Center for American Progress

U.S. Debt Limit 101

What You Need to Know About the Federal Debt Limit

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Over the past decade, the U.S. Department of the Treasury has borrowed trillions of dollars to finance military interventions in two countries, unfunded tax cuts, and, most recently, efforts to rescue our financial system from collapse and help our economy recover from the Great Recession. But there is a limit to this borrowing, which the Treasury expects to reach by no later than early July.

As this debt-limit deadline approaches, the American people are wondering what the effects will be should Congress not raise the debt limit. This Debt Limit 101 briefly outlines everything you need to know about our debt limit, as well as the potential consequences of failing to raise it.

What is the national debt?

When the federal government spends more money than it receives through tax revenue, it needs to cover the difference by borrowing. The total amount that the federal government cumulatively borrows over time, minus what it pays back, is the national debt. Simply, it is the sum of what the federal government owes to its creditors.

When the government spends less money than it collects in revenue, it runs a surplus. In years when there is a surplus, such as what happened between 1998 and 2000 under President Bill Clinton, the surplus money can be used to reduce the national debt. The key to this achievement in the 1990s was a bipartisan consensus on the need for both strategic, long-term spending reductions and revenue increases.

There are two major measures of our national debt: publicly held debt and gross federal debt. Publicly held debt refers to the total amount of money the federal government borrows from the public through the issuance of U.S. Treasury bonds, bills, notes, and other government debt instruments. But the federal government can also borrow from itself. Case in point: Excess payroll tax revenue that is not used to pay for Social Security is placed in the Social Security Trust Fund. This fund can then lend that money to the rest of the federal government by buying special government debt securities, similar to a government bond. The federal government is obligated to pay interest on these loans and pay it down in full when the funds are needed to pay out Social Security benefit payments.

The gross federal debt includes total publicly held debt and the total amount of debt it accumulates through borrowing from itself, commonly referred to as "intragovernmental borrowing." At the end of fiscal year 2010, total gross federal debt stood at approximately $14.1 trillion, of which $9.4 trillion was publicly held by U.S. and foreign investors, mostly Japan and China, with the remaining creditors primarily consisting of the U.S. Civil Service Retirement Fund, the Social Security Trust Fund, and the U.S. Military Retirement Fund.

Simply looking at the dollar amounts of our national debt, however, can be misleading. More than $9 trillion certainly sounds like a lot, but what matters is our ability to pay back that money. That's why the best way to understand the magnitude of the national debt is by comparing it to the total amount of economic activity in any given year. This is known as the debt-to-GDP ratio. By this measure, total publicly held debt is currently about 62 percent of gross domestic product, the highest level since 1955.

What is the debt limit?

The debt limit is a cap that Congress sets on the total amount of money the federal government can borrow. The first debt limit was set in 1917 when Treasury, on behalf of the federal government, was borrowing to finance the First World War. Up until this time, Treasury had to obtain the permission of Congress each time it wanted to issue different types of debt instruments. The 1917 legislation gave the department greater discretion to issue bonds on behalf of the federal government without needing to obtain the permission of Congress each time it chose to do so.

But to maintain some degree of oversight, Congress placed limits on the total amount the Treasury could borrow without requiring additional authorization from Congress. This debt limit exists to this day.

Why do we have one?

In theory, the debt limit provides Congress greater control over the national debt. In practice, however, the level of debt is a function of the budgets that Congress itself approves. No other country has a debt limit separate from its budget process.

A report released recently by the Government Accountability Office, the investigative arm of Congress, notes that credit rating agencies view this disconnect between fiscal policy decisions (taxing and spending decisions) and debt limit decisions as a "weakness in the U.S. budgetary framework."

How big is the debt limit and when will we reach it?

The current debt limit is $14.294 trillion. As of February 28, the total outstanding debt of the federal government was approximately $100 billion shy of the debt limit. The U.S. Treasury Department estimates that we may reach the current debt limit by as early as May 16 of this year.

How many times has Congress increased the debt limit?

Since 1962, the debt limit has been increased 74 times by Congress, and 10 of those increases have taken place in the past 10 years—with the debt limit increasing from $5.95 trillion in 2000 at the end of the Clinton presidency to the present level of $14.29 trillion. During President Bush's full eight-year term, the national debt increased by about $4.96 trillion to a total of about $10.6 trillion (for more, see here), a 75 percent increase over that period. This was due to weak economic growth, a decline in tax revenue following the 2001 and 2003 Bush tax cuts, and increased spending associated with the wars in Iraq and Afghanistan and the passage of a new prescription drug benefit program.

The national debt then increased under President Obama by approximately $3.5 trillion as his administration inherited the costs of rescuing the U.S. financial system and fought to prevent a second Great Depression upon taking office. Had he not inherited these twin crises, Obama's first years in office would have neither seen a sharp drop in tax revenue due to the rapid spike in job losses, nor have required increases in government spending on unemployment insurance, food stamps, Social Security insurance, and other parts of the social safety net that stabilize the economy during downturns.

But President Obama did take office as tax revenue fell and automatic government spending soared alongside new spending needed to rescue the U.S. economy. And he also inherited large, unfunded spending commitments made by his predecessor and higher interest payments on the debt associated with greater borrowing.

So what will happen if we don't raise the debt limit?

First, to maintain interest and principal payments on our debt in the absence of an increase to the debt limit would require drastic and immediate cuts in federal government spending that would hurt the U.S. economy and our country in general. To make sure we do not hit the debt limit, the federal government would need to cut a substantial amount from all spending. This could result in large job losses as public spending would fall sharply on everything from construction projects to social programs to government-sponsored research and development.

This would happen because government-funded programs would have to be cut dramatically, government-funded projects would halt mid-stream, and numerous other drastic cuts would lead to a swift reduction in overall economic activity. All of this would occur during a period in which unemployment remains at historically high levels.

Second, failure to raise the debt limit even if we continue making interest and principal payments on our debt could hurt confidence that investors have in the federal government. Investors might lose faith in the federal government's ability to come together on other important issues, such as dealing with the deficit and charting a path to a balanced budget. This could lead to significantly higher interest rates, the cost of which would be borne by all taxpayers as well as businesses and consumers—all of whom would also face higher borrowing costs as confidence in the United States eroded.

But with levels of government debt already high, isn't it bad to raise the debt limit?

No. The current federal debt is high, and steps need to be taken to reduce it over time, but raising the debt limit itself does not raise the deficit or create new items of government spending. Congress controls spending through its "power of the purse."

Indeed, increasing the debt ceiling this year is necessary because of the fiscal year 2011 federal budget passed by Republicans and Democrats in both chambers of Congress and signed into law on April 15 to pay for government spending through September of this year.

Have we ever failed to raise the debt limit before?

No, the U.S. government has never failed to raise the debt limit when necessary and has never defaulted on its debt obligations.

Some lawmakers have threatened to not raise the debt limit if we don't enact spending cuts now. Is there anything wrong with this?

Yes. Simply threatening to deny an increase to the debt limit, even if the threat does not materialize, can lead our creditors to demand higher interest rates in order to lend us money.

Threats to deny an increase to our debt limit make it impossible for the U.S. Treasury to ensure that future bond issuances are predictable and regular. The Treasury does not "time the market" by issuing bonds when interest rates are low, but, instead, lowers the cost of its debt by pre-announcing future issuances of bonds. If lawmakers threaten to not raise the debt ceiling, future Treasury borrowing will be perceived as unpredictable, which will further increase interest rates on our public debt.

Research shows that when the Republicans threatened to not raise the debt limit during the Clinton administration in the 1990s, our creditors became concerned and demanded higher interest rates on Treasury bonds. At the time, both Standard & Poor's and Moody's, credit rating agencies that rate the safety and security of corporate and government debt issued a warning of heightened default risk of the United States. Moody's even threatened to downgrade the credit rating of the U.S. government.

Conclusion

Republicans and Democrats in Congress must come together to raise the debt limit. But it is important not only that we raise the debt ceiling, but also do so with broad, bipartisan support that will send an important signal to the financial markets that both political parties are still able to work together to ensure that the United States is one of the most stable and secure destinations in which to invest. More importantly, a bipartisan decision to increase our debt limit will prove that our government is capable of charting a clear path to deficit reduction and a balanced budget over time.