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The Economic Costs of Debt-Ceiling Brinkmanship

U.S. Senate, Joint Economic Committee

One Hundred Thirteenth Congress, First Session

Hearing Contents:

Opening Statement:

Kevin Brady [view PDF]
Chairman, Joint Economic Committee

Witnesses:

Dan Mitchell [view PDF]
Senior Fellow, Cato Institute

Mark Zandi [view PDF]
Chief Economist and Co-Founder Moody's Analytics

David Malpass [view PDF}
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Joint Economic Committee Republicans

Representative Kevin Brady
Chairman

NEWS RELEASE

CHAIRMAN KEVIN BRADY

JOINT ECONOMIC COMMITTEE

SEPTEMBER 18, 2013

The Economic Costs of Debt-Ceiling Brinkmanship

Vice Chair Klobuchar, distinguished witnesses, and guests from the Republic of Ireland and Northern Ireland, welcome.

Vice Chair Klobuchar and I agree that political brinkmanship over raising the debt ceiling is costly to our economy. I wish President Obama felt as we do. His declaration this weekend—"What I haven't been willing to negotiate, and I will not negotiate, is on the debt ceiling."—represents the inflexible brinksmanship the American people deplore.

Despite the recent decline in the federal budget deficit, future projections are troubling. Add to that an ever-growing national debt; Medicare whose main trust fund runs empty within twelve years; and Social Security that had to borrow nearly $150 billion last year from foreign investors and the Fed simply to make payments to our seniors. As Dr. Zandi noted in his testimony, "…the long term fiscal outlook remains disconcerting."

This bleak outlook hurts middle-class families and the 20 million Americans who can't find a full-time job today in the weakest recovery since World War II. That's why House Republicans have reasonably and prudently passed a bill to take default off the table and invited the President to sit down together—today—to find a bi-partisan solution that puts Washington on a responsible fiscal path through pro-growth tax reform, ending wasteful spending and taking substantive steps to extend the lives of Medicare and Social Security.

Children born today owe nearly $50,000 as their share of the national debt. In other words, they owe a Lexus to Uncle Sam. If Washington doesn't change its spending ways by the time they reach 13 years old, they'll owe another Lexus. And when they graduate from college ready to begin their career, they'll owe yet a third.

Of course, young people don't buy luxury sedans for Uncle Sam. Instead, they will pay the price for this generation's spending addiction through a sluggish economy with higher taxes and higher interest rates. So if they are able to find a job, they'll have lower wages and keep less of their paycheck to pursue their American Dream.

For the first time in our history, we can't be confident that the next generation of Americans will be better off than the current one. That's unacceptable.

Admittedly, the debt ceiling is an imperfect vehicle to control the growth of federal spending. I would prefer that Congress and state legislatures amend the U.S. Constitution to limit the growth of federal spending and require a balanced budget except during war or emergencies. However, the debt ceiling remains an effective tool for Congress and the President to reach bi-partisan consensus on measures to limit the growth of federal spending and reform entitlements.

Both parties, Democrats and Republicans, have used the debt ceiling as a responsible means to shore-up America's financial house—the *Omnibus Budget Reconciliation Act of 1990* came about through debt ceiling negotiations between congressional Democrats and President Bush, and the *Budget Control Act of 2011* came about through debt ceiling negotiations between House Republicans and President Obama.

It is irresponsible to give the White House another blank check. Instead, it is responsible to limit the growth of federal spending and secure the future of entitlement programs in exchange for raising the debt ceiling.

If now isn't the time to tackle Washington's spending addiction, when is? Perhaps brinkmanship is just another word for a long overdue intervention.

One of today's witnesses, Dr. Mitchell, summarized good fiscal policy in a simple golden rule: private output should grow faster than government spending. In other words, Main Street should grow faster than Washington. I agree.

Some advocates of 'big government' claim that modest savings from the recent sequester are decimating government services and threatening economic growth. The reality is that since the recession ended, real federal consumption and investment spending has grown faster than real GDP—6.4 percent compared with 4.6 percent. The sequester is merely asking the 500-pound federal government to lose about 10 pounds.

What ails our economy is not too little government, but too much. Therefore, I will soon reintroduce the *Maximizing America's Prosperity or MAP Act* to limit the growth of federal spending through a new, innovative spending cap—non-interest spending as a percentage of potential GDP.

Using non-interest outlays as the numerator in the spending cap forces Congress to limit what it can control—program spending—through appropriations bills and changes in entitlement legislation, not what it can't—interest outlays—that are determined by past spending decisions and the Fed's monetary policy.

Using potential GDP as the denominator in the spending cap eliminates the "boom-bust" cyclicality in spending caps tied to GDP. The growth of GDP fluctuates with the business cycle, allowing spending blowouts in boom years, and then forcing deep cuts during recessions. Using potential GDP provides a more stable path for federal spending over time.

Vice Chair Klobuchar and I might not agree on what's the right level for a spending cap, but we should be able to agree on the right metric. And non-interest spending as a percent of potential GDP is the right metric.

I look forward to the testimony of today's witnesses.

The Economic Costs of Debt-Ceiling Brinkmanship

Vice Chair Klobuchar, members of the Committee, thank you for this opportunity to testify about the debt limit. My name is Dan Mitchell. I'm a Senior Fellow at the Cato Institute. The views I express here today are my own.

I want to make five points.

First, it's important to understand that America's chief fiscal problem is an excessive burden of government spending. That's true today, and, as yesterday's long-run CBO fiscal outlook demonstrated, too much spending is our problem in the future.

Deficits and debt are undesirable, of course, but so are high taxes and printing money, which are the other two ways of financing government spending.

Simply stated, the true fiscal tax on our economy is how much government is spending. That's the problem. Deficits and debt, by contrast, are symptoms of that problem. Overall government spending is the measure of how much money is being diverted from the economy's productive sector. That's the primary problem. The various ways of financing that spending are secondary problems.

Second, the best way to gauge the success of fiscal policy is to see whether the burden of government spending is growing faster or slower than private economic output. If the private sector is growing faster than the government – which I consider to be the Golden Rule of Fiscal Policy – then lawmakers are doing a good job.

But if the converse is true and the burden of spending is rising faster than the private sector, then policy is heading in the wrong direction.

The data for any one year is important, but the real test is what happens over time. In other words, fiscal trendlines are critical.

If government spending grows slower than the productive sector of the economy for an extended period of time, this almost certainly means better economic performance because the relative burden of government is declining. And because the problem of spending is being properly addressed, this also means that the symptom of red ink almost certainly is falling as well.

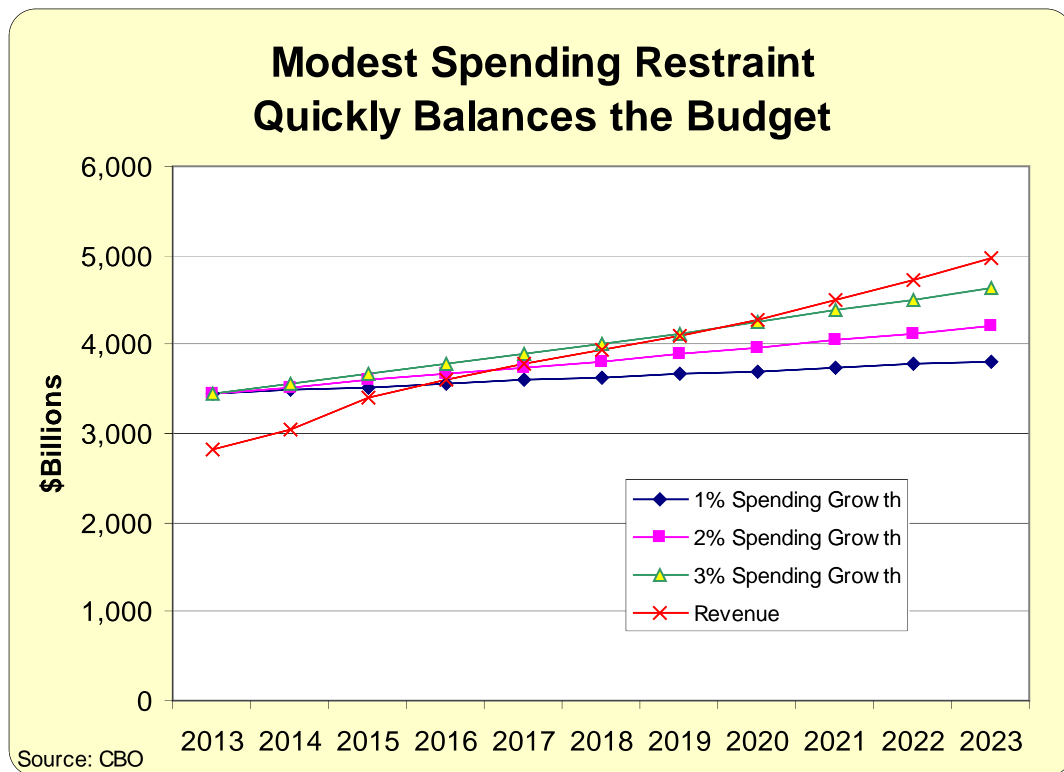
But if the opposite occurs, and government grows faster than the private sector for an extended period, then it's just a matter of time before serious fiscal and economic problems occur. Nations such as Greece, for instance, got in trouble because the politicians did the opposite of the Golden Rule of Fiscal Policy.

Third, it's possible to make rapid progress with even a modest amount of spending restraint. Consider what's happened the past two years. For the first time in more than 50

years, we've enjoyed two consecutive years when overall government spending was lower than the previous year.

This has led to a big improvement in the key fiscal indicator, with the burden of federal government spending falling from 24.1 percent of GDP to 21.5 percent of economic output. And because there was progress on the real problem, the symptom of red ink got much better as well, with the deficit falling by more than 50 percent, from $1.3 trillion to $642 billion.

We don't even need that degree of fiscal discipline going forward. As illustrated by this chart, we can balance the budget in just 3 years if spending grows by an average of 1 percent annually. Red ink disappears in 4 years if spending grows by an average of 2 percent per year. And the deficit goes away in 7 years if spending grows by an average of 3 percent each year.



Indeed, it's worth noting what Canada achieved in the 1990s. The burden of government spending had reached crisis levels by 1992, with government consuming more than 50 percent of economic output. But Canadian lawmakers – primarily during a time when the Liberal Party was in charge – put the brakes on spending.

For a period of five years, government outlays grew by an average of just 1 percent per year. That dramatically reduced the burden of government relative to the private sector. And by dealing with the underlying problem, Canada also went from having a large deficit of about 9 percent of GDP to a budget surplus.

Let's now deal directly with the debt ceiling. My fourth point is that an increase in the debt ceiling is not needed to avert a default. Simply stated, the federal government is collecting far more in revenue than what's needed to pay interest on that debt.

To put some numbers on the table, interest payments are about $230 billion per year while federal tax revenues are approaching $3 trillion per year. There's no need to fret about a default.

But don't believe me. Let's look at the views of some folks that disagree with me on many fiscal issues, but nonetheless are not prone to false demagoguery.

Donald Marron, head of the Urban-Brookings Tax Policy Center and former Director of the Congressional Budget Office, explained what actually would happen in an article for CNN Money.

> If we hit the debt limit… that does not mean that we will default on the public debt. …[The Treasury Secretary] would undoubtedly keep making payments on the public debt, rolling over the outstanding principal and paying interest. Interest payments are relatively small, averaging about $20 billion per month.

And here is the analysis of Stan Collender, one of Washington's best-known commentators on budget issues.

> There is so much misinformation and grossly misleading talk about what will happen if the federal debt ceiling isn't increased…it's worth taking a few steps back from the edge. …if a standoff on raising the debt ceiling lasts for a significant amount of time… a default wouldn't be automatic because payments to existing bondholders could be made the priority while payments to others could be delayed for months.

Or what about the Economist magazine, which made this sage observation.

> Even with no increase in the ceiling, the Treasury can easily service its existing debt; it is free to roll over maturing issues, and tax revenue covers monthly interest payments by a large multiple.

Let me add one caveat to all this analysis. I suppose it's possible that a default might occur, but only if the Secretary of the Treasury deliberately chose not to pay interest in the debt. But that won't happen. Not only because the Obama Administration wouldn't want to needlessly roil financial markets, but also since research by Administration lawyers in the 1960s concluded that the Secretary of the Treasury might be personally liable in the event of a default. Mr. Lew has more than one reason to make sure the government pays interest on the debt.

My final point is that a fight on the debt limit might be worthwhile, even if it does cause considerable short-run angst and uncertainty. It all depends on whether it leads to desirable reforms.

Let's look at the example of Greece. There's nothing akin to a debt limit in that country, but imagine there was. Let's further imagine that a group of lawmakers 15 years ago dug in their heels and refused to allow more red ink.

That probably would have caused a lot of turmoil at the time. But if the net result was to force Greek politicians to restrain spending for a multi-year period, then it's quite likely that the people of Greece would have been spared the economic and fiscal misery that they've been suffering over the past few years.

Let's close with an analogy. Yesterday's long-run fiscal outlook from CBO shows that a do-nothing or status-quo approach guarantees fiscal chaos. We don't know if a crisis will occur in fifteen years or twenty-five years. Or maybe we even have more than 25 years since the U.S. will benefit from capital flows when nations such as Japan and France implode.

But at some point the United States will suffer the same type of crisis that we've witnessed in other nations. We're in a car and we're heading toward a cliff, even though it's hard to estimate how much father we can drive before we careen over the edge.

Wouldn't it be a good idea to take steps today – when it's relatively easy – to avoid that potential future crisis? To at least begin to steer away from the cliff? Perhaps by adopting something akin to Switzerland's "debt brake," which basically imposes an annual spending cap?

In other words, I'm not at all worried about short-run brinksmanship. Particularly since there's no realistic possibility of default. But I am worried about the long-run trendline of government spending. And if some brinksmanship today means spending in the future won't grow as fast, then the nation will be in a much stronger fiscal position.

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Joint Economic Committee

"The Economic Cost of Debt-Ceiling Brinkmanship"

September 18, 2013

The U.S. economy remains frustratingly far from full employment. While there are many reasons for this, brinkmanship around the federal budget and Treasury debt ceiling has been a significant contributing factor. Much progress has been made since the Great Recession, and the economy's prospects are improving, but this will continue only if policymakers can resolve their differences in a timely way.

While negotiations over these fiscal issues will be difficult, it is generally expected that lawmakers will come to terms in time to avoid a government shutdown or a breach of the debt ceiling. They have shown an ability to come together at the last minute in other recent fiscal battles, including the showdowns over the debt ceiling in summer 2011 and the fiscal cliff earlier this year.

As such, the current budget battle should have little adverse effect on investors, consumers or businesspeople, provided it is resolved in time. But policymakers should not take solace in this. If they botch it and the government shuts down or fails to meet all its obligations, investor and consumer psychology will be damaged, and the economy will suffer serious harm.

To resolve the current budget impasse, policymakers should not add to the significant fiscal austerity already in place and set to last through mid-decade. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. In 2013 the fiscal drag is as large as it has been since the defense drawdown after World War II.

Moreover, because of fiscal austerity and the economic recovery, the federal government's fiscal situation has improved markedly. The budget deficit this year will be less than half its size at the recession's deepest point in 2009. Under current law and using reasonable economic assumptions, the deficit will continue to narrow through mid-decade, causing the debt-to-GDP ratio to stabilize.

As part of any budget deal, lawmakers should reverse the sequester. The second year of budget sequestration will likely have greater consequences than the first, affecting many government programs in ways that nearly all agree are not desirable. A sizable share of the sequestration cuts to date has been one-off adjustments, but future cuts will have to come from lasting reductions in operational budgets.

It would, of course, also be desirable for lawmakers to address the nation's daunting long-term fiscal challenges. While the fiscal situation should be stable through the end of this decade, the long-term fiscal outlook remains disconcerting. If Congress does not make significant changes to the entitlement programs and tax code, rising healthcare costs and an aging population will swamp the budget in the 2020s and 2030s. Both cuts in government spending and increases in tax revenues will be necessary to reasonably solve these long-term fiscal problems.

A grand bargain with comprehensive entitlement and tax reform is likely too much to hope for, but lawmakers can do some things now to address our long-term fiscal issues and help resolve the current impasse. New budget rules that recognize the magnitude of our long-term problems and encourage solutions would be especially helpful. These could include incorporating fiscal-gap and generational accounting in the budget process and significantly extending the current 10-year budget horizon.

Adopting the chained consumer price index for adjusting Social Security benefits and the tax code would also be a small but positive step in the appropriate direction. The chained CPI is a more accurate measure of inflation, and adopting it would both cut entitlement spending and raise tax revenue. The budget savings would not come close to what is needed, but it would be consequential nonetheless.

Revenue-neutral corporate tax reform that scales back tax expenditures in exchange for a lower top marginal corporate tax rate would also be a significant policy achievement. This would significantly improve the competitiveness of U.S. businesses and the economy's long-term growth. Much of the hard intellectual work necessary to accomplish this has been done, and there is general agreement among economists that this would provide a meaningful boost. As part of corporate tax reform, multinationals could be encouraged to repatriate their overseas profits with a temporarily lower tax rate. The resulting onetime boost to tax revenues could be used to finance infrastructure development here at home, also improving U.S. competitiveness and long-term growth.

Congress should use this opportunity to eliminate the statutory debt ceiling. It is an idiosyncratic, anachronistic and, as has been demonstrated, potentially destructive rule that is detrimental to sound economic policy. Absent repeal, an alternative would be to require debt-ceiling increases when spending, taxation and appropriations bills are passed. Doing so would restore the fundamental economic relationship between budgeting and borrowing, and reduce the risk that political brinkmanship could damage the full faith and credit of the United States or the stability of world financial markets.

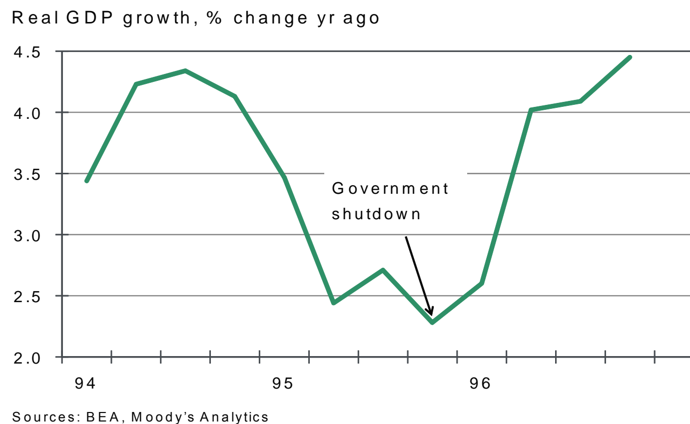
Recommendation #1: Do not shut down the federal government

Congress' first order of business is appropriating funds for the fast-approaching 2014 fiscal year. If lawmakers fail to act by October 1, the federal government will partially shut down. At a minimum, lawmakers must pass a continuing resolution to extend current spending authority, which expires at the end of this month.

A shutdown that lasts only three or four days would have modest economic consequences, costing the economy approximately 0.2 percentage point of annualized real GDP growth in the fourth quarter. A brief shutdown would have limited economic impact because it would affect only discretionary spending, the one-third of the budget funded through congressional appropriations. Mandatory spending would not be affected. Some appropriated spending would also likely be considered essential and not cut, in such areas as national security, air traffic control, law enforcement, and the processing of benefit payments. Using the 1995 government shutdown as a guide, approximately half of all government employees would not be able to go to work. Moreover, most government spending would be delayed and not canceled in a brief shutdown. Federal employees would lose pay, but most other activity would be made up later.

However, shutting the government down for three or four weeks would do significant economic damage, reducing real GDP by 1.4 percentage points in the fourth quarter. And this likely understates the economic fallout, as it does not fully account for the impact of such a lengthy shutdown on consumer, business and investor psychology. Any interruption much longer than a month would cause GDP to fall over the quarter, and one longer than two months would likely precipitate another recession.

For context, the longest government shutdown on record, in late 1995 and early 1996, lasted about three weeks. The economy's growth slowed sharply as a result (see Chart 1).



Recommendation #2: Raise the Treasury debt ceiling

Lawmakers must increase the $16.7 trillion Treasury debt ceiling before mid-October. According to Treasury Secretary Jack Lew, that is when the "extraordinary measures" the Treasury has been using since May to stay under the limit will no longer work (see http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf). At that point, the government would be able to pay bills with only the cash it has on hand, about $50 billion on any given day.

It is impossible to know precisely when the Treasury will run out of ways to avoid the ceiling. The key uncertainty is revenues: Quarterly corporate income taxes were due September 16, giving the Treasury some leeway, but the Treasury must issue a large amount of nonmarketable debt to the entitlement-related trust funds on October 1, reducing its flexibility. Timing will become clearer after that, but the Treasury will likely be out of options by the end of October, when a large interest payment on Treasury securities is due.

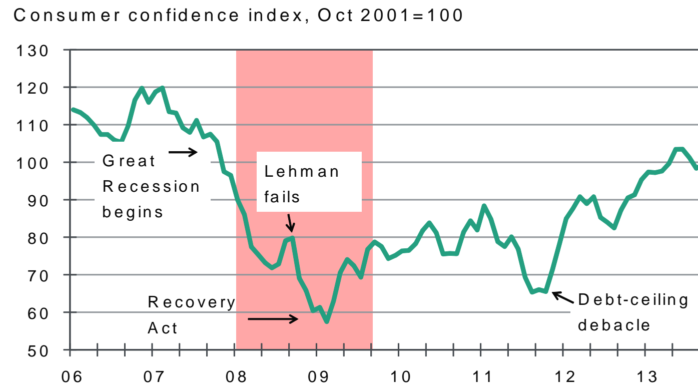
Operationally, the Treasury might be able to prioritize interest payments on U.S. government securities, as those payments are handled by a different computer system than other government obligations. But practically that would be difficult; it would entail paying bond investors before Social Security recipients, for example. Prioritizing other payments would likely not be possible, as the Treasury might not be able to sort through the blizzard of payments due each month to decide which to pay.

More likely, the Treasury would delay payments as officials suggested in a 2012 inspector general's report. The Treasury could also wait until it received enough cash to pay a specific day's bills. Initially, the resulting delays would be short, but they would increase over time. For example, if the Treasury hit its borrowing authority on October 18, payments to Medicare and Medicaid providers due that day would be delayed one business day, to October 21. But checks to be issued on November 1 for Social Security, veterans benefits and active-duty military pay would not go out until November 13.

It has become typical for Congress to run down the clock, but in the end it has never failed to come through. The motivation is clear: Any delay in raising the debt ceiling would have dire economic consequences. Consumer, business and investor confidence would be hit hard, putting stock, bond and other financial markets into turmoil.

This was clearly evident in the near-debacle that occurred in summer 2011, when lawmakers raised the debt ceiling at the very last minute. Brinkmanship nevertheless undermined consumer confidence, sent stock prices reeling, and caused credit default swap spreads on U.S. Treasury debt to widen sharply (see Chart 2). The bitter showdown

led Standard & Poor's to cut its rating on Treasury debt from AAA to AA+. Although policymakers acted before the debt ceiling was reached, the fallout nearly caused the fragile economic recovery to stall.



Another such confrontation would also effectively shut the government, which would have authority to spend but would not have the cash to pay for it. The Treasury would have no choice but to eliminate its cash deficit, which will run as high as $130 billion in November. This is about 9% of GDP (annualized). The economy would quickly fall into another severe recession.

Given the serious consequences of not raising the debt ceiling in a timely way, it is widely expected that Congress will do so. After several rounds of fiscal brinkmanship over the last few years, financial markets have become increasingly desensitized to the headlines coming out of Washington. However, lawmakers should not become complacent, thinking that breaching the debt limit is somehow all right. It is not. There will be a violent reaction in financial markets if policymakers fail to act in time.

Recommendation #3: Do not add to near-term fiscal austerity

In any agreement to increase the debt ceiling or extend funding for the federal government, lawmakers should avoid adding to the fiscal austerity in place through mid-decade. Congress has been appropriately focused on reducing the government's large budget deficits, but recent tax increases and government spending cuts have put a significant constraint on growth. Under current law, fiscal headwinds will continue to blow hard in 2014 and 2015. It would be wise not to add to those headwinds, and allow the private economy to gather momentum.

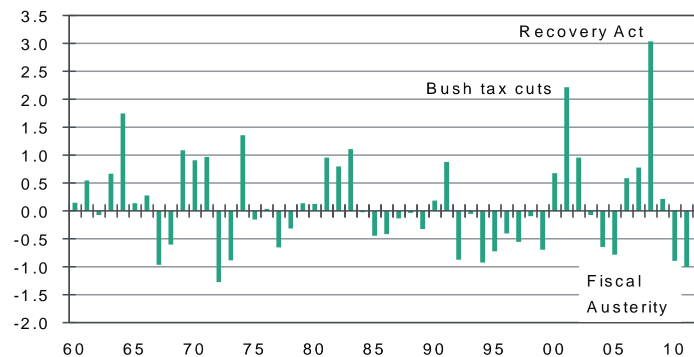
While the U.S. economy has begun its fifth year of recovery from the debilitating Great Recession, it remains fragile. Growth has been modest, with real GDP expanding close to 2% per year since the recovery began, and payrolls are still nearly 2 million jobs shy of their prerecession peak. The nation's 7.3% unemployment rate remains well above most estimates of full employment, which is closer to 5.5%. And this understates the stress in the job market given the large number of potential workers who have left the labor force because of a lack of perceived job opportunities.

The private economy has made significant strides since the recession. American companies have strong balance sheets with low debt and lots of cash, and they have done an excellent job reducing their costs. By most measures, they are highly competitive. The financial system is much better capitalized and liquid, and increasingly willing and able to extend credit. Households have also significantly reduced their debt loads, which are now about as low as they have ever been. Higher house prices and stock values are also supporting households' better financial condition.

But the strengthening private economy is not evident in the nation's overall performance because of fiscal austerity. In calendar year 2013, the drag on the economy from federal tax increases and spending cuts will amount to 1.5 percentage points of real GDP growth. That is, if fiscal policy were simply neutral with respect to the economy, real GDP growth this year would be closer to a strong 3.5% (2 percentage points in actual real GDP growth plus 1.5 percentage points from the elimination of the fiscal drag). The fiscal drag will reach its apex in the current quarter, and over the year is greater than in any other year since the defense drawdown that followed World War II (see Chart 3).

Chart 3: Fiscal Headwinds Are Blowing Hard

Real GDP growth impact of federal fiscal policy, fiscal yr, ppt



Source: Moody's Analytics

The federal government's improved fiscal situation also provides lawmakers with some leeway. Tax revenues are growing at a double-digit pace and government spending is falling. The budget deficit for fiscal 2013 is set to come in well below $700 billion.

This is still large, but it is half of what it was at its peak in fiscal 2009. Under current law and assuming the economic recovery stays intact, the deficit will continue to narrow through mid-decade. The nation's debt-to-GDP ratio, while uncomfortably high at more than 70%, will stabilize.

Given the still-fragile economic recovery, the austerity already in place, and a better near-term federal budget situation, policymakers should not add to the fiscal burden on the economy through mid-decade. This will help the private economy kick into higher gear, hasten a self-sustaining economic expansion, and promote a quicker return to full employment.

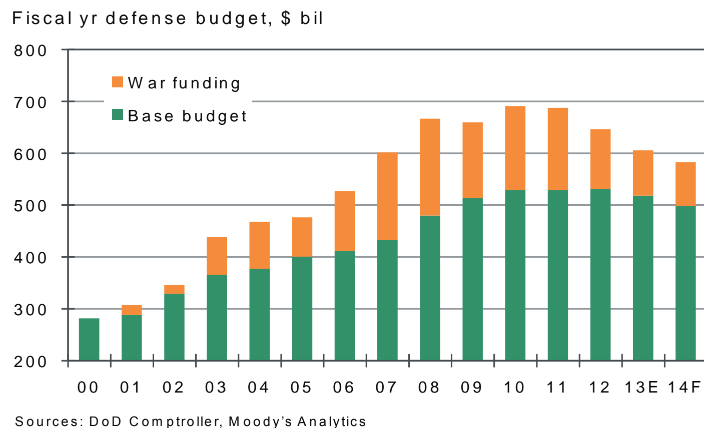
Recommendation #4: Replace the sequester

Policymakers should replace the cuts scheduled for the coming year as part of the sequester with other budget savings.

The impact of the current year's sequester, which began in March, is becoming more visible in the economic data. Hiring freezes announced early this year appear to have accelerated the decline in federal government employment. There has been an even larger impact on hours worked and personal income. Federal furloughs caused government wages and salaries to decline by half a percent in August alone. Cuts in procurement spending are also reducing support for private sector jobs, particularly among defense contractors, although the impact of the sequester on private employment is occurring gradually, with a significant lag.

A second year of sequestration will have greater consequences for the economy. The cuts will be larger and will start immediately, rather than beginning six months into the fiscal year as occurred this year. Because of lags between budgeting and actual spending, and between federal spending and its impact on the job market, the fallout from this year's cuts will carry over into 2014. A sizable share of the fiscal 2013 sequestration cuts was also made through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continuing the sequester would have particular implications for the Pentagon. While in fiscal 2013 sequestration cuts were divided evenly between security spending—on defense, homeland security and international affairs—and nonsecurity spending, in 2014 and beyond the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations. The potential for an escalation in military operations in Syria could increase the overseas contingency operations budget, which is not exempt (see Chart 4).



Recommendation #5: Enact budget reforms

The statutory debt ceiling is an anachronistic law that if not repealed should be reformed so that it can no longer lead to a voluntary default on U.S. government obligations. Fiscal-gap and intergenerational accounting should also be adopted in the budget process.

Using the threat of a default on U.S. government obligations as a tool in fiscal policy negotiations has meaningful economic costs. Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing, tax and spending policy, by requiring "ability to pay" language in any legislation that adds to future deficits. Ability to pay is defined as sufficient projected tax revenue and borrowing authority to cover the current Congressional Budget Office deficit forecast. This requirement would be applied to all direct spending, taxation and annual appropriations bills. Any discrepancies that result from changes in the CBO forecast could be reconciled in the annual budget process.

The debt ceiling would still force lawmakers to think about the long-term fiscal impact of any legislation, but it would do so in the context of the spending and taxation bills that create the need for that debt. This proposal makes use of current CBO budget projections and scoring practices, and thus should cause no new compliance costs.

Policymakers should also adopt the INFORM Act, which would require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting. (http://www.theinformact.org/content/text-bill) This provides a more accurate calculation of the nation's long-term fiscal obligations and thus would create the basis for sounder budgeting and fiscal decision-making.

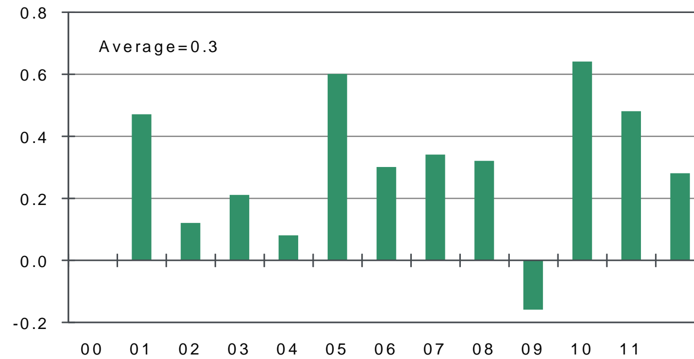
The fiscal gap describes the difference between the present value of projected government expenditures, including interest and principal payments on outstanding federal debt, and taxes and other receipts, including income accruing from the government's ownership of financial assets. Generational accounting measures the burden of closing the fiscal gap on today's and tomorrow's children, assuming they must do so on their own and that the burden on each generation is proportional to its labor earnings.

Fiscal-gap and generational accounting are comprehensive and forward-looking, and determine the sustainability of fiscal policy and the burden of that policy on future generations. Fiscal-gap accounting has already been adopted by the Social Security Trustees and Medicare Trustees and is becoming more widely used in other countries.

Recommendation #6: Adopt chained CPI and corporate tax reform

To break the budget impasse, policymakers should consider adopting the chained consumer price index in calculating Social Security benefits and tax liabilities. Revenue-neutral corporate tax reform resulting in a lower marginal corporate tax rate would also help the competitiveness of U.S. companies and thus support stronger long-term economic growth.

The chained CPI index is a more accurate measure of inflation than the current CPI index used in budgeting. Since chained CPI accounts for changes in consumers' spending behavior due to changes in the relative prices of goods and services (e.g. if the price of apples increases more quickly than that of bananas, consumers will buy fewer apples and more bananas) it grows more slowly than the CPI (see Chart 5). If the chained CPI were adopted in the budget, future Social Security benefits would increase more slowly and tax revenues would increase more quickly.



Overall, the change would save the federal government about $130 billion over the next decade, and much more in subsequent decades. This does not go nearly far enough to address our long-term fiscal problems, but it is a step in the right direction, as it includes both entitlement and tax reform. More of both will be necessary to put the nation on a sounder long-term fiscal footing.

Corporate tax reform, which involves reducing or eliminating tax expenditures in the corporate tax code and using the resulting additional revenues to reduce marginal rates for businesses, would also be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that result in lower effective tax rates. All the loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus long-term economic growth.

As part of corporate tax reform, multinational corporations would be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. This would give a onetime boost to tax revenues that could be used to finance needed infrastructure development in the U.S. This too would help the competitiveness of U.S. companies and thus long-term economic growth.

Conclusions

Washington’s recent budget battles have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and anxiety among consumers, businesses and investors, weighing on their willingness to spend, hire and invest.

Despite this, the economic recovery is four years old and counting, and the private economy has made enormous strides in righting the wrongs that triggered the Great Recession. Business balance sheets are about as strong as they have ever been, the banking system is well-capitalized, and households have significantly reduced their debt loads. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is Congress' willingness to fund the government after the end of this fiscal year and to raise the Treasury debt ceiling. If policymakers can find a way to do these things in a timely way, almost regardless of how ungainly the process is, then the still-fragile recovery will quickly evolve into a sturdy self-sustaining economic expansion.

We are close to finally breaking free from the black hole of the Great Recession. All it will take is for Washington to come together over the next few weeks.

Statement of
David Malpass before the
Joint Economic Committee
September 18, 2013

Vice-Chairman Klobuchar, Chairman Brady, members of the Committee, thank you for the invitation to testify on the debt limit. It's a vital economic and legislative issue.

The national debt already exceeds the nation's annual output, and the Administration is now requesting that Congress increase the debt limit above $17 trillion. As part of providing this increase, I think there should be an honest national debate on federal spending priorities and an agreement with the President on constructive spending restraint. There's huge economic upside for jobs, investment, the stock market and the dollar if you could lower the federal spending path or rewrite the debt limit to make it more effective.

The federal government is spending nearly $3.6 trillion per year and is planning to increase spending rapidly in coming years even with the sequester and the underfunding of national defense. Some of the spending is successful and adds to the nation's well-being, but another portion of the spending, several hundred billion dollars, is not successful enough to justify the taxes and debt used to pay for it.

This has created a spending and debt crisis that harms the economy and undermines investment and jobs. The crisis is particularly acute because several categories of federal spending will need to increase over the next two decades as the baby boom ages and requires more government services. Government health-care spending will more than double over the next decade to $1.8 trillion annually in 2023, while annual debt-service costs are expected to quadruple as interest rates normalize.

Given this demographic and interest rate cycle, spending and debt should be at lower-than-normal levels now in order to prepare for the coming increases. In addition, the maturity of the national debt held by the private sector should be longer than normal. Instead, the Fed's bond purchases have materially shortened the effective maturity of the national debt, and both spending and debt are at record levels even though the demographic bulge is just beginning to hit the federal budget. This leaves fiscal policies completely out-of-synch with long-term growth.

The debt limit provides a good opportunity to address this crisis. In negotiating the next increase, Congress and the Administration should take steps to downsize current spending and slow future spending growth. It's also vital to improve the allocation of spending -- less successful government programs should be reduced in order to make room for new programs and for more spending on successful programs. In my August 30 Wall Street Journal column, I advocated a menu approach in which the various parties suggest numerous methods to reduce spending and then negotiate a compromise.

Looking longer term, Congress should work to repeal and replace the current debt limit with a more effective limit. The current debt limit law is fatally flawed because Congress and the President are able to make unlimited spending commitments without first choosing how to pay for them. The debt limit law was initially created in 1917 to facilitate debt rather than limit it. The goal was to relieve Congressmen from having to vote for individual bond issues to fund their spending plans. This has left members unaccountable to voters – they get to create new spending programs and then let the Treasury Department and President demand more debt in order to pay for spending that has already occurred. The debt limit needs to be rewritten so that debt is approved prior to spending commitments rather than after-the-fact.

In my Forbes and Wall Street Journal columns, I've advocated replacing the debt limit with legislation to establish continuous spending restraint that strengthens when the debt-to-GDP ratio rises above a ceiling. I was privileged to work for Senator Bill Roth on this Committee in 1990 when he wanted to create a 50% debt-to-GDP limit. Unfortunately, the debt ratio is now more than double that, and it will take many years of continuous spending restraint to restore a more pro-growth debt level. In the ideal, there should be a downward glidepath for the debt ratio. It would set gradually lower debt-to-GDP limits which, if exceeded, would require Congress and the Administration to reduce their spending commitments or face escalating procedural restraints on spending.

I emphasis the huge economic and market upside from lowering the spending path and rewriting the debt limit to make it effective. Around the world and in the competition among U.S. states, investors reward spending limitations -- private sector investment and employment increase and median income rises. The second term of the Clinton Administration provides an example.

Movement toward spending restraint would also cause U.S. assets to appreciate materially. This lowers the cost of capital and creates more jobs. We've already seen a demonstration of that with the big market gains when the sequester was implemented. The sequester was a blunt instrument -- well-thought-out spending restraint would be even better received by financial markets.

There's been a great deal of discussion about whether an extended negotiation over the debt limit might unsettle financial markets or slow the economy. I think the benefits of a negotiation far outweigh the costs. Bond markets have examined the U.S. debt limit process and are very comfortable holding U.S. Treasury debt during debt limit negotiations – in fact, bond yields fell sharply during the 2011 negotiations, with the 10-year Treasury yield falling from 3.2% to 2% in July and August 2011.

In contrast with August 2011, it's unlikely that a major credit rating agency would downgrade the U.S. credit rating. I think financial markets would greet a partial shutdown of government spending during the debt limit negotiations with a yawn or quiet applause. The Administration would like to use financial markets to scare Congress into a clean debt limit, but I think the reality is that voter reaction will be the stronger referee on the debt limit negotiation. If voters think the negotiations are reasonable and constructive, they'll tolerate a partial shutdown, as will financial markets. There's no indication that financial markets are worried about a default or technical default on U.S. debt.

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. Austerity or "fiscal consolidation" encompasses two separate economic policies: government downsizing on the one hand, which causes more growth; and private sector downsizing on the other hand, which causes recessions. Many of the reform programs undertaken in Europe were harmful because they were built on private sector austerity, not government downsizing. The austerity often took the form of higher value-added taxes, wealth taxes and increases in government fees.

As the U.S. examines options, it should aim to reduce ineffective government spending. It drains the private sector because it requires new taxes or debt. An open Washington discussion of spending restraint, even a contentious one using a menu of options -- would receive a very positive market reaction.

In addition to spending restraint, I think the debt limit increase should include three steps to make the debt limit more honest. In recent years, the Federal Reserve has incurred extra debt by buying higher coupon Treasury bonds at a premium. The cumulative premiums that the Fed has paid and includes in its liabilities is already $200 billion and climbing fast. It is true national debt and should be included in the statutory debt limit.

Second, the Treasury is planning to issue a new class of debt, floating-rate notes. This would understate the nation's fiscal burden because interest payments on this type of debt will go up faster than on fixed-rate debt when interest rates rise.

Third, the debt limit should also consider the burden the Fed is creating for future taxpayers by buying longer-term Treasurys with trillions of dollars in short-term Federal Reserve debt. This will escalate the deficit and the national debt when interest rates rise.

One of the reasons for a debt limit is to protect future generations. This is being undermined by the government borrowing short-term. One concept would be to require Treasury to maintain a five-year minimum on the effective duration of the national debt held by the private sector. The Fed's bond purchases and any floating-rate notes issued by Treasury would reduce the effective duration, causing Treasury to lengthen the maturities of its fixed-rate debt issuance.

In conclusion, the U.S. is stuck in a "new normal" of very slow economic growth, high unemployment and falling median incomes. Federal spending and debt trends are weighing on growth and investment. The debt limit provides an opportunity to break out. The Administration and Congress should create a menu of constructive restraints and agree on a package. Movement in this direction would create a very positive economic and market reaction. Changes made now, even if they take effect in several years, would bring immediate benefits by improving the debt outlook.

The Costs of Debt Limit Brinksmanship*

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Testimony before the Joint Economic Committee
September 18, 2013

Vice-Chair Klobuchar, Chairman Brady, and Members of the Committee, thank you for inviting me to discuss the debt limit. It's a particular honor and pleasure to appear before this Committee, which gave me my start in public service more than a decade ago.

As you know, the federal government reached the debt limit in May. Since then, Treasury has used a variety of extraordinary measures, such as suspending investments in the Thrift Savings Plan's G-Fund, to stay within the limit. Those measures will be exhausted in mid-October, according to Treasury Secretary Jack Lew, leaving the government with just $50 billion of cash on hand.[1] The debt limit will become truly binding sometime soon thereafter. For example, the Bipartisan Policy Center projects that the "X Date" will fall between October 18 and November 5.[2] After that, Treasury won't be able to pay all of America's bills.

Congress should keep four things in mind as it works to raise the debt limit before that deadline.

1. Congress must increase the debt limit. Failure to do so will result in severe economic harm.

2. Debt limit brinksmanship is costly, even if Congress avoids breaching the limit at the last minute. The 2011 showdown scared investors and consumers, weakened the economy, and drove up Treasury borrowing costs.

* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its trustees, or its funders. Erin Behrman, Len Burman, William Gale, Benjamin Harris, Erika Poethig, Roberton Williams, and Eric Toder provided helpful comments, but all errors are my own.

[1] Lew (2013)

[2] Bell et al. (2013)

3. Our economy remains fragile. Unemployment has declined since the worst days of the Great Recession but remains far too high. Full employment appears to be years in the future. Now is not the time to hit the economy with unnecessary shocks.

4. The long-run budget outlook remains challenging. Deficits have fallen sharply in the past few years, due to the economic recovery, fading stimulus, deficit reduction efforts, and slower growth of health care costs. But current budget policies would still create an unsustainable trajectory of debt in coming decades. Congress should address that problem. But the near-term fiscal priorities are funding the government and increasing the debt limit.

Given the focus of today's hearing, I focus on the first and second points in the remainder of my testimony.

Failing to raise the debt limit would hurt our economy, perhaps catastrophically

If Congress fails to increase the debt limit, Treasury won't be able to pay all of America's bills. Someone—perhaps millions of someones—won't be paid on time. The resulting economic damage would grow with each passing day.

Delaying and prioritizing non-debt payments

After the "X date," Treasury would have to delay or stop transfer payments, employee salaries, and other non-debt payments. A key question is how it would do so.

One approach would be to delay payments day-by-day until sufficient resources are available. For example, if Treasury owed $15 billion on a particular day but had only $5 billion of free cash, it could wait—a day or a week or a month—until it had the full $15 billion in hand and then make all of those payments together. It could then repeat the process for the next day's set of payments. With each passing day, unpaid bills would pile up further, and payments would become more and more delayed. According to Treasury's Inspector General, officials concluded that this approach was "the least harmful option available to the country" during the 2011 debt limit impasse.[3]

Another approach would be for Treasury to pay some bills as they come due, while delaying others indefinitely. For example, Treasury might (hypothetically) prioritize

[3] Thorson (2012).

unemployment insurance and veterans' benefits, while delaying tax refunds and payments to contractors. In theory, such prioritization might allow Treasury to avoid some of the worst damage from a sudden stop in federal payments. In reality, however, it poses a host of logistical, legal, and political challenges. For example, Treasury's systems are not designed to allow picking and choosing among the more than 80 million payments it makes each month; payments are automatically made as they come due.[4]

Either approach would damage the economy. Federal employees, contractors, program beneficiaries, businesses, and state and local governments would find themselves suddenly short of expected cash, creating a ripple effect through the economy. Delays would be short at first, but would grow rapidly given current borrowing needs. The Bipartisan Policy Center estimates, for example, that if we hit the "X date" on October 18, Treasury will be more than $100 billion short in paying all its bills over the following month.[5]

Such delays could pose a significant challenge for any families or businesses that operate with tight budgets. Through no fault of their own, they could find themselves unable to pay their own bills.

The personal costs of delayed payments would grow, of course, as delays mounted. So would the macroeconomic damage. A short delay in non-debt payments might do relatively little harm to the overall economy, but a prolonged delay would be a powerful "anti-stimulus." In essence, the federal government would have to balance its budget immediately by cutting spending. That shock would grow with each passing month (except those occasional ones in which the government runs a surplus). It would also undermine confidence and increase economic uncertainty, further discouraging economic activity. During January's debt limit debate, Macroeconomic Advisers (2013) estimated that such spending cuts could drive the economy into a deep recession. Deficits have since come down, so the effect would be smaller today, but the basic result still applies. If the government has to suddenly move to a balanced budget for an extended period, the U.S. economy would likely plunge into recession.

Debt default

An even more severe possibility is that Treasury might default on the federal debt. To prevent that from happening, I expect that Treasury will attempt to prioritize interest and principal payments, but there is a risk that it won't succeed.[6]

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[4] Thorson (2012).
[5] Bell et al. (2013).
[6] The Bipartisan Policy Center (Bell et al. 2013) and Macroeconomic Advisers LLC (2013) also anticipate this approach. As far as I know, no administration representative has publicly endorsed

Prioritizing debt payments over other obligations is technically feasible because they go through Fedwire, a computer system separate from the one that handles other payments. It is also appropriate because it would maintain the full faith and credit of the United States in financial markets. Less clear is whether prioritizing debt payments would be financially feasible. Interest payments average only 8 percent of federal revenues at the moment,[7] but cash management isn't about averages. Interest payments are lumpy, and tax receipts are lumpy and uncertain, so Treasury would have to take care in matching them. In addition, there's a risk that a debt limit crisis may cause problems rolling over maturing debt issues. For both reasons, debt prioritization is harder than sometimes claimed, and Treasury might unintentionally find itself short of cash when an interest payment comes due or maturing debt needs to be rolled over.

In considering this risk, Congress should keep in mind that accidents can happen. In 1979, for example, Treasury accidentally defaulted on a portion of the debt in the wake of a debt limit showdown:

> Investors in T-bills maturing April 26, 1979 were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills which became due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules. (Zivney and Marcus 1989)

That default was narrow, applying only to T-bills owned by individual investors, and was rectified in a few weeks. Nonetheless, financial markets reacted badly. Zivney and Marcus (1989) estimate that T-bill interest rates increased by about 60 basis points after the first default and remained elevated several months thereafter. The default thus significantly boosted the government's borrowing costs.

If a debt limit impasse forced Treasury to default on the debt today, the results would be at least as severe. Faced with new risks, investors would demand a premium to invest in U.S. Treasuries. Debt service costs would rise, crowding out funding for government programs, forcing higher taxes, or boosting deficits.

But higher interest rates are only the beginning of the costs. Default would also threaten our financial system and, thereby, the real economy. Treasury securities play a unique and

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debt prioritization, but in the final days of the 2011 impasse, one anonymous official reportedly said that Treasury would do it if necessary (Cook and Hopkins 2011).

[7] Congressional Budget Office (2013).

vital role in financial markets. Large swaths of America's financial infrastructure have been built on the assumption that U.S. Treasuries pay on time. Treasury securities serve as collateral in the short-term lending markets that provide trillions of dollars of liquidity to the financial system. In addition, money market funds hold Treasury securities to make sure they can repay savers' investments.

Those financing arrangements all presume that Treasuries are money-good. If the federal government defaulted, those markets would begin to unravel. Credit would tighten, financial institutions would scramble for cash, and savers might desert money market funds. The magnitude of the resulting economic harm is difficult to judge and would depend on the scope and duration of the default. But anyone who remembers the financial crisis of five years ago should shudder at the thought of disrupting these markets again.[8]

"Super-extraordinary" measures won't save us

Given the severe economic harm of delaying payments or defaulting on the debt, many observers have wondered whether Treasury might find another way out—a "super-extraordinary" measure—that would allow it to keep paying America's bills even if the debt limit isn't raised. Ideas include ignoring the debt limit on the grounds that it violates the 14th Amendment to the Constitution,[9] using a loophole in coinage laws to mint platinum coins of extremely large denominations,[10] or selling gold or other assets owned by the government.

These ideas differ in their particulars, but share one common feature: administration officials have rejected all of them as impractical or illegal. The president's lawyers reportedly do not believe that the 14th Amendment gives him the authority to ignore the debt limit.[11] Treasury and the Federal Reserve announced that platinum coins won't work.[12] And Treasury officials have concluded that selling gold would be "destabilizing to the world financial system" and that selling student loans (the government's largest financial asset) would not be feasible.[13]

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[8] Matthew Zanes (2012) describes the financial market risks at greater length; at the time, he chaired the Treasury Borrowing Advisory Committee.
[9] Section 4 of the amendment reads: "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."
[10] Marron (2013).
[11] See, e.g., Calmes and Hulse (2011): "'I have talked to my lawyers,' Mr. Obama said, and 'they are not persuaded that this is a winning argument.'"
[12] Klein (2013) quotes Treasury spokesman Anthony Coley: "Neither the Treasury Department nor the Federal Reserve believes that the law can or should be used to facilitate the production of platinum coins for the purpose of avoiding an increase in the debt limit."
[13] Thorson (2012).

Treasury thus has no good options when the debt limit clock runs out. Billions, then tens of billions, then hundreds of billions in federal obligations would go unpaid, and millions of Americans would suffer the consequences.

Brinksmanship also imposes large economic and fiscal costs

Going past the "X date" would harm our economy and our people. That's why it's vital for Congress to increase the debt limit.

But that isn't enough. To completely avoid harm, Congress must do more: it must raise the debt limit without the extreme brinksmanship we saw in 2011. Such brinksmanship does not come free; instead, it imposes costs in its own right.

First, and most important, is the risk of making a mistake. Cash flows are uncertain, and parties to heated negotiations sometimes misread their opponents' position and capabilities. As a result, there is always the risk that brinksmanship would result in the United States going over the brink by accident, delaying payments and raising the risk of debt default.

Second, interest rates would rise. Investors are forward-looking. If they believe there is a real risk that Treasury might default in the future, they will demand a premium for holding Treasury securities today. That's exactly what happened during the 2011 crisis. As documented by the Government Accountability Office (2012), the funding advantage that the United States enjoys over private businesses narrowed during that debate, suggesting that investors saw greater risk in holding Treasuries. GAO estimates that the federal government paid out an extra $1.3 billion in interest during fiscal 2011 as a direct result. Over the full maturity of the debt, that figure balloons to $18.9 billion according to the Bipartisan Policy Center. Brinksmanship can be expensive.[14]

Third, debt limit showdowns increase uncertainty and reduce confidence. As a result, families and businesses may cut back on their spending and investment while they wait to see what will happen. During the 2011 debt limit crisis, consumer confidence and the stock market both plummeted and concern about financial market risks skyrocketed.

[14] The GAO (2011) notes that debt limit impasses disrupt the regular schedule of Treasury bill and bond auctions and thus weaken Treasury's ability to get the lowest interest rates. The GAO estimates that the debt limit debates in 2002, 2003, and 2010 "modestly" increased borrowing costs as a result.

Finally, brinksmanship weakens America's global image. The United States is the only major nation whose leaders talk openly about the possibility of self-inflicted default. At the risk of sounding like Vladimir Putin, such exceptionalism is not healthy. As every other nation understands, if you need to borrow, you can only hurt yourself by scaring your creditors. But the problem is deeper than that. Debating intentional default contributes to the perception that the United States does not know how to govern itself.

The debt limit is one failure of a broken budget process; we need a new one

The debt limit is a peculiar and flawed feature of America's fiscal policy. Borrowing decisions cannot be made in a vacuum, separate from other fiscal choices. America borrows today because this and previous Congresses chose to spend more than we collect in revenue, sometimes with good reason, sometimes not. If Congress is concerned about debt, it needs to act when it makes those spending and revenue decisions, not months or years later when financial commitments are already in place.

When the dust settles on our immediate fiscal challenges, Congress should re-examine the entire budget process, seeking ways to make it more effective and less susceptible to dangerous, after-the-fact brinksmanship.

Thank you again for inviting me to appear today. I look forward to your questions.

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