Statement before the Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Policy
On The Federal Debt Limit and its Economic and Financial Consequences

Default and near-default are dangerous

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Chair Warren, Ranking Member Kennedy, and Members of the Committee, thank you for the opportunity to offer testimony on the dangers of default and near-default. It is an honor.

Running up to the eleventh hour to raise the debt ceiling would be a substantial market and economic event that would leave U.S. taxpayers on the hook for billions of dollars of additional interest payments. Actually defaulting on federal spending obligations — including under a plan of prioritizing payments such that bondholders would still get paid what they are owed — would cause even more damage to the economy and to U.S. workers and households.

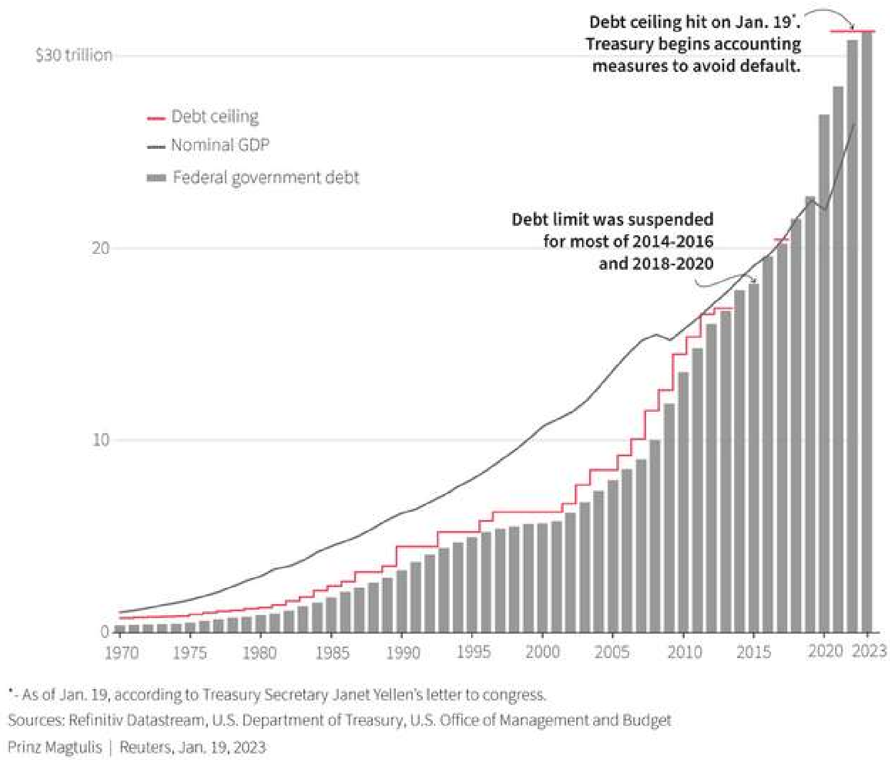
The level of projected future federal spending is much too high and will inflict damage on the economy. Current debt and deficits are having a negative effect on the economy, as well. Members of Congress in both parties should address this issue. But running up to the eleventh hour to increase the debt ceiling is too dangerous a tactic to use as leverage.

DEBT CEILING INCREASES ARE TYPICALLY NOT CONTROVERSIAL

The debt ceiling has been raised dozens of times over the past several decades, and has typically not been a source of political interest.

Raising the debt ceiling should be thought of as a routine function of government — and, in fact, it typically is treated by Congress as a routine function of government. Congress determines spending levels, and by setting tax rates and deciding the tax base, Congress implicitly determines revenue levels. Therefore, Congress implicitly determines the budget deficit. By raising the debt ceiling, Congress is simply giving the Department of the Treasury the authority to execute spending laws consistent with the borrowing needs that Congress has already implicitly set.

Figure 1: Previous debt ceiling increases and debt levels[1]



NEGATIVE CONSEQUENCES FROM BRUSHING UP AGAINST DEFAULT

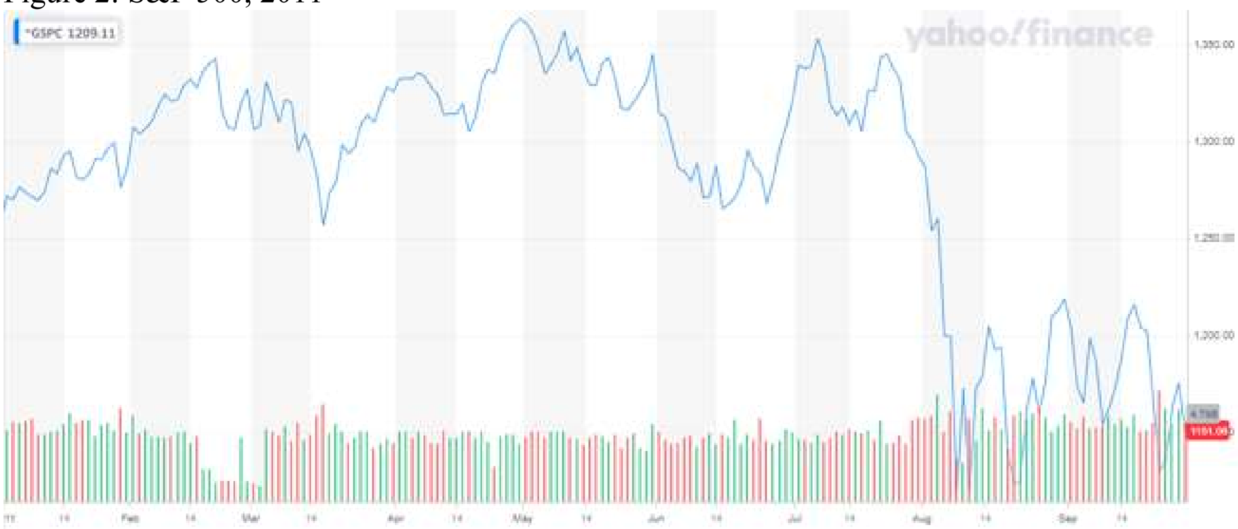
Brushing up against default would have serious and adverse economic effects. It would lead to reductions in stock prices, reducing the wealth of many taxpayers. It would reduce economic confidence, which in turn could reduce consumer spending. It would increase interest rates, leaving taxpayers on the hook for billions of dollars of interest payments. And it would increase the odds of an accidental default.

On the day before a deal was reached during the 2011 debt ceiling standoff, the S&P 500 was down 6 percent from its high that year. Four days later, credit rating

[1] Source: "A looming U.S. debt ceiling fight is starting to worry investors," Reuters, January 19, 2023.

agency Standard & Poor's downgraded the United States' credit rating, sending stock prices tumbling further. At its low point during this episode, the S&P 500 lost around 15 percent of its value.

Figure 2: S&P 500, 2011



The 2011 debt ceiling standoff sent economic confidence down to levels not seen since the 2008 global financial crisis. This matters because consumers' outlook for the economy has an effect on consumer spending. When consumers are pessimistic about the economy, they spend less, and since consumer spending is the main driver of the overall economy, consumer pessimism slows overall economic growth.

Figure 3: Gallup U.S. Economic Confidence Index

Even though a resolution was reached in 2011 in time for the U.S. not to miss any payments, the episode still drove up interest rates, costing taxpayers $1.3 billion in 2011, according to the Government Accountability Office.[2] The ten-year cost was estimated at around $19 billion.[3]

Running up to the eleventh hour runs the risk of the U.S. accidentally missing payments. Accidents can happen. In the spring of 1979, Congress reached a debt ceiling deal at the last minute, but a subsequent computer glitch meant that Treasury was late in making payments on maturing securities to individual investors and in redeeming Treasury bills. Economists Terry L. Zivney and Richard D. Marcus estimate that, as a consequence, T-bill rates at the initial occurrence of the default increased by 60 basis points, and that this increase was not offset by subsequent decreases after Treasury had fixed the default.

Zivney and Marcus conclude: “The default apparently warned investors that Treasury issues were not completely riskless, which translates into a $12 billion annual increase in federal

[2] U.S. Government Accountability Office, Report to Congress, “Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs,” July 2012.
[3] Collins, Brian, Shai Akabas, and Loren Adler, “Debt Limit Reinstated at $16.7 Trillion: Updated X Date Estimate,” Bipartisan Policy Center, May 23, 2013.

interest payments as a result of the 60 basis point permanent increase in interest rates."[4]

DEFAULTING WOULD BE EVEN WORSE

Actually missing a payment to a bondholder — actually defaulting, as opposed to running up to the eleventh hour and lifting the debt ceiling in the nick of time — would have consequences that would be much more severe than occurred in 2011 or 1979. The Dow would plunge by thousands of points per day, and the credibility of the United States — its trustworthiness as a country that pays its debts on time — would be substantially eroded. The beginnings of a global financial crisis would take hold as the riskiness of Treasuries increased and market liquidity dried up. After a day or two of this chaos, a clean bill to increase the debt ceiling would pass both houses of Congress with overwhelming bipartisan support.

Staying current on payments to bondholders while not executing other spending — *e.g.*, not paying full Social Security benefits or not funding components of discretionary spending at levels required by law as part of a plan to prioritize payments while not increasing the debt ceiling — would likely provoke a reaction similar to defaulting on U.S. debt obligations. The message Congress and the President would be sending to global markets would be that the U.S. government is unable to meet its spending obligations due to political dysfunction. Among global debt and equity investors, this would shake confidence in the U.S. in a very fundamental way.

[4] Zivney, Terry L. and Richard D. Marcus, "The Day the United States Defaulted on Treasury Bills," *The Financial Review*, vol. 24, no. 3, August 1989.

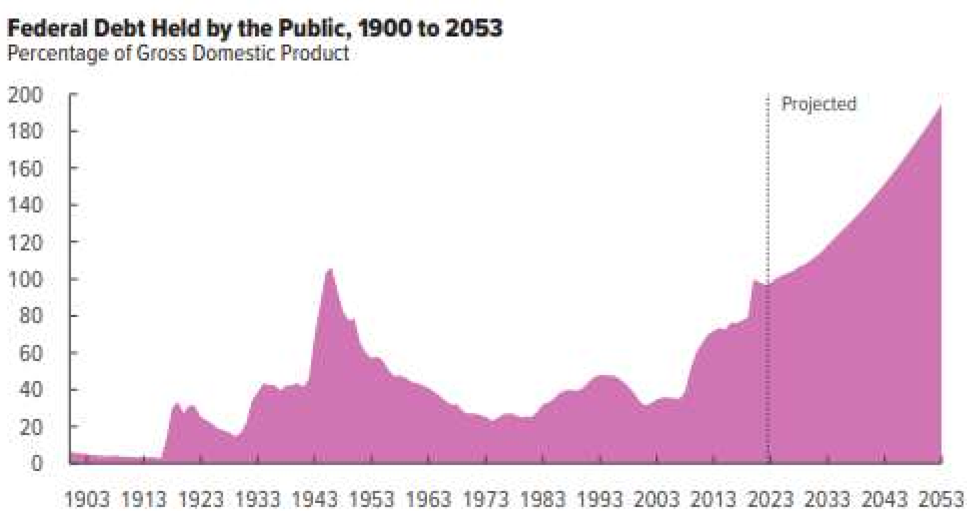
MARKETS ALREADY NOTICE

Markets are already showing some signs of concern about the possibility that Congress will run up to the eleventh hour before increasing the debt ceiling. This concern is manifesting itself in higher interest rates on U.S. debt, a cost that will be borne by the taxpayer. Bonds that mature around the time that markets think the Treasury Department will exhaust "extraordinary measures" have higher yields than those that mature earlier in the year. In addition, the cost of insuring U.S. debt against default (as measured by credit default swaps) is higher than at any point since the 2013 debt ceiling standoff.

SPENDING DRIVES OUR DEBT PROBLEM

Federal government debt as a share of annual gross domestic product is currently at a very high level, and is projected to rise.

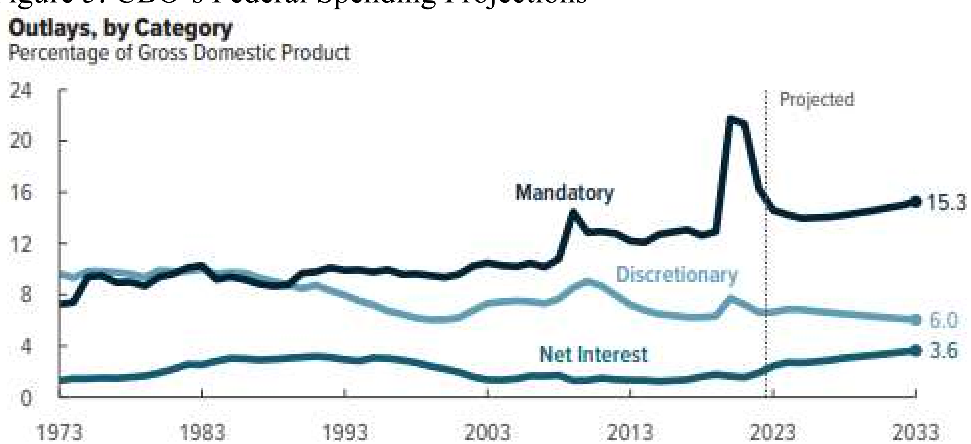
Figure 4: CBO's Debt Projection[5]



[5] Source: Congressional Budget Office, "The Budget and Economic Outlook: 2023 to 2033," February 2023.

The above chart is a projection, not a forecast. It assumes that laws currently in place will remain in place. It highlights the need to reduce projected debt and deficits. CBO's projections also point to the source of rising projected debt: spending on Social Security, Medicare, and interest payments on the debt. Discretionary spending as a share of annual GDP is projected to fall over the next decade, and thereafter. Over the five-decade period from 1973-2022, federal tax revenue was 17.4 percent of annual GDP. CBO projects revenue to equal 18.3 percent of GDP in 2023 and 18.1 percent of GDP in 2033.

Figure 5: CBO's Federal Spending Projections[6]



The U.S. needs to reduce projected debt and deficits, and that will require substantial spending cuts. Higher taxes alone cannot solve the U.S.'s debt problem. For example, the Committee for a Responsible Federal Budget estimates that returning the top individual income tax rate to 39.6 percent (while leaving in place the other 2017 tax cuts) and imposing a surtax of 5 percent on income above $10 million and 8 percent on income above $25 million (applied to

[6] *Ibid.*

both earned income and investment income) would lead the debt-to-GDP ratio to increase from 115 percent in 2033 to 191 percent in 2050.[7]

There is bipartisan consensus that taxes should not be raised on households with less than $400,000 in annual income. According to my estimates, increasing the tax rate on income above $400,000 to 95 percent would reduce the primary deficit by less than one-half by the end of the decade and by around one-third in 2050 — *i.e.*, the debt would still be growing, not shrinking.

This estimate assumes that there would be no behavioral effects from a tax rate that high. Of course, that would not be the case in reality. Such a high rate would lead to less work, less savings, more tax evasion and avoidance, and high-earners to flee from the U.S. This suggests that such a high rate would have an even smaller effect on the debt than reported in the previous paragraph.

Increases in tax revenue will not solve the U.S.'s debt problem. To solve the problem, projected spending will need to be cut. Specifically, projected future spending on entitlement programs needs to be cut.

DEBT IS A PROBLEM

Ever-higher debt and deficits gradually erode the ability of the U.S. economy to generate long-term increases in living standards. Government debt reduces private investment in productive capital.[8] Lower investment translates into a smaller capital stock, lower rates of productivity growth, lower wages, output reductions, slower economic growth, and lower living

[7] Committee for a Responsible Federal Budget, "Fix the National Debt," accessed March 2, 2023.
[8] A 2019 working paper from the Congressional Budget Office estimates that each additional percentage point in the debt-to-GDP ratio increases long-run interest rates by two to three basis points. See Edward Gamber and John Seliski, "The Effect of Government Debt on Interest Rates," Working Paper 2019-01, Congressional Budget Office, March 14, 2019.

standards. Higher deficits and debt also increase the borrowing costs facing the federal government and, ultimately, taxpayers. The vulnerability of the budget to changes in interest rates increases with higher debt levels, as does the amount of taxpayer money paid to foreign holders of U.S. debt.

Rising debt could have other consequences, as well. It could lead to a gradual decline in the value of U.S. assets, increase inflation expectations and actual inflation, and slowly erode confidence in the unique role of the U.S. dollar in global markets. This would make it more difficult to finance both private and public investment by U.S. entities. There are national security concerns for rising debt, as well. Ever-higher debt also reduces the political space for important investments in basic research, physical infrastructure, and programs to advance economic opportunity.

THE FUNDAMENTAL QUESTION

Is the United States a nation with a political system that is so dysfunctional that it cannot pay the bills it is legally obligated to pay? That question is at the heart of the uncertainty around the debt ceiling. If the U.S. defaults on our bond obligations, many investors, international and national leaders, and citizens will answer that question in the affirmative. If the U.S. resorts to prioritizing bond payments and not meeting other financial obligations, many will answer in the affirmative. If the U.S. again runs up to the eleventh hour but eventually raises or suspends the debt ceiling, some will still answer that question in the affirmative.

The right answer to that question is: No. Congress and the President need to answer that question clearly by raising or suspending the debt ceiling as soon as possible.