What the debt ceiling really means

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The clock is slowly ticking toward Aug. 2, the date on which the U.S. faces “fiscal Armageddon” — according to the Obama administration — unless Congress agrees to raise the debt ceiling. But would we?

The Obama administration, as well as much of the media and many economists, tend to equate failure to raise the debt limit with default. That’s not precisely true.

The Treasury Department estimates that the federal government will collect a bit more than $203 billion in taxes during August — roughly $36 billion just in the first three days. But, during August, the federal government is expected to spend $307 billion. That is why we have a problem.

If the government is not able to borrow more money after Aug. 2, spending will have to be reduced to the amount of revenue that the government has. That would require roughly a 44 percent cut in federal spending.

This will almost certainly hurt. But it’s not the same as default. During August, interest payments on the federal debt will total roughly $29 billion, meaning that there will be sufficient revenue to meet our obligations to creditors. If the Obama administration is truly worried that we might not do so, they could always support legislation by Sen. Pat Toomey (R-Penn.) that would require the Treasury Department to pay our creditors first.

In addition, some $467 billion in government bonds is expected to come due during August, and will have to be rolled over. Though this rollover requires Treasury to enter the debt markets to purchase new securities, it is not technically “new” debt, and so does not run afoul of the debt limit.

The concern is that the U.S. would end up having to pay higher interest rates on this rolled over debt. That’s not a trivial concern: A 1 percent increase in interest rates could cost taxpayers more than $100 billion per year.

Still, we should keep that in perspective — it’s less than the amount that the government expects to borrow this month. And that is sort of worst case scenario. In 1979, the federal government actually did briefly default on its debt as the result of a debt ceiling impasse (as well as technical problems). That resulted in just a 60-basis-point increase in interest rates.

If we are really worried about a hike in interest rates, what about the hike we can expect if we fail to get federal borrowing under control? Both our deficit and total liabilities are already higher as a percentage of gross domestic product than Greece — or any of the other failing welfare states of Europe.

Despite this, creditors have been willing to lend us money at very low interest rates, simply because they trust the U.S. economy over the long-term. If we don’t get our budgetary house in order, however, that won’t be the case forever. Eventually, we will have to hike

interest rates to ensure that the Chinese and others keep buying our bonds.

Former Federal Reserve governor Lawrence Lindsey estimates that if interest rates simply return to their historic average, it is likely to cost taxpayers $420 billion in higher payments in 2014, and $700 billion by 2020. The $100 billion or so that we might have to pay if we miss the debt ceiling looks good by comparison.

And what about that 44 percent cut in spending? That would require the federal government to cut spending all the way back to what it spent in 2003 — a year not notable for mass starvation and economic collapse. In fact, the revenue we will collect in August would more than cover Social Security payments, Medicare and military salaries, in addition to interest payments on the debt.

Obviously, the longer the impasse goes on, the more the inability to borrow will hurt. We will face a super version of the government shutdowns that we've endured before. But, eventually, the debt ceiling is going to be increased and government operations will return to more or less normal.

The real fiscal Armageddon that this country faces comes not from a delay in raising the debt ceiling, but from out-of-control federal spending and government debt.

If a little pain now helps solve that problem for the long term, it may well be worth it.

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