Statutory Debt Ceiling

Hearing

Committee on Ways and Means

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Mr. Chairman, Mr. Levin, and members of the Committee – it is an honor for me to testify before your Committee. My name is Bill Hoagland and I am a Senior Vice President at the Bipartisan Policy Center (BPC), established in 2007 by former Senate Majority Leaders Howard Baker, Bob Dole, George Mitchell and Tom Daschle.

Fundamentally, the debt ceiling discussion emerges from the most basic tenet of legislative sovereignty – the power of the purse. Thomas Jefferson wrote James Monroe in April 1791 saying: "We are ruined, Sir, if we do not over-rule the principles that 'the more we owe, the more prosperous we shall be,' 'that a public debt furnishes the means of enterprise…' "[1]

I began my career here on Capitol Hill with the establishment of the Congressional Budget Office in 1975. Later, as staff on the Senate Budget Committee and in the Majority Leader's office, I witnessed and participated in many budget standoffs, but one of the first and most memorable was the one that you Mr. Levin and Mr. Rangel will recall in 1985 – the Gramm-Rudman-Hollings Act. That legislation came about because of the need to raise the statutory debt limit over $2 trillion for the first time.

The debt limit bill has always been politically sensitive. But as the country's debt has continued to increase as a share of our economy, the need to legislate an increase in the debt limit has become more frequent and more difficult. Since 1940, Congress has increased the debt limit 78 times and based on the actions at the end of the 112th Congress, I estimate that the debt held by the public will continue to rise, reaching 77% by 2022. This must be addressed.

As announced by Secretary Tim Geithner, Treasury officially reached the statutory borrowing limit (to be exact, $16,393,975,000,000, or just $25 million under the $16.394 trillion statutory limit) on December 31, 2012. To raise additional funds for paying the nation's obligations, the Secretary has begun to use the approximately $200 billion in available so-called "Extraordinary Measures."

These legal financial maneuvers that are at Treasury's disposal allow it to increase cash on hand and continue paying all of the federal government's obligations. The measures are limited in size, meaning that they will only provide a finite amount of additional capacity to ensure timely payments during the period when Treasury is unable to issue debt as it normally would (since it is up against the limit).

In general, Extraordinary Measures temporarily reduce the debt held by certain restricted government funds, thus enabling the Treasury to issue additional securities to the public (while remaining under the debt limit) and raise cash to pay bills. For example, federal employees invest some of their retirement savings in government bonds. One measure allows Treasury to temporarily disinvest these bonds. After the debt limit is raised, Treasury must reimburse the

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[1] Meacham, Jon. *Thomas Jefferson: The Art of Power*. New York: Random House, 2012

retirement fund in full, including both the principal and whatever interest would have been earned.

Several reports by the Government Accountability Office (GAO) and the Congressional Research Service (CRS) provide details on how particular Extraordinary Measures work.[2] This year, there is one fewer measure available to Treasury than there was in 2011, when the debt limit event coincided with maturing debt in a government trust fund that contains pension assets. The measure is unavailable this time around because that trust fund has no debt maturing in this time frame.

Using this information along with the current size of the various funds, BPC estimates that $200 billion are available to help Treasury meet its financial obligations, some of which are already being used.

Absent an increase in the debt limit, a day will come when Treasury runs out of extraordinary measures to stay under the ceiling and further run out of cash to pay our nation's bills. The staff at BPC projects that date – which we call the X Date – would occur sometime between February 15 and March 1. Last week, the U.S. Treasury similarly concluded approximately this time frame.

This testimony will address two issues: first, provide a brief update on the BPC analysis that estimated daily cash flows to determine the X Date and second, look at what will happen when the X date is reached should the U.S. borrowing limit not be increased.

When is the X Date?

On the first question, the cash flows over the past week have been largely as anticipated, with no large fluctuations. We base our estimates of cash flows on known scheduled payment dates during this time period and on previous years' patterns of payments. The BPC staff also reviewed the Internal Revenue Service announcement of the delay in the start date of the tax filing season to January 30. We did not find it would have a significant impact on total tax refunds paid in February. Thus, at this point, our projected window for the X Date remains unchanged.

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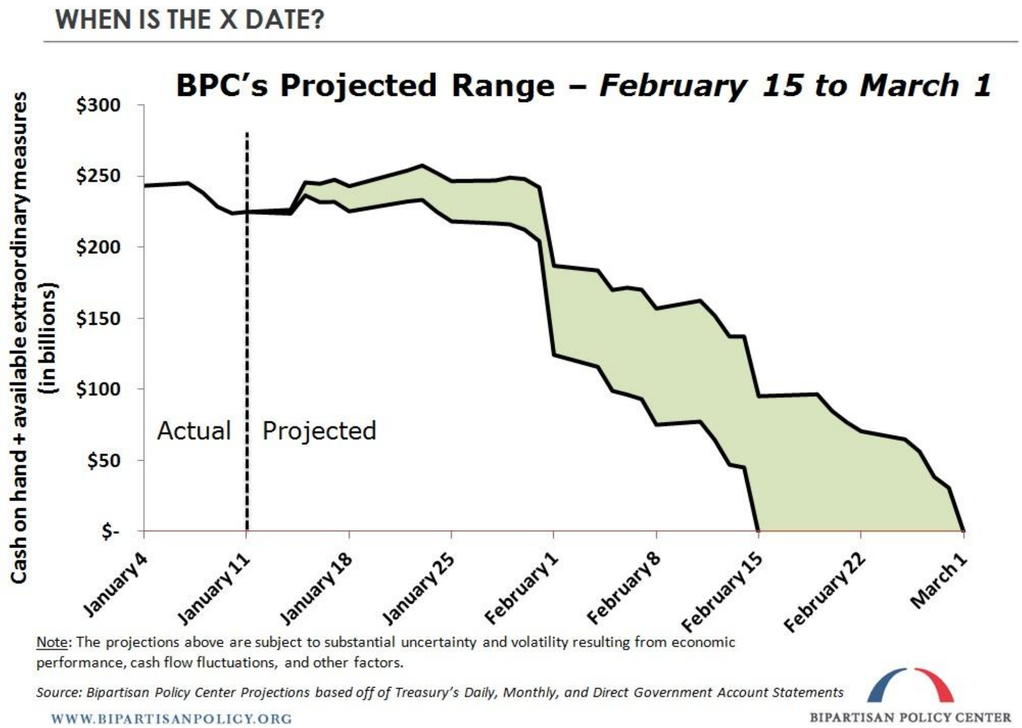
[2] Government Accountability Office. *Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs.*" July 2012. Available at: http://www.gao.gov/assets/600/592832.pdf.
Government Accountability Office. *Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market.* February 2011. Available at: http://www.gao.gov/assets/320/315843.pdf.
Congressional Research Service. *Reaching the Debt Limit: Background and Potential Effects of Government Operations.* May 2012. Available at: http://www.fas.org/sgp/crs/misc/R41633.pdf.



What Actions Might Treasury Take in a Post-X Date Situation?

Once the X Date is reached, the president and Treasury officials will find themselves in largely uncharted waters and be forced to choose a path forward.

Two potential scenarios:

1. Treasury could "prioritize" payments, choosing to pay some and not others until after the nation's borrowing authority is restored. The Comptroller General issued a letter to the then Chairman of the Senate Finance Committee Bob Packwood on October 9, 1985 concluding that the Secretary of the Treasury does have the authority to choose the order in which to pay obligations of the United States. The Comptroller General further stated that the "Treasury is free to liquidate obligations in any order it finds will best serve the interest of the United States." I have asked the GAO staff if this opinion has changed since 1985 and have been told that GAO has not issued an opinion on this question subsequent to the 1985 opinion to Senator Packwood.

   While prioritization may be legal, the actual implementation of it may not be practical. On average, Treasury must make over 5 million payments on <u>each</u> business day in the month following the X Date. Treasury's computer systems are set up to confirm and process all payments as they come due, so implementing prioritization would be a dramatic overhaul, and extremely difficult on short notice. The projections in BPC's report of daily cash inflows and outflows demonstrate the difficult decisions that Treasury would confront, as it would be unable to fulfill all of the country's financial obligations.

Further, from a timing perspective, should Congress – the legislative branch – take to itself the responsibility of the executive branch and attempt to pass legislation to set the order of government payments, overturning the Prompt Payment Act, Title X of the 1974 Budget Act addressing agency impoundment and other existing laws, one must be realistic as to how long such a debate would last.

2. In the event that Treasury deems prioritization to be illegal or implausible, the secretary could instead announce that the government will make all payments for each individual business day (with the likely exception of interest on the public debt, which would be paid on time and in full) once enough revenue has been received to cover that day's bills. In other words, all post-X Date obligations would be paid in the order in which they come due, but on a delayed schedule.

The Treasury Department's Office of Inspector General (OIG) released a report last year in response to Members of Congress who inquired about Treasury's planning during the debt limit event of 2011.[3] Among the OIG's findings was that some Treasury officials determined prioritization to be an unlikely course of action due to the concerns I have raised, and that delay of payments was the most likely outcome because the officials considered it to be feasible and the least harmful among a variety of bad options.

Treasury officials realized that delays would cascade dramatically within a short amount of time due to the nation's large deficit, resulting in significant consequences for individuals and organizations expecting government payments or tax refunds. The result: a further slowdown in the broader economy.

BPC has estimated the consequences of this payment delay scenario under a set of assumptions, including (for illustrative purposes): that the X Date occurs at the beginning of the BPC estimated window (February 15); that Treasury enters the X Date with precisely enough cash on hand to make that day's $30 billion interest payment on the debt; that all interest payments are prioritized and paid on time; and that federal trust fund operations continue as normal.

In this situation, the $22 billion of non-interest payments owed on February 15, which include military pay and unemployment benefits, would be delayed until February 20. Similarly, over

[3] Thorson, Eric M. Letter to Senator Orrin G. Hatch. 24 Aug. 2012. Department of the Treasury, Washington, DC 20220

$30 billion of payments due on February 20, which include Social Security benefits, would not be made until February 25. Delays would continue to grow – payments due February 22 would be made a week late on March 1. And payments due on March 1, which again include Social Security benefits, as well as payments for all Medicare Advantage and Part D prescription drug benefit plans, military salaries, and veterans' benefits, would be delayed until March 15, half a month late. This process would only cascade the longer a debt limit increase is delayed.

FEDERAL PAYMENTS AFTER THE X DATE

Illustrative Potential Payment Delays (assuming a Feb 15th X Date)

Payment	Due Date	Delayed Until
Military Active Duty Pay	February 15	February 20
Unemployment Insurance	February 15	February 20
Social Security	February 20	February 25
Defense Vendor Payments	February 22	March 1
Food Stamps	February 25	March 5
Tax Refunds	March 1	March 15
Social Security	March 1	March 15
Veterans Benefits	March 1	March 15
Medicare and Medicaid Payments to Providers and Plans	March 1	March 15

Note: These projections incorporate a set of assumptions, including (for illustrative purposes) that the X Date occurs at the beginning of the BPC estimated window (February 15); that Treasury enters the X Date with precisely enough cash on hand to make that day's $30 billion interest payment on the debt; that all interest payments are prioritized and paid on time; and that federal trust fund operations continue as normal.

Source: Bipartisan Policy Center projections off of Daily Treasury Statements

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Setting aside the fact that the government could face innumerable challenges under the Prompt Payment Act as these cascading payment delays multiply, there would be a real impact on individuals and businesses across the country. Consider a point at which payments are delayed for multiple weeks. Both the first- and second-order effects of such a delay would be very tangible: a senior who depends on Social Security benefits and has no other source of income might be unable to pay rent when due; or a small government contractor may be unable to pay a subcontractor on time. These and many other similar circumstances would all be possibilities under a delayed-payment scenario.

Rolling Over Debt

Under normal conditions, Treasury issues new debt to the public in order to raise cash to pay off outstanding securities as they mature. Many buyers of U.S. government debt routinely roll over their debt at maturity, and Treasury has never been unable to find sufficient purchasers for its auctions.

In a situation where Treasury has begun to default on its obligations, however – meaning a post-X Date environment where certain payments owed by the federal government have not been made – there is a possibility that such auctions would not go smoothly. Investors might demand a significant premium on their debt purchases, or in a worst-case scenario, Treasury could find itself with insufficient buyers for an auction. Were this to occur, it would force Treasury to step in with enough cash to pay off the redeeming bondholders or face a default on the U.S. debt.

The OIG's report found that this was a serious concern among Treasury officials during the summer of 2011, as there was a large auction scheduled to take place in early August of that year. BPC staff has researched the upcoming bond rollovers and finds that there will likely be over $500 billion of debt that will need to be rolled over from February 15 through March 15, 2013. (Very short-term securities that would be due in that period have yet to be issued; therefore, we cannot determine exact total quantities at this point.)

DEBT ROLLOVER AND THE X-DATE

Debt Maturing After February 15

Date	Debt Maturing
February 15	$20 billion
February 21	$60 billion
February 28	$115 billion
March 7	$86 billion
March 14	$60 billion
March 15	$40 billion

Note: Does not include estimates of 4-week maturities that have yet to be auctioned.

Source: TreasuryDirect

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Fitch Warns of Downgrade

Last week, fearing some of the potential impacts and consequences laid out above, Fitch Ratings issued a sharp warning:

"With no legal authorization for net debt issuance, the Treasury would be forced to immediately eliminate the deficit - a fiscal contraction twice as great as the recently avoided 'fiscal cliff' - by delaying payments on commitments as they fall due. It is not assured that the Treasury would or legally could prioritize debt service over its myriad of other obligations, including social security payments, tax rebates and payments to contractors and employees. Arrears on such obligations would not constitute a default event from a sovereign rating perspective but very likely prompt a downgrade even as debt obligations continued to be met."

In addition to threatening a downgrade, Fitch is alluding to the overnight cutback in government spending – and thus, economic activity – that would result from only having enough cash on hand to pay approximately 60 percent of the bills. The impact of this type of pullback for any extended period of time is unknown, but could very well be calamitous.

Conclusion

If the U.S. goes past the X Date without an increase in the debt limit, the country should be prepared for a likely downgrade. This would most likely lead to higher interest rates on our already large borrowing portfolio, and therefore in turn, further add to an already excessive deficit. The goals for our country should be to spur economic growth and control our debt and deficit going forward; I am concerned that a prolonged dispute over the debt limit could, in fact, produce the opposite effect. For example, BPC analysis, based off of GAO modeling, estimates that the debt limit event of 2011 cost the U.S. taxpayer an additional $19 billion over 10 years from the interest rate premium that the federal government was forced to pay on its debt during that period.

We at BPC strongly believe that the imbalance in our federal ledger does need to be addressed. Prolonged negotiation over the debt limit, however, has the potential for substantial downsides to our economy – increased uncertainty, instability in the markets, disruption to individual and families' lives – and our standing in the world as having the currency of choice.

Risks are risks, and while no one can know for sure what ramifications the largely unprecedented scenario of passing the X Date would have, those risks clearly grow by day and eventually could become catastrophic. These are considerations that we hope all policymakers keep in mind as they deliberate these vital issues for the future of our country.