

## Change the Trajectory of Debt

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Hearing: The Effect of Borrowing on Federal Spending

Chairman Paul, Ranking Member Peters, and members of the subcommittee:

Thank you for the opportunity to testify today.

After briefly looking at how we arrived where we presently are, I would like to make the following points:

- 1) High and increasing debt has adverse consequences for our economy.
- 2) At the minimum, Congress should look for institutional reforms (such as credible budget caps and a BRAC commission for discretionary spending) that would be a first step to addressing our long-term debt problem as a condition to raising the debt ceiling.
- 3) Optimally, Congress would reform the drivers of our future debt as it raises the debt ceiling, ending a cycle of pushing the unsustainability of the federal government, punishing taxes, and slower growth onto future generations.
- 4) There are a few measures the Department of the Treasury can take, and there are sufficient assets available to prevent a default for several months, which should give Congress and the administration some time to reach an agreement that reflects the commitment to implement reform.

### THE INCREASING FEDERAL DEBT

The origins of the federal government's statutory debt limit can be traced back to 1917, when the country was borrowing money to finance the First World War.<sup>1</sup> Limitations on federal borrowing were intended to control congressional spending by limiting the amount of debt that the federal government could accumulate. Policymakers have routinely pushed the debt limit ever higher with the passage of time. Indeed, the limit has been increased almost

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<sup>1</sup> D. Andrew Austin, "The Debt Limit: History and Recent Increases," Congressional Research Service, October 1, 2015, 5.

21 times between 1993 and 2015,<sup>2</sup> including the Bipartisan Budget Act of 2015 passed in October 2015 that suspended the debt limit until March 15, 2017.<sup>3</sup> During that time, the federal debt ballooned from less than \$5 trillion in 1993 to \$19.9 trillion as of February 2017.<sup>4</sup>

As of March 16 of this year, a new debt limit has been established to reflect the additional borrowing that took place during the suspension and through March 15, 2017. From this point on, “Treasury will, from that date forward, have no room to borrow under standard operating procedures. Therefore, to avoid breaching the ceiling, the Treasury would begin taking the extraordinary measures that would allow it to continue to borrow for a limited time,” according to the Congressional Budget Office (CBO).<sup>5</sup>

It is worth noting that the 2015 suspension of the debt limit was part of a deal to increase spending (for the second time) above what was intended by caps implemented by the Budget Control Act of 2011. Despite the popular perception of Republicans and Democrats caught in gridlock, the truth is that after the political dust settles, the end result is always the same: a bipartisan agreement on more spending and more debt.

This needs to change. According to the most recent ten-year fiscal forecast from the Congressional Budget Office, federal outlays remain near 21 percent of GDP for the next few years—higher than their average of 20.2 percent over the past 50 years. Also, if current laws generally remained the same, growth in outlays would outstrip growth in the economy, and outlays would rise to 23.4 percent of GDP by 2027.

CBO projections also show that federal debt held by the public will reach 77.5 percent by the end of 2017. It is expected to grow from \$14.8 trillion this year to \$24.8 trillion by 2027. Gross debt will reach \$20.3 trillion at the end of this year and total \$27.5 trillion at the end of 2027.

That’s probably an underestimate, since it is a projection based on the assumption that promises to cut spending and raise taxes will be kept. Based on Congress’s termination of the sequester years ahead of schedule and its historical propensity to spend more and more each year, this is unlikely. The projections also assume that the economy will grow at current projected rates and without any recessions. This too is unlikely, because the economy, historically, has cycled into recession every five to six years.

Deficits are projected to balloon from \$559 billion in 2017 to \$1.4 trillion in 2027. Over the coming decade, the size of the federal deficit will double to reach an almost annual gap of 5 percent of GDP in 2027. CBO predicts that cumulative deficits will total \$10 trillion between this year and 2027.

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<sup>2</sup> D. Andrew Austin, “The Debt Limit Since 2011,” Congressional Research Service, March 14, 2017, 5.

<sup>3</sup> Veronique de Rugy, “Budget Deal Is Business-as-Usual in Washington,” Mercatus Center at George Mason University, November 18, 2015.

<sup>4</sup> Department of the Treasury, “Monthly Statement of the Public Debt of the United States, February 28, 2017,” table I—Summary of Treasury Securities Outstanding.

<sup>5</sup> Congressional Budget Office, “Federal Debt and the Statutory Limit, March 2017,” March 7, 2017.

The projected explosion of spending from programs such as Social Security, Medicare, and Medicaid will trigger even higher levels of debt in the years outside the 10-year budget window.

The growth in spending on mandatory programs—such as Medicare, Medicaid, Affordable Care Act subsidies, and Social Security—is the driving force behind this spending growth and our exploding debt. In 2017, spending on those programs will reach \$2.1 trillion, or 54 percent of total spending.

Unfortunately, as the debt grows, so too will the interest payments on that debt. Debt payments, which were \$270 billion in 2017, are currently projected to increase to \$768 billion in 2027. If the United States doesn't change course, debt will end up as one of the federal government's biggest budget items. Our unfunded liabilities keep going up, too. The net present value of the promises made to the American people that the United States does not have the money to pay is roughly \$75.5 trillion, according to the Treasury Department.

Even leaving aside the fact that the federal budget isn't sustainable on its current trajectory, high debt levels are problematic. As CBO explained a few years ago:

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 was 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. Finally, a large debt increases the risk of a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates.<sup>6</sup>

These numbers should be at the forefront in any discussion about the need to raise the debt ceiling again.

#### WHAT'S AT STAKE

The debt ceiling will need to be raised in the near future. As such, we can expect Washington to have the same debate it has had for the last few years about whether or not to raise the debt ceiling and under what circumstances. On one side, you will find those who want to raise the limit with no conditions. On the other side, you will find those who will demand reforms in exchange for yet another increase in the debt ceiling.

Default should not be an option on the table. However, raising the debt ceiling without a commitment to improve our long-term debt problem has adverse consequences. In 2011, the

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<sup>6</sup> Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 2013.

rating agency Fitch Ratings warned the US government that while it wanted the debt ceiling to be raised, it also wanted the government to come up with a credible medium-term deficit-reduction plan.<sup>7</sup> Other rating agencies at the time also warned the United States of the negative consequences of not dealing with the country's long-term debt.

The federal budget is unsustainable. According to economist Paul Winfree, this unsustainability is driven by 2 percent of nearly 1,800 spending accounts funding all government activities—mainly public healthcare programs administered by the Department of Health and Human Services and benefits paid by the Social Security's Old-Age and Survivors Insurance Trust Fund.<sup>8</sup> The spending on those accounts is about 60 percent of gross spending over 10 years. It is currently projected to keep increasing faster than GDP, but this cannot sustainably continue indefinitely.

This makes it incredibly important to address our country's long term debt problem. A delay in dealing with this underlying unsustainability will severely restrict our future fiscal choices and make it very hard to respond to emergencies.

With that in mind, the need to raise the debt ceiling offers a great opportunity to demand that Congress take some steps toward a more fiscally responsible future. Optimally, the White House, Congress, and Treasury will raise the debt limit while Congress passes and the president signs a credible plan to reduce near-and long-term spending at the same time.

It takes some time to come up with such a plan. Fortunately, this administration acknowledges that the United States need not risk defaulting on its debt while it figures out what reforms can be adopted as part of a debt ceiling deal. The Treasury Department has the legal authority to use extraordinary measures to prioritize interest payments on the debt above all else, thus avoiding a default.

As was the case in 2011, the United States will have enough expected cash flow (tax revenue) and assets on hand to avoid either of these unattractive options. Managing payments in this manner is by no means optimal, and Treasury officials have indicated that this will be difficult owing to payment automation. That said, it is important to recognize the options that are available to prevent a default. While Washington has difficult choices to make, defaulting on its debt obligations is not one of them, such a step should not be a consideration in the current or foreseeable discussion about how to handle the debt limit or reduce long-term government spending.

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<sup>7</sup> Veronique de Rugy, "Policy Implications of the S&P Warnings," *The Corner, National Review Online*, July 22, 2011. Also see Jeannette Neumann, "Fitch Unveils Two Possible Routes to Downgrading US Debt Rating," *Wall Street Journal*, January 15, 2013.

<sup>8</sup> Paul Winfree, "Causes of the Federal Government's Unsustainable Spending" (Backgrounder No. 3133, Heritage Foundation, Washington, DC, July 7, 2016).

## REAL INSTITUTIONAL REFORM

We can predict that in the coming months the heated rhetoric about whether Congress should raise the debt ceiling will obscure the federal government's real problem: an unprecedented increase in government spending and the future explosion of entitlement spending has created a fiscal imbalance today and for the years to come. No matter what Congress decides to do about the debt ceiling, the United States must implement institutional reforms that constrain government spending and return it to a sustainable fiscal position.

Real institutional reforms, as opposed to one-time cuts, would change the trajectory of fiscal policy and put the United States on a more sustainable path. Such reforms could include:

1. **A constitutional amendment to limit spending.** The inability of lawmakers to constrain their own spending makes spending limits enforced through the US Constitution preferable.<sup>9</sup>
2. **Meaningful budget reforms that limit lawmakers' tendency to spend.** In the absence of constitutional rules, budget rules should have broad scope, few and high-hurdle escape clauses, and minimal accounting discretion.<sup>10</sup>
3. **The end of budget gimmicks.** Creative bookkeeping is at the center of many countries' financial troubles. Congress should end abuse of the emergency spending rule, reliance on overly rosy scenarios, and all other gimmicks and institute a transparent budget process.<sup>11</sup>
4. **A strict cut-as-you-go system.** This system should apply to the entire federal budget, not just to a small portion of it. There should be no new spending without offsetting cuts.<sup>12</sup>
5. **A BRAC-like commission for discretionary spending.** Commissions composed of independent experts often tackle intractable political problems successfully.<sup>13</sup>

## REAL ENTITLEMENT REFORMS

Some members of Congress believe that we can stabilize our debt problems by raising taxes, preferably on the wealthiest Americans. However, the math doesn't add up. Other members believe that we can make the budget more sustainable by simply reducing nondefense discretionary spending, engaging in regulatory reforms, and cutting taxes. While there is

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<sup>9</sup> David M. Primo, "Constitution is Only Way to Cut US Deficit," *Bloomberg*, February 24, 2011.

<sup>10</sup> David M. Primo, "Making Budget Rules Bite" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, March 2010).

<sup>11</sup> Veronique de Rugy, "Budget Gimmicks or the Destructive Art of Creative Accounting" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2010).

<sup>12</sup> Veronique de Rugy and David Bieler, "Is PAYGO a No-Go?" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, April 2010).

<sup>13</sup> Jerry Brito, "The BRAC Model for Spending Reform" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, February 2010).

some merit to doing all these things, it won't be enough to address the unsustainability of our fiscal outlook.

As I mentioned earlier, the drivers of our future debt are spending on Medicare, Medicaid, and Social Security. Without reforms today, vast tax increases will be needed later to pay for the unfunded promises made to a steadily growing cohort of seniors. For instance, looking only at the excess spending growth in Medicare and Medicaid, Katherine Baicker and Jonathan Skinner find that “if spending growth is completely funded through tax increases, by 2060 GDP would be reduced by between 5 percent and 11 percent, depending on the future tax changes.”<sup>14</sup>

While there is some disagreement among economists when it comes to fiscal policy prescriptions, a consensus has emerged recently that spending-based fiscal adjustments are not only more likely to reduce the debt-to-GDP ratio than tax-based ones, but they are also less likely to trigger a recession.<sup>15</sup> In fact, if accompanied by the right type of policies (especially changes to public employees' pay and public pension reforms), spending-based adjustments can actually be associated with economic growth.

Fortunately, numerous workable solutions are available to lawmakers, including adding a system of personal savings accounts to Social Security, liberalizing medical savings accounts, and making the latter permanent to reduce healthcare costs by increasing competition between providers and making consumers more responsive to tradeoffs.<sup>16</sup>

These options would encourage families to save more and use their money more responsibly, in a manner more consistent with their long-term needs. And because taxpayers remain in control of their wealth, they can bequeath any surplus to their heirs—giving the next generation a head start when it comes to building assets.

Better yet, we should free the healthcare supply from the many constraints imposed by federal and state governments and the special interests they serve.<sup>17</sup>

The stakes are high: Bringing revolutionary innovation to this industry could mean not just bending the healthcare cost curve but breaking it to bits—making the need for health insurance much less important if not moot in many cases.

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<sup>14</sup> Winfree, “Causes of the Federal Government’s Unsustainable Spending,” 17.

<sup>15</sup> Veronique de Rugy, “The Effect of Tax Increases and Spending Cuts on Economic Growth” (Testimony before the Senate Budget Committee, Mercatus Center at George Mason University, Arlington, VA, May 22, 2013).

<sup>16</sup> Chris Edwards and Tad DeHaven, “War between the Generations: Federal Spending on the Elderly Set to Explode” (Policy Analysis No. 488, Cato Institute, Washington, DC, September 16, 2003).

<sup>17</sup> Robert Graboyes, *Fortress and Frontier in American Health Care* (Arlington, VA: Mercatus Center at George Mason University, 2014).

## REVENUE AND ASSETS AVAILABLE TO FUND OUR COMMITMENT UNTIL AN AGREEMENT IS REACHED

When the government reaches the debt ceiling and the Treasury is no longer able to issue federal debt, the federal government could reduce spending, increase federal revenues by a corresponding amount to cover the gap, or find other funding mechanisms. This would allow time for Congress and the president to reach an agreement to make some important policy changes to change the debt trajectory we are on.

At that time, the Department of the Treasury will have several financial management options to continue paying the government's obligations. These include (1) prioritizing payments;<sup>18</sup> (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;<sup>19</sup> (3) liquidating some assets to pay government bills;<sup>20</sup> and (4) using the Social Security Trust Fund to continue paying Social Security benefits.<sup>21</sup>

## PRIORITIZING PAYMENTS

The secretary of the treasury has long-standing authority to prioritize payments and does not have to pay bills in the order in which they are received. The Government Accountability Office found that

the Secretary of the Treasury has the authority to determine the order in which obligations are to be paid should the Congress fail to raise the statutory debt ceiling and revenues are inadequate to cover all required payments. There is no statute or other basis for concluding that the Treasury must pay outstanding obligations in the order they are presented for payment. Treasury is free to liquidate obligations in any order it determines will best serve the interests of the United States.<sup>22</sup>

According to a report by the Department of the Treasury's Inspector General (IG), during the 2011 debt ceiling crisis, 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

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<sup>18</sup> Jason J. Fichtner and Veronique de Ruy, "The Debt Ceiling: What Is at Stake?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2011).

<sup>19</sup> Jason J. Fichtner and Veronique de Ruy, "The Debt Limit Debate" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, May 2011).

<sup>20</sup> Fichtner and de Ruy, "The Debt Ceiling: What is at Stake?"

<sup>21</sup> The Social Security Trust Funds can only be used to pay Social Security benefits. See Glenn Kessler, "Can President Obama Keep Paying Social Security Benefits Even If the Debt Ceiling Is Reached?," *Washington Post*, July 13, 2011; Contract with America Advancement Act of 1996, Pub. L. No. 104-121, 110 Stat. 847 (1996).

<sup>22</sup> Government Accountability Office, letter to Senator Bob Packwood, October 9, 1985.

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.”<sup>23</sup>

#### TEMPORARY MEASURES

During the last debt ceiling debate in 2011, my colleague Jason Fichtner and I listed all the assets that Treasury could tap into to avoid a default until the president and Congress reached an agreement.<sup>24</sup> For instance, we found that Treasury was expected to collect \$2.6 trillion in revenue. As we explained:

That alone would be enough to cover interest on the debt (\$218 billion), thereby avoiding any technical default of the US government on its debt obligations to Social Security (\$809 billion), Medicare (\$581 billion), and Medicaid (\$267 billion), and it would leave approximately \$725 billion for other priorities.

In addition, we noted that the Department of the Treasury had financial measures at its disposal to fund government operations temporarily without having to issue new debt. To be clear, our list was only meant to present the range of possible options available to Congress. And as we noted then, they may well be neither good nor desirable options. These assets totaled \$1.9 trillion and included \$50.2 billion in nonrestricted cash on hand,<sup>25</sup> \$121.1 billion in restricted cash and other monetary assets (gold, international monetary assets, and foreign currency),<sup>26</sup> or the redemption of existing investments in other trust funds.<sup>27</sup>

We also noted that the government could rely on the determination of a “debt issuance suspension period.” This determination would permit the redemption of existing, and the suspension of new, investments of the Civil Service Retirement and Disability Fund (CSRDF).<sup>28</sup> The latest data show \$858.7 billion in intergovernmental holdings in the CSRDF.<sup>29</sup>

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<sup>23</sup> Department of the Treasury, Office of Inspector General, letter to Senator Orrin G. Hatch, OIG-CA-12-006, August 24, 2012.

<sup>24</sup> Jason J. Fichtner and Veronique de Rugy, “The Debt Ceiling: Assets Available to Prevent Default” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2013).

<sup>25</sup> Department of the Treasury, “Daily Treasury Statement,” January 14, 2013.

<sup>26</sup> Department of the Treasury, “2012 Financial Report of the US Government,” 2013, 65. Note: At the time, the Treasury owned approximately 261.4 million ounces of gold and marked the value of its gold holdings at \$42 per ounce, giving a reported value of \$11.1 billion. At a spot market price of \$1,500 per ounce, Treasury’s gold holdings could be valued near \$400 billion.

<sup>27</sup> Department of the Treasury, “Monthly Statement of the Public Debt of the United States, December 31, 2015.”

<sup>28</sup> In September 1985, the Treasury took the step of disinvesting the Civil Service Retirement and Disability Trust Fund, the Social Security Trust Funds, and several smaller trust funds.

<sup>29</sup> Office of Personnel Management, “Civil Service Retirement and Disability Fund Annual Report: Fiscal Year Ended September 30, 2015,” January 2016.



Today, the numbers are different, but the same assets may be used to avoid a default, as confirmed by CBO.<sup>30</sup> Relying on any of these sources of funds or increasing the debt ceiling without reducing existing budget commitments illustrates the irresponsibility of the path the country is on and the urgent need for institutional spending reform. Nonetheless, these assets could be used as a temporary measure to allow Congress and the administration to negotiate spending reductions and institutional reforms to the budget process to ensure the nation is put back on a sound fiscal path.

Thank you. I am happy to take your questions.

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<sup>30</sup> Congressional Budget Office, “Federal Debt and the Statutory Limit, March 2017.”