projected to increase from about $220 billion in 2012 to $570 billion in 2022.

The rise in the ratio of publicly held debt to the size of the economy also suggests strong upward pressure on future interest rates.[6] However, this interest rate effect appears to be missing entirely from the economic assumptions in the CBO's budget analysis. It also appears to be missing from the Administration's economic assumptions.[7] For example, the CBO projects the interest rate on the bellwether 10-year Treasury note will average 5 percent in the latter half of the next decade. This projection is actually *lower* than the CBO projected for the long-term rate prior to the recent run-up in publicly held debt.[8] Far more likely, interest rates will permanently increase due to the recent run-up in debt.

The most immediate consequence of such an interest rate jump would be even higher government interest expense. According to the Administration's own analysis, a 1 percentage point increase in interest rates—a reasonable, rough estimate of the effects of the increase in debt—would increase interest expense in 2022 by $206 billion and by over $1.3 trillion from 2013 to 2022.[9] The implication is that both the CBO and the Administration appear to ignore the recent run-up in debt as they project future interest rates and thus appear to underforecast substantially future interest expense.

Higher future interest rates have major consequences beyond their effects on future budget deficits. Higher future interest rates necessarily imply significantly lower levels of productive capital employed in the U.S. economy. Increasing capital drives productivity growth, which leads to a stronger economy and higher wages. Higher interest rates therefore mean lower wages and potentially fewer jobs. They also mean a smaller economy, which means lower government revenues than would otherwise be generated and thus even more upward pressure on federal budget deficits.

Recent academic studies confirm these are not merely theoretical or hypothetical

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[5]See Congressional Budget Office, "An Update on the Budget and Economic Outlook: Fiscal Years 2012 to 2022," August 2012, http://www.cbo.gov/publication/43539 (accessed January 17, 2013).
[6]The term "interest rates" as used here refers to nominal interest rates. There is little reason to believe the issues under discussion would alter the path of inflation. Thus, real interest rate movements would parallel nominal interest rate movements.
[7]See U.S. Office of Management and Budget, "Budget of the United States Government, Fiscal Year 2013: Mid-Session Review," July 27, 2012, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/13msr.pdf (accessed January 17, 2013).
[8]For example, see "The Budget and Economic Outlook: An Update," Congressional Budget Office, August, 2007, at http://cbo.gov/sites/default/files/cbofiles/ftpdocs/85xx/doc8565/08-23-update07.pdf.
[9]U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives* (Washington, DC: U.S. Government Printing Office, 2012), http://www.whitehouse.gov/omb/budget/Analytical_Perspectives (accessed January 17, 2013).

considerations. According to a study by Kumar and Woo, countries with debt levels of 90 percent of GDP or more (commonly labeled "high-debt status" countries) experience a loss in annual real GDP growth of about 1.3 percentage points compared to their low-debt counterparts.[10] That means if the U.S. economy were otherwise projected to grow about 2.5 percent annually—a common mid-range assumption—then reaching high-debt status would be expected to cut that growth rate roughly in half.

A second, oft-quoted study by Reinhart, Reinhart, and Rogoff reached a similar conclusion.[11] A third study by Cecchetti, Mohanty, and Zampolli also arrive a similar conclusion, but importantly using a different methodology.[12] They find that at high debt levels, a 10 percentage point increase in the ratio of debt to GDP tends to reduce real GDP growth by 0.18 percentage point per year over the next five years.

Beyond the economic analysis, the consistent implication for American families is that families will have less income to spend, and they will have fewer career opportunities, and the opportunities they have will tend to pay less. It also means young families will need to work harder and save more as a share of their income to save for a down payment for a home. Then, they will struggle more to save for the children's college education or retirement. Rising government debt will also mean employers will have a more difficult time competing in the global economy, and Americans overall will face greater challenges from the world's newly ascending powers. Rising government debt will mean higher interest expense for the government, which means either higher taxes or less spending on other priorities, or both.

The bottom line is that the federal debt held by the public—the total outstanding debt Washington has borrowed from the financial markets, setting aside the borrowing the government does from its trust funds—stood at $3.4 trillion in 2001 and rose to $5.8 trillion by 2008. Assuming current tax-and-spending policies continue, publicly held debt will top $19 trillion by 2022 according to Administration projections.[13] Leaving future generations such a legacy of debt is unacceptable. It is also financially unsustainable and will leave American families with far less economic security.

A change of course is inevitable. The question is whether it will be an orderly, beneficial change brought by design or a disorderly change brought by congressional and presidential gridlock or by credit markets increasingly intolerant of Washington's fiscal imprudence. In their August 2011 explanation of why they downgraded U.S. federal government debt from the highest rating of AAA to AA+, Standard & Poor's observed, "Our lowering of the rating was prompted by our view on the rising public debt and our

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[10]Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth," International Monetary Fund *Working Paper* No. 10/174, July 1, 2010, http://www.imf.org/external/pubs/cat/longres.cfm?sk=24080.0 (accessed January 17, 2013).

[11]Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt," *American Economic Review*, Vol. 100, No. 2 (May 2010), pp. 573–578, http://www.ycsg.yale.edu/center/forms/growth-debt.pdf (accessed July 12, 2012).

[12]Stephen Cecchetti, Madhusudan Mohanty, and Fabrizio Zampolli, "The Real Effects of debt," Bank for International Settlements *Working Paper* No. 352, September 2011, http://www.bis.org/publ/work352.pdf (accessed July 12, 2012).

[13]See U.S. Office of Management and Budget, "Budget of the United States Government, Fiscal Year 2013: Mid-Session Review."

perception of greater policymaking uncertainty."[14] Reaching the debt limit provides the critical moment to force the necessary action to reduce spending and borrowing, slowing and eventually halting the rise in the public debt.

The Source of the Debt Limit

Section 8 of Article 1 of the Constitution of the United States vests Congress with "Power…To borrow money on the credit of the United States." Congress then, by law, delegates the exercise of this power to the Treasury Department. The borrowing power is a natural extension of the related authorities vested in Congress to raise revenues and appropriate funds. In exercising these related fiscal powers, Congress limits the amount of federal debt the government may issue at any one time to borrow money.

The level of publicly held debt at any one time reflects the extent to which the federal government has engaged in deficit financing. The level of debt summarizes the financial consequences of past fiscal policy. In contrast, the need to raise the debt limit reflects an intention to continue deficit financing, effectively distilling the financial implications of current policy and forcing debate, discussion, possibly reform, and ultimately affirmation of current policy if the limit is increased. Thus, contrary to a popular refrain, raising the debt limit reflects current decisions, not past policy.

Congress could dispense with the periodic ritual of raising the debt limit. It could simply give Treasury the authority to borrow such funds as are needed to carry out the deficit consequences of current law. This would be the easier course politically and highly popular with the current and every future President, but Congress has wisely chosen not to take it. The nation is far better served when Congress and the President are forced to acknowledge the net effects of their policies by raising the debt limit to maintain that course. Whereas individual policies are typically enacted and extended piecemeal, the debt limit provides a unique opportunity to assess the overall course of fiscal policy. The discomfort of legislators facing a debt ceiling increase validates the importance of the ceiling and creates a climactic opportunity for Congress to make crucial policy course corrections that both distant and recent history demonstrate are often too difficult in the course of the regular annual budget and appropriations processes.

Once the limit is effectively reached, Treasury has a small, limited toolbox of financial management measures it then uses to maintain current spending levels pending congressional action before actual spending becomes strictly limited by incoming receipts. For example, Treasury can abstain from refinancing certain cash management bills allocated to the Supplementary Financing Program (SFP).[15] The Treasury may also delay making deposits to certain accounts and to redeem securities in the Thrift Savings Plan's G Fund, the Civil Service Retirement and Disability Fund, and the Exchange

[14]See Standard & Poors, "United States of America Long-Term Rating Lowered to "AA+" Due to Political Risks, Rising Debt Burden; Outlook Negative," August 5, 2011, at http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563.

[15]The SFP is an account at the Treasury created to assist the Federal Reserve in its operations in support of the financial system. See Federal Reserve Bank of New York, "Statement Regarding Supplementary Financing Program," September 17, 2010, at *http://www.ny.frb.org/markets/statement_091708.html*.

Stabilization Fund.[16] According to Treasury Secretary Geithner, at this time these measures would be expected to "create approximately $200 billion in headroom under the debt limit."[17]

In years past, budget deficits typically on the order of 2 or 3 percent of the economy allowed Treasury to use these tools to continue federal spending unabated for some months.[18] With a deficit on the order of 8 percent of the economy, these tools may only bridge the government's cash flow into late February 2013.

Managing Government's Finances with No Headroom

The amount of debt the federal government is allowed to issue is set by statute. Federal spending is similarly established by law.[19] Treasury is at once prohibited by law from issuing additional debt above the limit and obligated by law to spend certain amounts for designated purposes. If the federal government exhausted its financial management tools having already reached the debt limit, then government spending would be limited to incoming receipts. At that point, the law setting a debt limit and the laws in place directing government spending would conflict. Something would have to give.

The legal prohibition on selling additional debt because government borrowing has reached the statutory limit does not translate into an inability to spend (because tax money is still coming in), but rather an inability to spend all the law requires. Thus, the consequences of reaching the debt limit are quite different from a "government shutdown" resulting from the inability of Congress and the President to agree on spending.

Very simply, reaching the debt limit means spending is limited by revenue arriving at the Treasury and is guided by some method of prioritization among the government's obligations. Certainly, vast inflows of federal tax receipts—inflows that far exceed amounts needed to pay monthly interest costs on debt—would continue.[20] To be sure, how the government would decide to meet these obligations with the limited resources is a matter of some conjecture, yet the government clearly would never be forced to default on its debt because of a lack of income. Whether the Treasury is required as a matter of law to prioritize incoming receipts to pay interest costs first is an open question, but there appears to be little doubt the Treasury would do so.[21] Therefore, there is no real question

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[16]See Congressional Research Service memorandum, "Reaching the Debt Limit," December 28, 2010.
[17]See correspondence from Treasury Secretary Timothy F. Geithner to Senate Majority Leader Harry Reid (D-NV) dated December 26, 2013, at http://www.treasury.gov/connect/blog/Pages/Secretary-Geithner-Sends-Debt-Limit-Letter-to-Congress-12-26.aspx.
[18]While federal spending is generally fairly well distributed over the course of the year, federal receipts demonstrate a very uneven monthly pattern. Whereas receipt levels in February and March are traditionally relatively low, receipts are traditionally exceptionally high in April with the tax filing season and again in June with quarterly tax filings. Thus, the timing of when the debt limit is reached is very important to policy.
[19]Section 9 of Article I of the Constitution provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law…."
[20]See U.S. General Accounting Office, *A New Approach to the Public Debt Legislation Should be Considered*, September 1979, at *http://www.archive.gao.gov/f0302/110373.pdf*.
[21]See Section 3123 of Title 31 of the United States Code, which says that "[t]he Secretary of the Treasury shall pay interest due or accrued on the public debt." Section 3123 does not provide guidance, however, on

that Treasury would take the actions necessary to preserve the full faith and credit of the U.S. government and avoid defaulting on debt and interest due. Suggestions that the United States would default on its public obligations are irresponsible and wrong.

The issue is less clear-cut with all of other government spending obligations. With insufficient funds on hand to make all expenditures required by law, the Treasury would be forced to prioritize what is spent now and what is postponed or never spent—a de facto recission by executive fiat. If spending must be funded out of receipt levels that are insufficient to meet all obligations, it appears an ever-growing backlog of unmet bills, excluding net interest, would ensue until Congress took action one way or another. In 2013, the federal government is expected to run an average monthly deficit of around $80 billion.

Some may argue Treasury has an implicit authority to prioritize spending on programs that have dedicated revenue sources. For example, the Social Security payroll tax provides a dedicated revenue source. Whether such sufficient authority exists or not, the fact remains that benefits have been paid on time during past episodes when the debt limit was reached. In some cases, Congress legislated specifically to ensure Social Security benefits would be paid, thus eliminating any doubt.

The Treasury would face a difficult question once all funding headroom is exhausted:

1. The Treasury would not have enough money to pay out all of the appropriations made;
2. Congress has, by law, said that the Treasury must carry out all appropriations laws and cannot refuse to carry out a portion of them (an action called "impoundment" that was prohibited years ago by law); and
3. Congress has, by law (the debt limit statute), said that the Treasury cannot borrow to supplement income tax receipts to pay the government's bills.

In short, the Treasury would not have enough money to go around. Although the law generally does not appear to tell the President what he must do in that situation, some may argue that, as a practical matter, he would have to "just do it" and set priorities for which lawfully owed bills to pay and which not to pay until the Treasury again has the money to pay everything that the laws require.

One question raised is whether Treasury has the administrative tools to prioritize spending. To be sure, it is unlikely Treasury's payment systems were designed to sift through the various spending demands according to some priority list. It is equally likely Treasury would take whatever actions were necessary to continue making the highest priority payments, such as interest on the debt, Social Security payments, and so forth because these obligations all flow from discrete payment systems.

A related question is how long Treasury could operate such a prioritization system and how long the nation would tolerate the federal government operating in this fashion. The

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how to implement Section 3123 and other statutes directing expenditures when there is not enough cash on hand at the Treasury to cover all of the directed expenditures.

answers are unknown, but the likely upshot is somewhere between days and weeks, certainly not months or years because no doubt certain proper functions of the federal government and certain higher congressional priorities would go unmet. Moreover, a President acting alone, without statutory authority, to decide which government bills to pay and which not to pay is anathema in a government based on the rule of law. Clearly, that is something best avoided.

A helpful step would be for Congress to pass legislation similar to the Full Faith and Credit Act, introduced in 2011 by Senator Pat Toomey (R–PA), establishing explicit guidelines and clear authorities for the Administration to prioritize spending after-the-fact if it were to prove necessary.[22] For example, legislation could clearly indicate that net interest on publicly traded federal debt would receive the first claim on income tax receipts, thus eliminating any remaining shred of substance from the question of defaulting on outstanding debt. The legislation could also clarify the high priority that should be accorded national security spending and perhaps other clearly high-priority spending programs such as Social Security, Medicare, and Medicaid. Funding each of these would leave roughly $22 billion a month available to cover the remaining $92 billion in obligated spending.

How Would Credit Markets React?

A key consideration for any course of action is how credit markets would react to a particular outcome. If credit markets react badly, the repercussions for the economy could be harsh and prove expensive for future government finance at all levels of government. For this it is important to recognize which measures of debt are relevant. Two measures of government debt are common to the debt limit discussion: debt that is sold in the credit markets, typically called “publicly held debt,” “gross debt,” or “public debt,” which includes publicly held debt plus debt the federal government has issued internally to record certain intergovernmental transfers such as transfers from the general fund to the Social Security trust fund.

Credit markets are concerned with the publicly held debt, its growth over time, and on-time net interest payments.[23] Publicly held debt approached $12 trillion at the end of 2012.[24] While publicly held debt is the relevant measure of the debt for credit markets, the debt limit applies to the gross debt.

If the federal government were forced to operate indefinitely at the current debt limit, the initial reaction in credit markets would surely be unfavorable. Credit markets value certainty and carefully evaluate and exact a price for uncertainty. Despite the recent run-up in federal debt and the tremendous financial difficulties facing the federal government due to past promises made in major entitlement programs, U.S. government debt is still

[22]See “A New, Extra-Extraordinary Debt Ceiling Tool,” by J.D. Foster, Ph.D., Heritage Foundation Issue Brief No. 3814, January 3, 2013, at http://www.heritage.org/research/reports/2013/01/debt-ceiling-and-extraordinary-measures-to-fund-budget-shortfall.

[23]For a discussion of why publicly held debt is the meaningful quantity, see Alex Brill, “Reform, Don’t Raise, the Debt Limit,” American Enterprise Institute, January 20, 2011, at *http://www.aei.org/article/103031*.

[24]See Monthly Treasury Statement, U.S. Department of the Treasury, November, 2012, at *http://www.fms.treas.gov/mts/mts1112.pdf* .

the global benchmark for safety. The uncertainty surrounding how the federal government would operate if it could not fund all obligated spending would rattle markets initially, likely leading to adverse movements in interest rates and the dollar exchange rate.

However, not all of the news would be grim, as the passage of time would soon make clear. As noted, the Treasury Department would surely affirm that it would make all interest payments on government debt, thus reassuring bond holders and allaying all concerns over defaulting on the debt. While spending cuts required to align total spending with revenues would be deep, credit markets ultimately might see the forced austerity as beneficial because the U.S. government would be running an enforced balanced budget. Once the novelty wore off—how long this would take is unclear—markets ultimately might see the forced austerity as beneficial, especially if they concluded that the result would be congressional action to put the government on a sound financial footing after decades of rising spending and borrowing.

Following recent events, including the previous debt ceiling debate and the fiscal cliff fiasco, credit markets are also rightly concerned about whether the U.S. government can function to address fundamental issues at least at a minimum level. After passing laws obligating a certain level of spending, if Congress then denied the Administration the funding for that spending it would raise reasonable and serious questions in the minds of credit market participants about the institutional soundness of U.S. government. In its August 2011 publication explaining the cut in the U.S. government's credit rating, Standard & Poors specifically referred to concerns regarding "America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."[25] Credit markets assess both the quality of the creditor as well as the quality of the credit.

Finally, policymakers need to be equally concerned with the possible credit market reaction if the President and Congress were to fail to make significant progress on credibly reducing federal spending. Market participants are fully aware of how policymakers have failed in every recent opportunity to constrain spending growth. They are fully aware that entitlement spending is projected to soar in the very near future. Market participants also are aware that the particulars of the American political calendar strongly imply that this debate triggered by the debt ceiling may be the last, best opportunity to enact credible, significant fiscal reforms.

Three Options on the Debt Limit: Two Drastic, One Sound

Congress and the President broadly face three options on the debt limit.

Drastic Option #1: Hold the line.

One option is to hold the debt limit in place, thereby forcing an immediate almost $1 trillion reduction in non-interest spending for the year (about $80 billion a month). If Congress and the President choose this option, then the legislative guidance described

[25]See Standard & Poors, "United States of America Long-Term Rating Lowered to "AA+" Due to Political Risks, Rising Debt Burden; Outlook Negative," August 5, 2011, at http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563.

above and enacted in advance would be consequential.

This option is equivalent to forcing the federal government to operate with a balanced budget henceforth, and Congress would need to act quickly to amend the law adjusting spending for 2013 downward by about $1 trillion. In rough terms, federal spending in 2013 is projected to be about 23 percent of the economy compared with the norm of about 20 percent, while revenues are projected to be about 17 percent of the economy, compared with the norm of about 18.5 percent. If the debt ceiling is held in place, Congress will need to slash spending substantially below the postwar norm for spending and even below the postwar norm for revenues.

Drastic Option #2: Raise the debt limit without cutting.

A second option is for President Obama and Congress to raise the debt ceiling and do nothing more, once again missing their opportunity to restrain the growth in federal spending, enact some basic reforms to major entitlements, and thereby put the federal government's finances on a path to balance. This option is drastic because it means once again federal policymakers would have ignored the imperative of restraining spending. Worse, there are few apparent opportunities remaining in the near future for substantive action. Simply raising the debt ceiling may appear to some as the most natural path of least political resistance, but circumstances created by the rapid growth in debt, projected deficits, and soaring entitlement spending dictate otherwise.

Both options 1 and 2 -- holding the debt limit in place and raising the debt ceiling without entitlement reforms and spending cuts – represent extreme choices in terms of fiscal policy and as expressions of the federal government's ability to function. Congress should seek a more sensible approach addressing both the immediate concerns surrounding the debt limit, and also addressing the federal government's irresponsible near-term and long-term fiscal paths.

The Sound Option: Credibly control spending and then raise the debt limit.

Congress should not authorize the government to borrow any more money without first setting the government firmly and credibly on the path to balancing the budget.[26] The immediate difficulty is Congress may lack the time to agree to complicated, comprehensive budgetary solutions. It spent many months in fruitless conflict over the fiscal cliff. The sequester is looming at the end of February. The continuing resolution allowing domestic discretionary or "day-to-day" spending expires at the end of March, and the Treasury has only a few weeks of headroom to continue to pay the federal government's bills,

Of course, Congress could pass a small increase or a series of small increases in the debt ceiling to gain time for more comprehensive solutions. The danger is that passing small increases to gain time could become a habit en route to the drastic solution of simply raising the debt ceiling by a large amount without the necessary entitlement reforms and

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[26]See David S. Addington, "Don't Raise the Debt Limit Without Getting Spending Under Control," Heritage Foundation Background Paper No. 2549, April 21, 2011 at *http://www.heritage.org/research/reports/2011/04/dont-raise-the-debt-limit-without-getting-spending-under-control.*

spending reductions.

Fortunately, with the sequester in place, Congress has already taken a big first step in restraining discretionary spending. Regrettably, the sequester makes deep and ill-considered cuts to national security spending, so Congress needs to reconfigure the composition of spending cuts in the sequester to preserve sufficient national security spending. Additional cuts to domestic discretionary spending beyond the sequester amounts will be needed to reach a balanced budget.[27]

While cutting discretionary spending is important, the greater fiscal issues involve the nation's entitlements, especially Social Security, Medicare, and Medicaid. In recent years analysts have developed and Congress has already considered a handful of meaningful, yet simple reforms to Social Security and Medicare that meet the test of real reform and enjoy broad, bipartisan support. These reforms would substantially restrain the growth of government spending in the near term, but especially in the long term where the fiscal threat is greatest.[28]

To be sure, these reforms will not resolve either Social Security's or Medicare's key structural flaws. They constitute a start of the reform journey, not the conclusion, but they would be a powerful start that would markedly alter the nation's fiscal trajectory.

At a minimum, Congress should consider:

1. **Raising the Social Security eligibility age to match increases in longevity.** Americans are living longer and so they are receiving benefits longer compared with the number of years that they are paying into Social Security. As the President's own Simpson-Bowles Commission observed, it is important for the program's sustainability to increase the eligibility age in line with longevity.[29] Originally set at 65, the normal eligibility age is rising two months every year until 2022, when it will reach 67. According to the Social Security actuaries, continuing to increase the eligibility age to 69 by the year 2034 and allowing it to rise more slowly thereafter to reflect gains in longevity could go a long way toward reducing Social Security's funding shortfall.[30] While this would not reduce today's budget deficit, it would strengthen Social Security's finances and

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[27]See "$150 Billion in Spending Cuts to Replace the Sequester" by Patrick Louis Knudsen, Heritage Foundation Background Paper No. 2744, November 15, 2012, at *http://www.heritage.org/research/reports/2012/11/150-billion-in-spending-cuts-to-offset-defense-sequestration.*

[28]See "Six Bipartisan Entitlement Reforms to Solve the Real Fiscal Crisis: Only Presidential Leadership is Needed," by J.D. Foster, Ph.D., and Alison Acosta Fraser, Heritage Foundation Background Paper No. 2748, November 30, 2012, at *http://www.heritage.org/research/reports/2012/11/six-bipartisan-entitlement-reforms-to-solve-the-real-fiscal-crisis-only-presidential-leadership-is-needed.*

[29]See "The National Commission on Fiscal Responsibility and Reform," The White House, December 2010, at *http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf*

[30]Social Security Administration, Office of the Chief Actuary, "Individual Changes Modifying Social Security," Actuarial Publications, December 21, 2011, http://www.socialsecurity.gov/OACT/solvency/provisions/index.html (accessed November 27, 2012).

dissipate far more important long-term budget pressures.[31]

2. **Correcting the cost-of-living adjustment (COLA).** The annual COLA benefit adjustment is determined today by the Bureau of Labor Statistics' Consumer Price Index (CPI). However, the CPI, an antiquated measure, generally overstates inflation, meaning that benefits are increased a little too much each year to offset inflation. The effect on benefits in a given year of switching to a more accurate inflation measure is minute, but Social Security spans generations. Again, according to the Social Security actuaries, using a more modern inflation measure would substantially reduce Social Security's shortfall over time.[32]

3. **Raising the Medicare eligibility age to agree with Social Security.** As with Social Security, Medicare has an eligibility age problem in that Americans are living longer and so they are receiving benefits longer, but unlike Social Security the Medicare eligibility age remains stuck at 65. An obvious solution is to wait a few years and then slowly raise the eligibility age to align eventually with the Social Security eligibility age. While the short-term budgetary savings would be modest, the critical issue for fiscal policy is the long-run trajectory and the long-term savings in Medicare from raising the eligibility age would be profound.

4. **Reducing the Medicare subsidy for upper-income beneficiaries.** In 2012, the average Medicare beneficiary received a subsidy of about $5,000. Subsidizing Medicare benefits for low-income seniors—and perhaps for some middle-income seniors—makes sense. But retired millionaires do not need and should not receive a $5,000 subsidy to buy Medicare health insurance. The Medicare subsidy was first cut for the wealthiest seniors in legislation signed by President George W. Bush in 2004. Obamacare cut it further, and President Obama proposed paring it back further yet in his budget proposals in February 2012.

   Medicare has many programmatic problems demanding attention and the sooner the better, but the foremost fiscal problem is the subsidy. The total cost of the Medicare subsidy, about $230 billion in 2012, will soar over time as health care costs rise and the baby boomers retire.[33] Paring back the subsidy for wealthy retirees is an obvious step toward reducing the budget deficit today and shoring up Medicare for the long run.

These four proposals for Social Security and Medicare reform meet the test of simplicity, being relatively easy to communicate to the American people, having been thoroughly

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[31]See David C. John, "Three Social Security Fixes to Solve the Real Fiscal Crisis," Heritage Foundation Issue Brief No. 3807, December 19, 2012, at *http://www.heritage.org/research/reports/2012/12/3-social-security-fixes-to-solve-the-real-fiscal-crisis*.

[32]See "Restoring America's Future," by Senator Pete Domenici and Alice Rivlin, Bipartisan Policy Center, November 2010, at *http://bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf*.

[33]Centers for Medicare and Medicaid Services, *2012 Annual Report of the Board of Trustees of the Federal Health Insurance and Federal Supplementary Medical Insurance Trust Funds*, April 23, 2012, p. 10, Table II.B.1, http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2012.pdf (accessed November 27, 2012).

vetted, and enjoying widespread support. Together, they would dramatically improve America's fiscal future for the better.

Two additional proposals Congress should consider immediately meet the tests of simplicity and effectiveness, but have not been considered as intensively**:**

5. **Phasing out Social Security benefits for upper-income retirees.** Everyone who has ever paid into Social Security is entitled to the benefits prescribed by law. However, as a nation we need to ask whether today's working families should pay payroll taxes so that upper-income retirees can continue to receive their checks. We need to ask why phasing out the Medicare subsidy to upper-income seniors would make sense while continuing to send them their full Social Security check. In short, Social Security should be reformed as social insurance against poverty rather than a government-run pension scheme.

   Some might charge that this is redistributionism, but would anyone suggest millionaires should receive food stamps? Food stamps and other welfare programs are specifically intended to operate as part of the social safety net, yet their existence constitutes a form of redistributionism that most Americans accept. Social Security (and Medicare) should become true social insurance, meaning only those seniors who need help should receive help. On the other hand, if Social Security remains a government-run pension, then it remains a vastly larger program built on an entirely different redistributionist principle**—**in many cases from workers to the wealthy.

6. **Consolidating Medicare's elements and collect a higher, single premium.** Medicare is actually three distinct components, referred to generally as Parts A, B, and D, reflecting the fact that Medicare coverage has expanded over the years in distinct phases. This antiquated structure is confusing to seniors and administratively inefficient. An obvious reform is to consolidate the three distinct parts into a unified Medicare program.

   Medicare Parts B and D each require beneficiaries to pay a premium covering 25 percent of the costs of the program. As the Medicare Parts are consolidated, the premium should also be consolidated and then raised to cover 35 percent of the relevant costs.[34] This, again, is a long-standing bipartisan proposal that was included, for example, in the so-called Domenici–Rivlin plan named after former Senator Pete Domenici (R–NM) and Alice Rivlin, former Director of the Office and Management and Budget in the Clinton Administration.[35]

Charting a Sustainable Course

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[34]See Robert E. Moffit, "The First Stage of Medicare Reform: Fixing the Current Program," Heritage Foundation Backgrounder No. 2611, October 17, 2011, *at http://www.heritage.org/research/reports/2011/10/the-first-stage-of-medicare-reform-fixing-the-current-program.*

[35]See "Restoring America's Future," by Senator Pete Domenici and Alice Rivlin, Bipartisan Policy Center, November 2010, at *http://bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf.*

The federal budget deficit is unsustainable today because of out-of-control spending. Even as the economy strengthens and revenues recover, spending in years to come is slated to rise to even more unsustainable levels. The debate over the debt ceiling is an appropriate, indeed may be the last prime opportunity for a course correction to putting the government on a credible path to balancing the budget in 10 years.

The silver lining in this otherwise dark cloud is Congress has already enacted a substantial down payment in cutting discretionary spending through the sequester. While more can and should be done to reduce discretionary spending while fully funding national security, Congress should next focus particularly on the entitlement programs. Fortunately, the Administration, Congress, and outside analysts have already vetted a number of sound reforms to Social Security and Medicare.

Congress faces two roughly equally drastic options: keeping the debt ceiling in place or raising the debt ceiling without any other actions to slow the growth in spending. Alternatively, if Congress ultimately inclines toward raising the debt limit, then in the same legislation it should enact substantial entitlement reforms and other spending reductions with the clear goal of putting the nation on a credible path to balance in 10 years. Fortunately, there are well-vetted options available that would not only move the budget toward balance, but also help to keep the budget in balance while preserving the major entitlement programs for future generations.

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