Summary

Public vs Private Debt: Public debt is not like private debt. Private debt is a zero-sum game, where one person's liability is another person's asset. *Public* debt is owed and owned by the same people. And where private debt should be reduced and extinguished, public debt should grow alongside the real economy, providing investors with a stratum of "risk-free" protection which serves as a baseline for, and a refuge from, riskier investments.

There are Limits: Even so, concerns about the size of public debt have a basis in economic realities. We have seen sovereign defaults around the world: at some point a country can no longer carry its debt. When that point is reached, hardships are inflicted upon its people in the form of worthless currency and abandoned investments.

The Impact of Higher Rates: For many years, the Federal Reserve's interest rate policies eased the burden of servicing the public debt. Those conditions no longer exist. With the Fed normalizing rates, debt service costs have skyrocketed. The federal government is currently spending about 8% of its budget on debt service. This is about 2/3rds of what is spent on national defense.

Debt Ceiling: In one form or another, the "debt ceiling" has played a role in budgetary politics for more than a century. While Congress has already appropriated the spending, the debt ceiling enforces discipline for spending going forward. The debt ceiling is a statutory tool created by Congress to monitor itself and the executive branch.

Competing Interests in Washington: Politicians on both sides are willing to battle over the debt ceiling because fiscal policy is where the rubber hits the road in government. Republicans are demanding significant reductions in federal spending while Democrats are pushing for an automatic increase of the ceiling. House Republicans have increased their leverage with the recent passage of the "Limit, Save, and Grow Act." Democrats are torn between engaging the Republicans or undergoing some tricky budgetary maneuvering.

The Stakes: A debt default would leave self-inflicted damages upon our national economy. At a minimum, it would hurt our reputation worldwide and reinforce the idea that Americans cannot self-govern. More impactfully, it could lead to permanently higher rates, as investors discount the risk of not getting paid. It could even undermine the dollar's status as the world's reserve currency.

The Likely Outcome: Given the unknown calamities of a debt default, the incentive to split differences and cut a deal is there. Our baseline scenario is compromise, without default and without fiscal funny business. There may be some harrowing moments, including a government shutdown, before we get there. And there remains a non-insignificant prospect that we end up on a path that no one wants.

Brief History of the Debt Ceiling

The debt ceiling has its origins in World War I. During that conflict, the federal government began issuing debt generally rather than for specific purposes. The *Second Liberty Bond Act* of 1917 included a provision which placed limits on types of debt (such as bills vs. bonds). From that point on, once limits were breached, Congressional action was required to expand them.

In 1939, Congress dispensed with the distinction between different types of debt and set a "debt ceiling" for the total accumulated debt. Over the next 35 years, the debt ceiling played a role in public debate. For instance, in 1954, the Senate butted heads with the Eisenhower Administration for a period, forcing Treasury Secretary George Humphrey to monetize gold reserves in order to sustain spending.

In the 1970s, the dynamic was altered with the "Gephardt Rule," which automatically increased the debt limit when Congress voted for deficit-funded appropriation. When Republicans swept into the House in 1995, taking control for the first time in forty years, they suspended the Gephardt rule. This led to the budgetary standoff in that year.

The three major budgetary standoffs have been 1995, 2011, and 2013. During other periods, Congress has reimplemented the Gephardt rule. The new Republican House is suspending the rule once again, forcing another budgetary standoff.

Some Democrats, hewing to the Gephardt logic, argue that debt ceilings are a destructive redundancy, since that money has already been constitutionally appropriated and spent. But if Congress, in its wisdom, wants to enforce additional fiscal disciplines upon itself and the executive branch, then that seems well within its legitimate power. Among other things, it is the constitutional function of the House of Representatives to be the source and origin of all public expenditure.

The debt-ceiling is a legitimate debate. It has its origins in the quest for mechanisms to keep federal spending in line. Moreover, federal spending as a percentage of GDP has increased substantially over the past several years (see chart 1 in the Appendix). The recent experience is that when there is a Democratic administration and a Republican Congress, the brinksmanship becomes severe. Still, Democratic legislators, including former Senator Joe Biden, have used the debt ceiling to pressure Republican administrations.

What Are Some Possible Outcomes?

Can the federal government default on its debt? In the narrow sense, yes. A state of default exists when an issuer goes "flat" on its obligations. In a broader sense, though, there is a difference between the default of an issuer who cannot pay due to insolvency and an issuer who cannot pay due to politics. A default on United States debt would belong to the second category.

The political aspect is always difficult to calculate. In any negotiation, one strategy is to hold out as long as possible for the best possible outcome. Like a game of "chicken," the problem arises when neither side relents. Then the game crashes and both sides lose.

The debt ceiling "game" is complicated by the fact that elected officials have not been especially hurt by government shutdowns. Despite the bad "look" of budgetary impasses, the Republicans held the House

in 1996 and 2012, even as the Democrats held the White House in those same years. And after the 2013 impasse, in 2014, Republicans expanded their hold on Congress by retaking control of the Senate.

In the past, the debt ceiling game has led to government shutdowns, but not to a default of government debt. While the market is not overly concerned about shutdowns, a default on government debt would be another matter. At a minimum, defaulting would increase government borrowing costs going forward, as creditors grow wary of lending funds to a borrower which may or may not make its payments in a timely manner. A debt default would also undercut the dollar's role as the world's reserve currency. This role creates an inherent demand for dollars and puts a floor under American financial economy. Losing that status would eliminate a critical strategic advantage for our country.

The debt ceiling issue cuts to the question of the federal government's role in the life of the national economy. The stakes are obviously high, but politicians on both sides are willing to battle over this because fiscal policy is where the rhetoric ends and the values are set.

What Do the Competing Interests Want…

Until recently, the Democrats were acting as though the very debt ceiling process is illegitimate. Republicans, and especially Speaker Kevin McCarthy, had limited leverage because they had no specific legislation to take to the bargaining table. But the Republican Conference in the House has overcome its divisions with the passage of the "Limit, Save, and Grow Act."

The legislation rolls spending levels back to those in place two years ago. It also limits spending increases to 1% per year. It repeals fiscal initiatives undertaken in the first two years of the Biden administration and claws back unspent funds. Finally, the "Limit, Save, and Grow Act" pursues other goals, such as making permitting easier for energy companies and tightening requirements for welfare recipients.

While no one is under any illusion this bill will become law, it does provide a concrete set of conditions for raising the debt ceiling. The GOP may have a razor-thin margin in the House, but McCarthy and his lieutenants were able to "whip" its passage and give themselves specific negotiating points affirmed by a House majority. Democrats can no longer claim that they do not know what the Republicans are demanding, which gives them less leverage to insist upon a "clean" hike of the debt ceiling.

Over the past several months, leaders on both sides have sought to reassure the public that there will not be a debt default, although these assurances seemed more self-absolving than inspiring. No one wants to be accused of opening Pandora's Box, but the self-interested logic of negotiation has everyone reaching for the lid. It will be a good sign when there is less posturing in the media and more evidence that the leaders are negotiating with one another.

Constitutional Challenge?

The previous Democratic Presidents in these debt ceiling standoffs—Bill Clinton and Barack Obama—did not challenge the constitutionality of the debt ceiling. Rather, they negotiated with their Republican counterparts and struck deals. There is some talk that Joe Biden's administration is thinking differently,

with the idea of forcing a constitutional showdown. We do not think this will happen, mainly because the constitution appears to be with the Republicans.

The basis for making a constitutional challenge would be Section 4 of the 14th Amendment. It says: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void."

A loose interpretation claims that the Fourteenth Amendment creates a constitutional mandate for the redemption of federal debt. After all, within Section 4 are the words, "the validity of the public debt of the United States...shall not be questioned." But there were also historic circumstances that cannot be ignored.

Written in the aftermath of the Civil War, the Fourteenth Amendment was designed to outline the terms of Southern reintegration into the Union. Among other things, Section 4 specifies that the debt incurred by the South was null and void, while those incurred by the North "shall not be questioned." This is not a grandiose pronouncement prohibiting debt defaults for all time. The "Reconstruction Amendments," including the Fourteenth, were designed to set our country on the path of what Lincoln called "a new birth of freedom." Section 4 of the Fourteenth Amendment outlined the financial rules of that path.

It is also important to remember that the Civil War marked a new period in American economic history. For the first time, the dollar was not backed by gold and silver. Rather, the War was financed in the North through greenbacks, our country's first foray into "fiat currency." The South, too, engaged in paper finance. After that conflict, there was a lot of paper in circulation and the issue had become whether the paper was money good.

One problem with invoking the Fourteenth Amendment in challenging the constitutionality of the debt ceiling is that it will change budgetary politics going forward. The Supreme Court would have to either reduce the ability of Congress to control the budgetary process, which is expressly granted to it by the Constitution, or to make the Administration a toothless tiger. We know that President Obama flirted with the idea of invoking the Fourteenth Amendment, but ultimately decided against it on grounds that the constitutional arguments were too flimsy. We share his view.

Nuclear Options

If the Biden Administration does not care to negotiate the debt ceiling, or thinks that negotiations are not moving satisfactorily, it does have some "nuclear options" for circumventing the process. For instance, Treasury could issue "perpetual bonds" which do not add to the overall debt (although they would increase debt service costs). The proceeds from these sales can be used to retire debt and put the federal government back under the ceiling. Or the Fed could "donate" treasury securities on its balance sheet to the Treasury, reducing the overall amount outstanding.

The most widely known "nuclear option" has its basis in a 1997 law designed to give the federal government an opportunity to make money from coin collectors. Section K of the Coinage Act allows the Treasury Department to mint platinum coins in any denomination. Some people think the Treasury Department could mint a trillion-dollar coin, which would then be deposited in its account at the Federal Reserve. The new "funds" would be used to pay down debt, opening space from the debt ceiling and allowing appropriated spending to continue.

This approach was advocated a decade ago during the last serious debt ceiling crisis. At the time, Fed Chair Janet Yellen called the idea a "gimmick" which threatened to undermine confidence in the American economy. Yellen is the Treasury Secretary today. As the pressure mounts, it will be interesting to see if her view of these extraordinary types of machinations has changed.

Any fiat deposit at the Fed would require the compliance of the Federal Reserve. It would presumably be in the power of Fed Chair Jerome Powell to refuse the deposit. On principle, the Federal Reserve avoids fiscal imbroglios. Fed officials are aware that they answer to Congress. Congress could change their charter. Congress could strip them of their independence and autonomy. If the situation is grave, with default looming, one could imagine the Fed playing along, but it is clearly not a decision anyone there wants to make.

Now that the Republican House has passed its debt ceiling legislation, Democrats are divided into two camps. One wants to refuse to negotiate over the debt ceiling and hold these nuclear options in the back pocket. The other wants to go to the table and cut a deal. Time will tell which path the Administration follows, but time is also running out.

Prioritization

Congressional Republicans are arguing that the Treasury Department could prioritize expenses, meaning they could make some payments while deferring others. To put it another way, Treasury could meet its debt obligations and keep the market whole, even as it defaults on other expenses.

There are a couple problems with "prioritization." First, there are technical limitations upon the Treasury Department's ability to cut checks for A, but not B. The Treasury Department makes more than a billion separate disbursements every year. That is almost four million payments every business day. Its payment system is not configured to prioritize certain obligations over others, but to treat every obligation as equally important—as indeed they are, at least to the recipients of those checks.

The second problem is that prioritization raises the tricky political question of *which* obligations get prioritized. For instance, most Americans would agree that active members of the Armed Forces should move to the front of the line, but how many Americans think bondholders belong there? While those with some economic knowledge understand how essential it is to keep the financial plumbing uninterrupted, putting the "fat cats" first is a difficult lift politically.

From a certain perspective, the prioritization argument makes sense. The Treasury is already engaged in "extraordinary measures" to fend-off the approaching debt ceiling. For instance, it is suspending reinvestments in retirement funds. It is also halting reinvestment in international exchange stabilization funds and intergovernmental transfers with state and local governments. In a sense, this is a form of

prioritization. A more detailed form of prioritization would no doubt be inconvenient to the Treasury Department. "Inconvenient" is not the same as "impossible."

What Happens Next?

There are many ways to negotiate a solution to the debt ceiling crisis. But if one side had to work like mad just to get a deal among themselves and the other side is fighting among themselves over whether they even want to negotiate, the stage seems set for an intractable standoff. On the other hand, resolving the debt ceiling is a necessity, and necessity is the mother of invention, even with government.

"Compromise" has become a dirty word. Threatening to blow up the system seems to have become a mainstream negotiating tactic for both parties. Finding our way clear of this mess will probably come down to two experienced Washington politicians, Joe Biden and Kevin McCarthy. Each is beholden to fringier wings of his own Party, but each also has a legislative background of splitting differences.

We have seen debt defaults in other countries and it is not a pretty picture. The market dumps the currency, and the citizens of that country can scarcely afford anything. That would not necessarily be the outcome here, but if a government shutdown becomes protracted and leads to a default, Americans will be absorbing the costs in years to come. It could even lead to an erosion of stature around the world, as it is difficult to fear, much less respect, those who do not pay their bills on time.

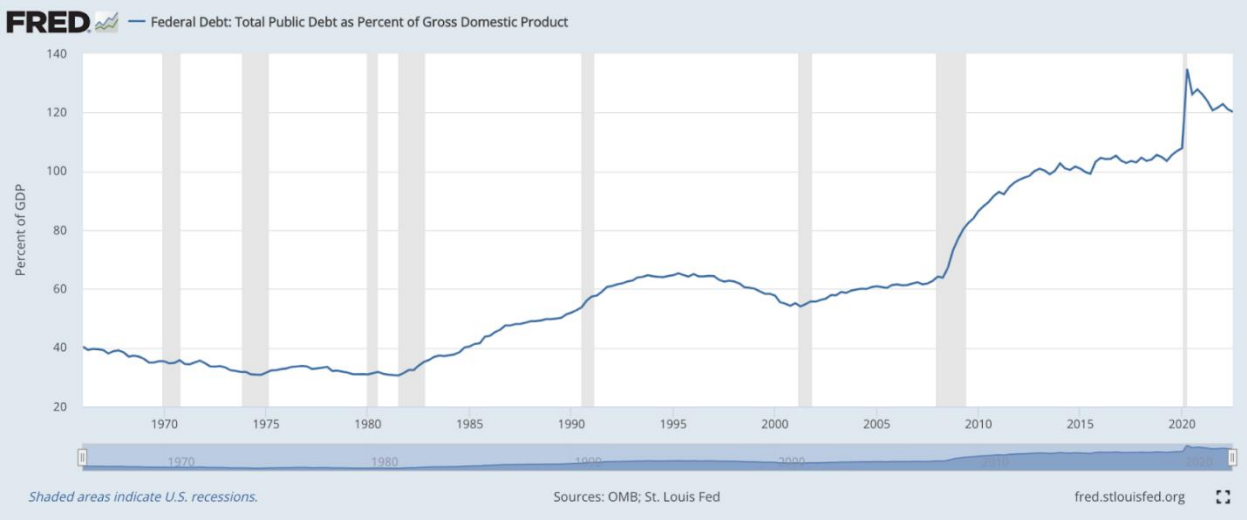
If we reach an intractable standoff, we think challenging the constitutionality of the debt ceiling is a loser. The nuclear options are highly disruptive and would properly be interpreted as straight power politics. The prioritization option, though inconvenient to the Treasury Department, seems the best path if the standoff cannot be resolved and the government shutdown appears to be spiraling towards default.

But the least disruptive and most stabilizing path is to find the compromise. It is out there, and needs to be found sooner rather than later. Managing the public debt is a legitimate issue, the debt ceiling is a legitimate mechanism, and in our view, the Biden Administration is obliged to find a way to get it done. Even without default, higher interest rates mean debt service now accounts for roughly 8% of the federal budget (see Chart 2). The Republican majority in the House, duly elected by the people of the United States, is entitled to be alarmed about the public debt and is entitled to put its stamp upon the budgetary process.

"Getting it done" probably means Biden and the Democrats will have to accept flatter spending levels while McCarthy and the Republicans will have to accept that hated programs will not be gutted. That was the sweet spot in the Clinton and Obama standoffs. No one was particularly happy. There was no catalyzing transformation in how government functions. But both sides lived to fight another day, and neither side was responsible for fatally impairing what all sides are supposed to cherish: a strong, stable, and solvent United States.

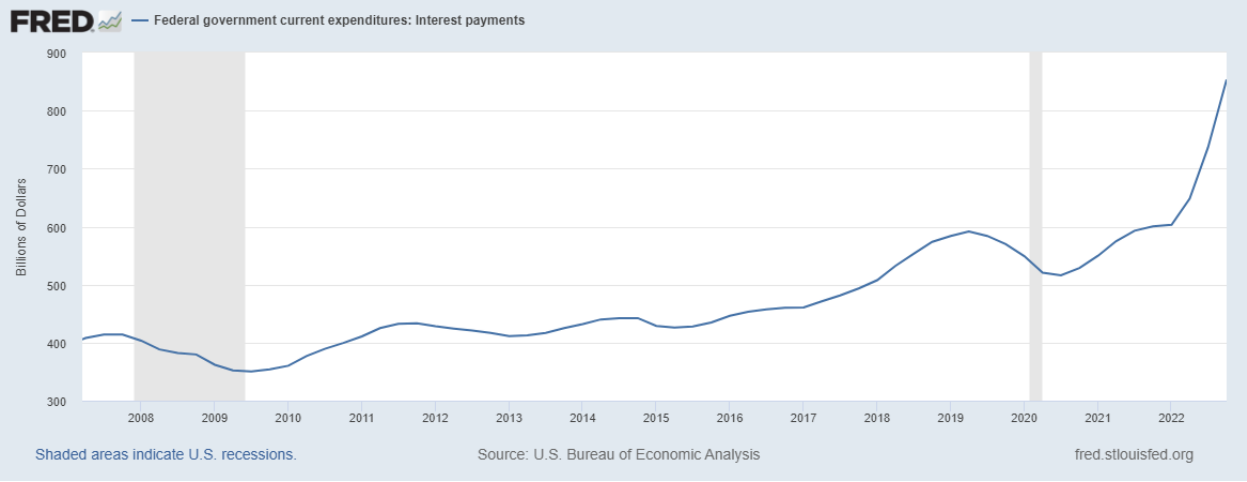
Appendix

Chart 1



"Fred" Database, St. Louis Federal Reserve Bank

Chart 2



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