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On March 15th, the United States Treasury reached the limit of its authority to borrow money. Commonly known as the debt ceiling, the limit is imposed by Congress and is intended to maintain control over the executive branch's power to spend money. The debt ceiling (total) now stands at $20 trillion dollars. As part of the October 2015 deal that saw the rise of Rep. Paul Ryan to the position of Speaker of the House of Representatives, the debt ceiling (then $18.1 trillion) was allowed to float upwards until it would be frozen on March 15th. This was intended to remove (or perhaps just delay) partisan bickering over the debt ceiling until after the presidential election.

Unless Congress acts to raise the debt ceiling, the U. S. Treasury cannot borrow more money. Treasury can continue to issue new debt as old debt expires, and they can use incoming revenue to pay bills that come due (a good thing, since April is a month when a lot of money comes in from taxpayers, including me). While this may seem rather dire, Treasury officials have developed a number of cash conserving strategies that will allow critical bills to be paid until October. After all, this is not the first time that increasing the debt ceiling has been used as a political weapon.

No one expects that the debt ceiling will be left at $20 trillion. If that were to happen, many payments that Treasury makes, such as Social Security, Medicare, military payrolls, etc. would not be paid in full or might even go unpaid. The failure of the U.S. to pay its bills would cause serious cracks in the credibility of the U.S. to honor its obligations, including U.S. Treasury bills, notes and bonds. The U.S. is the only issuer of debt in the world to have its debt regarded as so safe that a failure to pay it seems unthinkable, and the politician(s) who cause the cracks would be guaranteed to lose elections and their jobs.

The safety of U.S. debt was not always so. At the birth of our nation, we were behaving like a teenager with a credit card and a set of car keys. As a result of the War of Independence, our overall debt was around $77 million, much of that consisting of IOUs given to soldiers in lieu of actual pay. Debt had been issued by the states and the Continental Congress and most investors doubted it would be paid back. Many soldiers sold their IOUs to speculators at discounts of as much as 85%. In 1789, a new Congress and President took office facing this serious money problem.

Perhaps one of the wisest acts George Washington did upon taking office was to name Alexander Hamilton as the first Secretary of the Treasury. Hamilton had served Washington faithfully as his key aide during the war, despite his itch to have a command of his own, and his loyalty was rewarded. Next, we set the stage with a wise move by Congress (pun only partly intended – I have not seen 'Hamilton' and as one client recently put it, seeing it is not in my tax bracket).

In 1789, the House of Representatives requested that Hamilton issue reports on fiscal and economic policy to them by January 1790. Hamilton issued the First Report on the Public Credit on January 9th, and this contained his recommendations that proved to be the seeds of our current status as the sole economic superpower of today. At the time, there were three theories about how to deal with our mountain of debt. The first, Repudiation, was exactly what the word means – the U.S. Treasury would disavow or reduce payment on debt held by U.S. residents, while still guaranteeing full payment of the approximately $12 million held by foreigners. The second idea, called Discrimination, was to pay those

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IOUs back at full value to the original owners while also reimbursing the speculators for what they paid to purchase them from those poor soldiers. This would cost more than the original value of the debt.

The third choice, and Hamilton's advice was Redemption. In the First Report, he argued for the consolidation of the debt issued by the states under the new federal government, and to pay them back at full value to the current holders. He further advised that the interest on those debts be converted into new principal to be paid back, and that a portion of the government income from tariffs be devoted exclusively to the repayment of the debt. This focus on fidelity to creditors proved to lay the foundation for the "full faith and credit" reputation that our debt now holds among investors all over the world.

This decision, while ultimately sound, did cause pain for a long time. From 1790 to 1800, 80% of federal revenue went to debt repayment and fully half of that was interest. In today's federal budget, only 6% (about $225 billion a year) goes to pay interest on our debt, and we aren't reducing the principal. As interest rates rise, we expect that interest cost will become a much larger chunk of our budget.

For most of our history, our debt burden has been reasonable – averaging 40% of gross domestic product (GDP). The percentage has risen during three wars – the Civil War, World Wars I and II – but each time it has been paid down to a reasonable level during peacetime. The debt level during World War II was the first time that debt exceeded annual GDP, and while it was paid down in the 1950's (through high taxes), the debt increased again during the 1970's. The increase accelerated after the 2008 financial crisis, as entitlement spending expanded to deal with the aftermath of the Great Recession and job losses. Total debt held by the public (including foreigners) stands at $14 trillion, or about 75% of GDP, while the remaining $6 trillion is debt between government agencies. The total of $20 trillion amounts to 105% of GDP. Much of the interagency debt is lent by the Social Security Trust Fund, which issues its own form of bonds. It still must be paid back, eventually, by tax revenues.

So it seems we are in a bit of a pickle, given our high level of debt. While it might be a nice idea to pay it all off, this isn't practical and is probably a bad idea for the same reasons Hamilton used – we need some established credit in order to maintain investor confidence and keep borrowing. The U.S., unlike a household, is a perpetual entity and thus can be a perpetual borrower. We personally may want to pay our mortgage off before we retire, but the U.S. can continue to grow. We may have to issue more debt someday to deal with a critical need, much like we had to during World War II.

There are three basic ways to resolve this. More growth would lift GDP and the resulting increase in tax revenue could help lower the actual debt over time. Decreasing spending – primarily through managing entitlement spending, which is more than half of our total annual spending – could also lower the growth rate of our debt. Improving taxation to collect more revenue as a % of GDP would also help. In reality, we need all three ideas, as none will likely work on its own.

Don't be surprised (or disheartened) at the rhetoric that accompanies the discussion over raising the debt ceiling in the coming weeks and months. After all, we have different groups of Americans who think the only answer is growth – or more taxes – or cutting spending – without looking at a balanced approach. This particular raise in the debt ceiling isn't that likely to break our piggybank, and is pretty much assured despite the rhetoric. We hope that over time, a sensible approach emerges and we can rest easier knowing our country, thanks to Alexander Hamilton, will always be good for its debts.

Thomas E. Dexter, CFP®

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