



THE DEBT-LIMIT DEBATE 2013: ADDRESSING KEY MYTHS

As federal government borrowing is set to exceed yet another debt limit, most are quick to recall—and wish to avoid a repeat of—the 2011 debt-limit showdown. If current rhetoric is any indication, it appears many of the last debate’s lessons have been forgotten. Regrettably, it seems many of the debate’s *facts* have been forgotten as well.

Below, [Jason Fichtner](#) and [Veronique de Rugy](#), senior research fellows at the Mercatus Center at George Mason University, address some of the most pervasive myths that surrounded the 2011 debt-limit debate and continue to muddle the current debate.

For more information, please see [“The Debt-Limit Debate,”](#) [“The Debt Ceiling: What Is at Stake?”](#) [“The Debt Limit Debate: Addressing Key Concerns,”](#) and [“The Real Debt Crisis: What Can be Done?”](#)

MYTH VS. REALITY

Myth #1: Standard and Poor’s (S&P) US credit rating downgrade in August 2011 was caused by Washington’s brinkmanship over increasing the debt limit. Congress must therefore avoid attaching spending-cut demands to the current debt-limit increase if they want to avoid jeopardizing the nation’s fragile economy.

Reality: Washington’s failure to deal with unsustainable federal spending mostly related to entitlement programs and debt caused the 2011 S&P downgrade and is spurring warnings of another downgrade by the credit rating agencies.

2011 Pre-downgrade Warnings

- On June 21, 2011, [S&P reported](#): “If the U.S. government maintains its current policies . . . it [is] unlikely that Standard & Poor’s Ratings Services would maintain its ‘AAA’ rating on the U.S. government.” From the same report: “One contributing factor in our negative outlook decision is our view that there has, as yet, been no significant progress in addressing these long-term cost drivers nor any consensus developing among the Obama Administration, the Senate, and the House of Representatives regarding the specifics of a comprehensive plan to address the long-term budgetary challenges.”
- On July 14, 2011, [S&P warned](#) it would downgrade US debt if “Congress and the administration have not achieved a credible solution to the rising U.S. government debt burden and are not likely to achieve one in the foreseeable future.”

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2011 Downgrade

- When S&P downgraded the US credit rating, [they cited entitlement spending](#) as a key factor. “In addition, the plan envisions only minor policy changes on Medicare and little change in other entitlements, the containment of which we and most other independent observers regard as key to long-term fiscal sustainability.”

2012/2013 Warnings

- Moody’s Investors Service [assigned a negative outlook for US debt](#), which could lead to a possible downgrade if “there is a weakening in fiscal discipline in the coming year” and “further fiscal consolidation measures are not adopted in 2013.”
- On January 1, 2013, Moody’s said the deal to avoid the fiscal cliff was insufficient to protect the nation’s AAA rating. [It warned](#), “The debt trajectory resulting from this process is likely to determine whether the Aaa rating is returned to a stable outlook or downgraded to Aa1.”
- On July 18, 2013 Moody’s changed the outlook on US Aaa sovereign rating to stable from negative, but also stated that “without further fiscal consolidation efforts, government deficits are anticipated to increase once again over the longer term. If left unaddressed, over time this situation could put the rating again under pressure.”

In their July 2013 rating Moody’s also highlighted the possibility that CBO’s projected 3.4 percent average growth rate for the 2014–2018 period might prove to be optimistic, and that that “the main risk to the CBO GDP forecasts,” which were used as the rationale for changing the outlook from stable to negative, is the possibility that “real GDP growth turns out to be lower than assumed.”

Myth #2: Had Congress and the administration failed to raise the debt limit by the Treasury’s stated deadline in 2011, the Treasury would have been forced to default on the nation’s debt.

Reality: Had the 2011 agreement to increase the debt limit been postponed, [the Treasury could have met federal government obligations](#)—including Social Security benefits and interest on the debt—until the end of the fiscal year, [possibly longer](#).

The Treasury has several financial management options to continue paying the government’s obligations, including:

1. [Prioritizing payments](#)
2. [Taking financial steps](#), including permitting the suspension of investments in, and the redemption of securities held by, certain government Trust Funds or postponing the sale of nonmarketable debt
3. [Liquidating roughly \\$2.0 trillion of assets](#) to pay government bills
4. Using the Social Security Trust Fund to [continue paying](#) Social Security benefits

According to [a report by the Department of the Treasury’s Inspector General](#) (IG), the Treasury “considered a range of options with respect to how Treasury would operate if the debt ceiling was not raised.” Further, the report notes that Treasury officials told the IG that “organizationally they viewed the option of delaying payments as the least harmful among the options under review” and that “the decision of how Treasury would have operated if the U.S. had exhausted its borrowing authority would have been made by the President in consultation with the Secretary of the Treasury.”

Myth #3: If Washington agreed to significant spending reforms and cuts—and then actually followed through on them—it would cripple the recovery and devastate the economy.

Reality: The most dangerous thing Washington can do is continue on its current course. [The economic literature is clear](#): chronic overspending and its result, chronic excessive debt, lead to economic harm. Washington must agree on meaningful spending reforms—and begin implementing these policies immediately to satisfy markets about the credibility of spending cuts.

Myth #4: The real problem with [the last debt-limit deal](#) was that it failed to apply a “balanced approach” of spending cuts and tax increases.

Reality: Replacing borrowing with higher taxes does not solve the fundamental problem: federal spending—including Social Security, Medicaid, and especially Medicare—is unsustainable.

- [Past experiences](#) have shown that in the so-called balanced approach, taxes go up but [spending fails to go down](#).
- Fiscal adjustments based on spending cuts are [more likely to reduce deficits](#) and debt-to-GDP ratios than those based on tax increases. In addition, adjustments in spending rather than taxes are less likely to create recessions.
- Fiscal reform that focuses on large revenue increases and modest spending reductions is [likely to inflict the most damage on the economy](#).
- A [study of 21 countries](#), looking at 37 years of data representing 107 episodes of fiscal reform, shows that reform efforts that focus on a package of both spending and revenue reductions [tend to be much more effective](#) than those that have modest spending reductions but continue to increase revenue.
- Of more than 100 attempts to reduce the debt-to-GDP ratio in all developed countries over the past 30 years, some 20 percent succeeded. [They had two common components](#): 1) a focus on spending cuts and 2) policy reforms that increase competitiveness.

Myth #5: Interest rates on public debt declined in the wake of the 2011 downgrade. This suggests that the United States can retain its global creditworthiness, regardless of its credit ratings or debt levels.

Reality: Interest rates are artificially low today because the Federal Reserve is keeping rates low in hopes of boosting the economy and because other countries are in even worse fiscal shape than the United States. This extraordinary situation is not sustainable in the long term. If Washington does not act to significantly improve the federal government’s dire fiscal outlook, its creditors will demand higher interest rates to continue lending, and the already unsustainable budget and economic situation will worsen.

- A Mercatus Center [study](#) by economist Arnold Kling finds that “interest rates are affected by perceived risk,” or the level of confidence in the financial entity. In a high-confidence state, creditors tend to think the institution to which they are lending is credible and stable

and will thus accept a lower return on their investment. In a low-confidence state, creditors require a higher return on investment, or a risk premium.

- An [analysis of a panel](#) of Organization for Economic Co-operation and Development (OECD) countries from 1960 to 2002 shows that interest rates, particularly those of long-term government bonds, decrease when countries' fiscal positions improve and increase during periods of budget deteriorations.
- [According to the Congressional Budget Office](#) (CBO), revenues are projected to rise slightly above the long-term average rate of 18 percent of GDP and eventually projected to stabilize around 19 percent of GDP by 2023. However, spending is projected to grow much faster, exceeding 22 percent of GDP by then. Hence, if current spending policies remain in place, the gap between revenues and spending on government benefits and services would continue to grow, adding to the already large public debt. "Under current law, the government's net interest spending will more than double as a share of GDP in the coming decade—from 1.4 percent in 2014 to 3.2 percent in 2023." Even worse, [as CBO also points out](#),

Such high and rising debt later in the coming decade would have serious negative consequences: When interest rates return to higher (more typical) levels, federal spending on interest payments would increase substantially. Moreover, because federal borrowing reduces national saving, over time the capital stock would be smaller and total wages would be lower than they would be if the debt were reduced. In addition, lawmakers would have less flexibility than they would have if debt levels were lower to use tax and spending policy to respond to unexpected challenges.