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What You Should Know About the Debt Ceiling

Both sides have clearly stated that they will not allow the U.S. government to default on its obligations. But time is growing short.

On Monday, May 22, President Joe Biden and House Speaker Kevin McCarthy met at the White House to discuss raising the statutory limit on U.S. government debt, generally called the debt ceiling. Although both leaders termed the discussion "productive," there was no resolution, and their respective negotiating teams continued discussions.[1] Here are some answers to questions you may have about the issues behind the current impasse.

What is the debt ceiling? The debt ceiling is a statutory limit on cumulative U.S. government debt, which is the sum of annual deficits since 1835 — the only time the U.S. government had no debt — plus interest owed to investors who purchased Treasury securities issued to finance the debt.[2] It limits the amount that the government can borrow to meet financial obligations already authorized by Congress. It does not authorize future spending. However, in recent years, raising the debt ceiling has been used as leverage to negotiate on the federal budget.

Why do we have a debt ceiling? A debt ceiling was first introduced in 1917 to make it *easier* for the federal government to borrow during World War I. Before that time, all borrowing had to be authorized by Congress in very specific terms, which made it difficult to respond to changing needs. The modern debt ceiling, which aggregates almost all federal debt under one limit, was established in 1939 and has generally been used as a flexible structure to encourage fiscal responsibility.[3] Since 1960, the ceiling has been raised, modified, or suspended 78 times, mostly with little fanfare until a political battle in 2011.[4]

How much is the debt ceiling? The current limit was set by Congress at about $31.4 trillion in December 2021.[5] For perspective — the debt was less than $6 trillion in 2001, when it began to rise due to tax cuts and increased military and national security spending in response to 9/11. It has tripled since 2008, driven by reduced tax revenues and stimulus spending during the Great Recession and the COVID-19 pandemic.[6]

When will we reach the debt ceiling? The government reached the $31.4 trillion limit on January 19, 2023. Since then, the Treasury has been using short-term accounting tactics (called "extraordinary measures") to allow spending for a limited period without raising the ceiling.[7] According to Treasury Secretary Janet Yellen, this extension is expected to expire on or shortly after June 1, 2023.[8] The so-called "X-date" could vary because tax revenues are not fully predictable. It has come more quickly than anticipated, due to postponement of the tax-filing deadline for disaster-area taxpayers in certain states and lower capital gains tax receipts.[9]

What will happen if the ceiling is not increased? The U.S. government will not be able to pay all of its financial obligations. This has never happened, so it is difficult to predict exactly how it would play out. The Treasury could still pay some of its obligations from incoming revenues, but there would have to be choices regarding what bills would not be paid. These are some of the possible results.

- **The government could default on its bond payments.** U.S. Treasury securities are generally considered among the safest investments in the world because they are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. These securities are widely held by individual and institutional investors as well as local, state, and foreign governments. Even the possibility of defaulting on interest payments could disrupt global markets, and an extended default could have serious economic repercussions around the world. An estimate by Moody's Analytics suggests that a one-week default could send the U.S. economy into a mild recession with the loss of 1.5 million jobs and real GDP contraction of 0.7 percentage point. A default through the end of July (which seems highly unlikely) could cause a deep recession with 7.8 million lost jobs and a real GDP decline of

4.6%. Any default, or even near-default, could result in downgrading the U.S. credit rating, as occurred in 2011. This would make borrowing more expensive, adding to the ongoing problem.[10]

- **Government payments could be delayed.** Social Security and Veterans benefit payments could be delayed, causing hardship to those who depend on them for immediate needs. The same is true for wages of U.S. government workers, and late payments to government contractors could mean they may not be able to pay their employees. Late reimbursements to Medicare providers could strain smaller hospitals and medical practices. Any late payments would be made once the debt ceiling is raised, but the short-term consequences could be painful.

What are the issues in the negotiations? According to public statements from negotiators, key issues include caps on future spending, use of unspent COVID-relief funds, work requirements for certain social programs, and expediting rules for energy projects. Both sides have agreed to spending caps in general terms, but they differ on how caps should be structured. The 2011 debt ceiling impasse resulted in spending caps, which had mixed results over the long term.[11] Any caps would only affect discretionary spending, which accounts for just 28% of federal spending, almost half of which is for defense. The rest is mandatory spending, including Social Security and Medicare (which will account for nearly 35% of federal spending in 2023) and interest on the national debt.[12]

Will there be a resolution? It is impossible to know for sure, but both sides have clearly stated that they will not allow the U.S. government to default on its obligations. However, time is growing short, and any agreement must pass in both the House and the Senate, requiring at least some bipartisan support. Speaker McCarthy has said that an agreement must be reached early enough to give House lawmakers a required 72-hour period to review the legislation before the June 1 deadline.[13] If an agreement is not reached by that time, a temporary measure could suspend or raise the ceiling for a limited period to provide more time for negotiations.

Should investors worry? Although a default could have serious market repercussions, the most likely scenario is that the ceiling will be suspended or raised close to the deadline. If so, any related market volatility is likely to be temporary.[14] While the U.S. debt is a serious issue, your investment strategy should be based on your long-term goals and risk tolerance, and it's generally wise to stay the course through political conflicts.

The principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid. Forecasts are based on current conditions, are subject to change, and may not come to pass.

1, 11, 13) *The New York Times,* May 22, 2023

2, 4, 6, 8) U.S. Treasury, 2023

3) Bipartisan Policy Center, 2023

5, 7, 12) Congressional Budget Office, February 2023

9-10, 14) Moody's Analytics, May 2023
