JOINT ECONOMIC COMMITTEE
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ECONOMICS OF THE FEDERAL DEBT AND THE DEBT LIMIT

The statutory *debt limit* is a cap on the total amount of federal debt the United States government can have outstanding at any given time. According to the Treasury Department, the U.S. government has already reached the current debt limit of $7.384 trillion. While the Treasury is currently using accounting maneuvers to avoid a breach of this limit, these actions are only temporary, and Congress must take action soon to raise the ceiling in order to avoid government default on current obligations. Some observers argue that the need to raise the debt limit is a reflection of fiscal irresponsibility, but as this report explains, the debt limit should not be used as a barometer of economic or fiscal health.

What is the debt limit?

The debt limit is a cap on the total amount of debt the federal government is allowed to have outstanding at any given time. This limit, which is set in law and currently stands at $7.384 trillion, can only be raised with the authorization of Congress. Nevertheless, increases in the debt limit have been routine since 1940. Indeed, in the last 64 years Congress has raised or extended the debt limit nearly 80 times.

Without a debt limit, Congress would be laden with the operationally challenging task of approving each issuance of debt by the Treasury. This is because the authority to borrow money on the full faith and credit of the United States government is vested in the Congress by Article I of the Constitution. In 1917, when planning for World War I required government financing flexibility, Congress passed a law delegating borrowing authority to the Treasury Department, subject to a debt limit.

What is the federal debt?

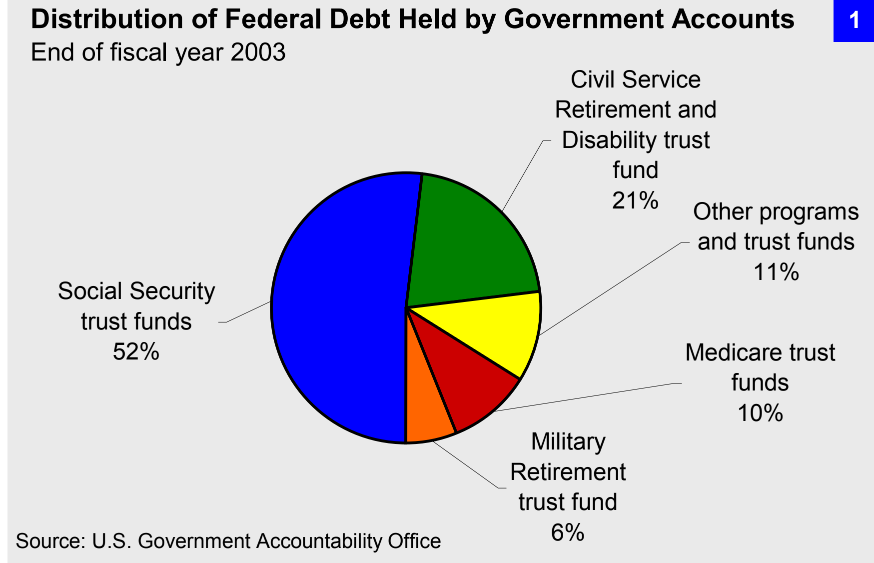
The national debt, or more properly, the *federal debt*, is the total amount of money the government of the United States as a legal entity owes. According to the Treasury Department, this amount currently stands at roughly $7.4 trillion.

However, the actual net debt owed by the federal government is much lower than this sum suggests. This is because not all debt is equal.

Federal debt comes in two types: publicly-held and government-held. *Publicly-held debt* is the total of all federal securities sold to the public (such as T-bills, notes and bonds) that are currently outstanding. At the end of fiscal year 2004, the amount of publicly-held debt equaled $4.3 trillion, or approximately 60% of total federal debt.

In essence, the publicly-held debt represents the net amount borrowed from the general public to finance the federal government's accumulated budget deficits. It is a useful measure because it reflects how much of today's economic resources – resources that could otherwise be used for private investment – are absorbed by the government in order to finance its obligations. Moreover, the interest on that debt, which must be paid regularly, imposes a burden on current taxpayers and impacts the government's flexibility in funding various programs and activities.

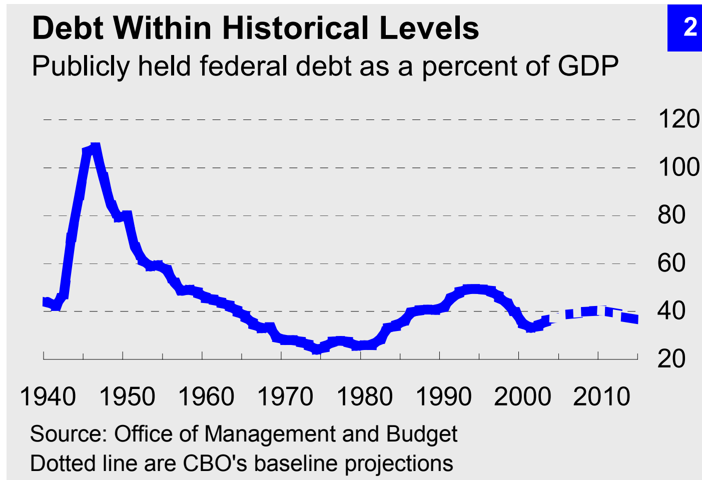
The other type of debt, *government-held debt*, represents amounts loaned from one part of the government to another; in other words, it is debt the government owes itself. At the end of fiscal year 2004, this type of federal debt totaled $3.1 trillion, or 40% of total federal debt.



As shown in Figure 1, this debt is owed primarily to federal trust funds, including the Social Security and Medicare trust funds. By law, when these trust funds run surpluses, the excess cash is transferred to the Treasury's general fund to cover current government expenses, and special, non-marketable federal securities are credited to the trust fund accounts to reflect the transaction. In this sense, this type of debt is largely an accounting mechanism, and counting it as debt is analogous to counting an IOU to oneself as personal debt. As noted by the Congressional Budget Office (CBO), these intergovernmental transfers of "debt" are only "reallocat[ing] costs from one part of the budget to another; they do not change the deficit or the government's federal borrowing needs. Consequently, they have no effect on the economy or the government's future ability to sustain spending at the levels indicated by current policies."[1]

How heavy is the American debt burden?

Due to differences in the economic significance between publicly-held and government-held debt, when economists talk about "the debt" and its current impact on the economy, they are generally referring to the publicly-held portion. As mentioned above, publicly-held debt represented $3.9 trillion, or nearly 60% of total federal debt, at the end of fiscal year 2003. However, even though this smaller figure is a better measure of the government's debt, it alone does not tell us anything about the magnitude of the *debt burden* on the economy.

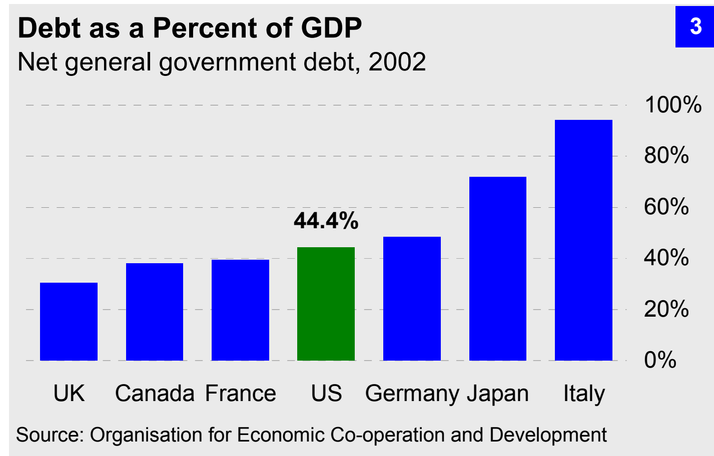


To determine the burden of the federal debt, one should weigh not only the dollar amount of that debt, but also the government's ability to repay it and the economy's ability to absorb it. Thus, economists typically measure the publicly-held debt relative to Gross Domestic Product (GDP), the most commonly used measure of national income.[2]

[1] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*, p. 22.
[2] GDP is the value of all final goods and services produced domestically in a particular year, and it is conceptually equal to incomes earned in production. It is roughly a measure of the government's revenue base.

According to CBO, the publicly-held debt was 37.5% of GDP at the end of fiscal year 2004, a percentage that is still lower than the ratios the U.S. sustained for most of the 1980s and 1990s. Indeed, the debt amounted to almost 43% of GDP as recently as 1998. Since 1940, the highest ratio achieved was 108.6% in 1946. The lowest proportion was 23.9%, reached in 1974. (See Figure 2)

Furthermore, by international standards, the U.S. net general government debt – which includes the consolidated debt of national, state and local governments – as a percentage of GDP is lower than that of many other industrialized countries.[3] As illustrated in Figure 3, the U.S. net government debt-to-GDP ratio of 44% is lower than those of other industrialized countries, including Germany, Italy and Japan.



Is the debt limit a good indicator of fiscal or economic health?

The necessity of raising the federal debt limit says little or nothing about the soundness of U.S. fiscal or economic policy. For one, the debt limit applies to both publicly-held *and* government-held debt, and surpluses in government trust funds can make the total federal debt grow, *even when the government is operating in a surplus*. For example, in fiscal years 1998 through 2001, federal budget surpluses allowed the government to reduce the debt held by the public by $448 billion. However, this debt reduction was more than offset by surpluses in federal trust funds that were credited to debt-holding government accounts (as mentioned above, trust fund surpluses by law must be credited to these accounts through the issuance of special, non-marketable federal securities, which also count as federal debt). These trust fund surpluses, which totaled $853 billion over the same four year period, resulted in the total federal debt increasing by $405 billion.

Second, the debt limit is set in nominal dollars, not as a percentage of GDP. Consequently, the level of the debt ceiling does not convey any information about the nation's ability to repay debt nor the debt's economic impact. In fact, unless Congress raises the debt limit periodically, its real value falls over time. This is because inflation, even low inflation, erodes the value of a dollar.

In summary, the debt limit is not a useful metric of economic health. It merely indicates the maximum amount of debt the Treasury may issue to cover current obligations. It does not measure the actual amount of inflation-adjusted debt outstanding, nor does it indicate how large the actual debt burden is relative to the economy or the federal budget. Trust fund surpluses may require a periodic expansion of the debt limit regardless of the state of the economy or the federal budget.

Despite its shortcomings as a fiscal measure, however, Congress must take action soon to raise the debt limit in order to ensure that the federal government can continue to fund vital federal programs.

[3] Comparative figures with just the federal or national portion are not available.

Further Reading about the Budget

Congressional Budget Office, *The Budget and Economic Outlook: An Update*, September 2004. http://www.cbo.gov/ftpdocs/57xx/doc5773/08-24-BudgetUpdate.pdf

Government Accountability Office, *Federal Debt: Answers to Frequently Asked Questions, An Update*, July 2004. http://www.gao.gov/new.items/d04485sp.pdf

Joint Economic Committee, "What Happened to the Surplus?," September 2004. http://jec.senate.gov/_files/Surplus09202004.pdf

Joint Economic Committee, "Budget Deficit $56 Billion Less than Previously Projected," September 2004. http://jec.senate.gov/_files/CBODeficit092004.pdf

Office of Management and Budget, *Budget of the United State Government, Fiscal Year 2005*. http://www.whitehouse.gov/omb/budget/fy2005/budget.html