

# CRS Report for Congress

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## Paying Down the Federal Debt: A Discussion of Methods

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### Summary

Beginning with fiscal year 1998, the federal government began running budget surpluses; that is, the flow of revenue into the U.S. Treasury exceeded the outflow of expenditures. The Treasury lowered the amount of outstanding publicly held debt by reducing new debt issuance as existing federal debt issues matured. In addition, on March 9, 2000, the Treasury conducted its first buyback operation of outstanding Treasury securities before maturity. As of January 25, 2002, the Treasury had repurchased outstanding Treasury securities with a total par value of \$63.5 billion. This report examines these two methods of paying down the publicly held debt and discusses estimates of the publicly held debt that could not be retired by the end of FY2011. Recent budget projections indicate that the U.S. government will incur deficits in fiscal years 2002 and 2003. Hence, at least in the near term, the publicly held debt will no longer be paid down but instead will increase. This report will not be updated.

Beginning with fiscal year 1998, the federal government began running budget surpluses; that is, the flow of revenue into the U.S. Treasury exceeded the outflow of expenditures. Consequently, the Treasury reduced the amount of outstanding publicly held debt.<sup>1</sup> This report examines the Treasury's methods of reducing the publicly held debt.<sup>2</sup>

In January 2001, the Congressional Budget Office (CBO) reported that the budget surplus was \$236 billion in fiscal year 2000. CBO's baseline projections of the budget

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<sup>1</sup> The sum of publicly held federal debt and federal debt held in government accounts equals total federal debt. For an explanation of the relationship between budget surpluses (and deficits) and different concepts of federal debt, see CRS Report RS20767, *How Budget Surpluses Change Federal Debt*, by Philip D. Winters.

<sup>2</sup> For an examination of some economic consequences of eliminating the publicly held debt, see CRS Report RL30614, *What If the National Debt Were Eliminated? Some Economic Consequences*, by Marc Labonte.

showed rising budget surpluses through fiscal year 2011; consequently, the publicly held debt was projected to decline in nominal dollars through fiscal year 2011.<sup>3</sup> In January 2001, CBO's baseline projections indicated that the publicly held debt would decline from year to year as follows: \$3,410 billion (FY2000 actual), \$3,148 billion (FY2001), \$2,848 billion (FY2002), \$2,509 billion (FY2003), \$2,131 billion (FY2004), \$1,714 billion (FY2005), and \$1,251 billion (FY2006).<sup>4</sup> After FY2006, CBO's projected surpluses would result in the Treasury's cash on hand exceeding its ability to retire debt held by the public. Hence, CBO's projections of the amount of publicly held debt "simply assume[d] that the Treasury ... [would] ... accumulate all funds exceeding the amounts needed to retire available debt."<sup>5</sup>

## Methods of Paying Down the Debt

When the government first began running surpluses in FY1998, the Treasury used only one method to pay down the debt—reducing new debt issuance. Today, the Treasury has another method—buying back outstanding debt.<sup>6</sup>

### Reduction and Elimination of New Debt Issuance.

All publicly held debt eventually matures. To reduce the debt outstanding, the Treasury issued smaller replacement issues, issued securities less frequently, and discontinued the issuance of particular maturities. For example, on May 6, 1998, the Treasury announced that it would stop issuing three-year notes after May 1998, and that the auctions of five-year notes would be changed to quarterly auctions from monthly auctions.<sup>7</sup> The dollar volume of new debt issued was less than the dollar volume of maturing debt; consequently, the dollar volume of outstanding publicly held debt declined.

### Buybacks of Outstanding Debt.

On August 4, 1999, the Treasury published for comment proposed rules for permitting it to buy back outstanding debt securities before maturity.

Lawrence H. Summers, the Secretary of the Treasury, stated that buyback of debt would offer the following three advantages:

First, by prepaying the debt we would be able to maintain larger auction sizes than would otherwise be possible. Enhancing the liquidity of Treasury's benchmark

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<sup>3</sup> For an examination of the accuracy of budget projections, see CRS Report RL30854, *Uncertainty in Budget Projections*, by Philip D. Winters.

<sup>4</sup> U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002 - 2011* (Washington: GPO, Jan. 2001), p. 15.

<sup>5</sup> *Ibid.*, pp. 15-16.

<sup>6</sup> For an overview of federal debt management, see CRS Report 98-370 E, *Federal Debt Management: An Overview of Concepts and Policy Options*, by James M. Bickley.

<sup>7</sup> John M. Berry, "Treasury to Reduce Sales of Securities," *The Washington Post*, May 7, 1998, p. E4.

securities should lower the government's interest costs over time and promote overall market liquidity.

Second, by paying off debt that has substantial remaining maturity, we would be able to prevent what would otherwise be a potentially costly and unjustified increase in the average maturity of our debt: from just over five years to more than seven years on the current trajectory.

Third, by paying off debt, we can absorb excess cash at times of the year when tax revenues exceed immediate spending needs. This kind of absorption is an important part of sound debt management.<sup>8</sup>

On January 13, 2000, the Treasury announced that during calendar year 2000 it would purchase outstanding Treasury securities before maturity worth as much as \$30 billion.<sup>9</sup> On January 19, 2000, the Treasury published its final rules, which adopted the proposed rules without significant changes. Under the final rules, redemption prices would be determined through a process in which market participants would submit competitive offers to sell particular Treasury securities back to the Treasury.<sup>10</sup> On March 9, 2000, the Treasury bought back \$1 billion in Treasury bonds in its first debt buyback in calendar year 2000.<sup>11, 12</sup> As of January 25, 2002, the Treasury had conducted buyback operations of outstanding Treasury securities with a total par value of \$63.5 billion.<sup>13</sup>

Through fiscal year 2011, the magnitude of the maximum possible reduction in the publicly held debt was controversial. Non-retireable debt can be classified as marketable debt and non-marketable debt. Marketable debt can be readily purchased or sold on financial markets. For example, Treasury coupon bonds are actively traded. Non-marketable debt cannot be sold on financial markets. For example, savings bonds and state and local government series debt (used to house state and local bond proceeds temporarily) are non-marketable.

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<sup>8</sup> U.S. Dept. of the Treasury, *Treasury News*, Statement of Lawrence H. Summers, Secretary of the Treasury, Washington, Aug. 4, 1999, p. 2.

<sup>9</sup> Yichi J. Dreazen and Gregory Zuckerman, "Treasury Announces Its Plan to Buy Back Debt of as Much as \$30 Billion, Above Expectations," *The Wall Street Journal*, Jan. 14, 2000, p. C19.

<sup>10</sup> For a presentation of the final rules, see: U.S. Dept. of the Treasury, Fiscal Service, "Marketable Treasury Securities Redemption Operations," *Federal Register*, vol. 65, no. 12, Jan. 19, 2000, pp. 3,114-3,118.

<sup>11</sup> U.S. Dept. of the Treasury, "Treasury Announces Debt Buyback Operation," *Treasury News*, March 7, 2000, p. 1.

<sup>12</sup> The Treasury last repurchased debt during the Hoover Administration in 1930, as reported in the following source: Jacob M. Zuckerman, "Treasury Unveils Anticipated Buyback Plan as Bond Prices Finish with Only Small Gains," *The Wall Street Journal*, March 8, 2000, p. C24.

<sup>13</sup> For a summary of Treasury buyback operations, see: [<http://www.publicdebt.treas.gov/of/ofbuybaksum.htm>], visited Jan. 25, 2002.

## Projections of Non-Retireable Publicly Held Debt.

Projections varied concerning the amount of publicly held debt that could not be retired by the end of FY2011 because of different assumptions. For example, assumptions differed about the willingness of owners of Treasury bonds to sell their bonds back to the federal government without being paid an “unacceptably high” premium.

The Bush Administration maintained that \$1,158 billion was non-retireable by the end of FY2011.<sup>14</sup> Of this total, \$790 billion was marketable debt consisting of \$677 in coupon issues (non-matured 10 and 30 year bonds) and \$113 billion in inflation-indexed issues (non-matured 10 and 30 year bonds).<sup>15</sup>

OMB [the Office of Management and Budget] estimates that it would cost between \$50-\$150 billion in bonus payments to entice these holders to give up their bonds. It makes more sense to let this debt mature naturally, leaving the Nation on a glide path to zero debt after 2011.<sup>16</sup>

The other \$368 billion was non-marketable debt consisting of savings bonds (\$170 billion); state and local government series (\$86 billion); bonds backing up emerging market Brady bonds, maturing between 2019-2023 (\$19 billion); bonds issued as part of the savings and loan clean-up, maturing between 2019-2030 (\$30 billion); and “other” debt (\$63 billion).<sup>17</sup>

The Congressional Budget Office projected that \$818 billion was non-retireable by the end of FY2011.<sup>18</sup> CBO assumed that after 2002 the magnitude of the Treasury’s debt buyback effort would decline because most holders of outstanding 30-year bonds would not “... sell them at prices that the government is willing to pay.”<sup>19</sup> CBO assumed that non-marketable debt (for example, savings bonds or securities issued to state and local governments) that serves other purposes besides financing government activities would continue to be issued.<sup>20</sup> Lastly, CBO assumed that “no debt with a maturity of five years or more will be issued after 2002.”<sup>21</sup>

On March 2, 2001, Alan Greenspan, Chairman of the Federal Reserve Board of Governors, testified before the House Budget Committee that

As of January 1, ... there was in excess of three quarters of a trillion dollars in outstanding nonmarketable securities, such as savings bonds and state and local series

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<sup>14</sup> U.S. Executive Office of the President, Office of Management and Budget, *A Blueprint for New Beginnings, A Responsible Budget for America’s Priorities* (Washington: GPO, 2001), p. 31.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid., p. 30.

<sup>17</sup> Ibid., p. 31.

<sup>18</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002 - 2011* (Washington: GPO), Jan. 2001, pp. 13-15.

<sup>19</sup> Ibid., p. 15.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

issues, and marketable securities (excluding those held by the Federal Reserve) that do not mature and could not be called before 2011. Some holders of long-term Treasury securities may be reluctant to give them up, especially those who highly value the risk-free status of those issues. Inducing such holders, including foreign holders, to willingly offer to sell their securities prior to maturity could require paying premiums that far exceed any realistic value of retiring the debt before maturity.<sup>22</sup>

But, Gary Gensler, former Treasury Undersecretary for Domestic Finance during the Clinton Administration, stated that

close to \$3.0 trillion of the currently outstanding 3.4 trillion in publicly held debt could be paid off, leaving outstanding between \$410 and \$500 billion in debt at the end of ten years. I believe that Treasury can achieve this in the future, by: (1) allowing the vast majority of this debt to mature as it comes due; (2) making various changes to debt management policies over time; and (3) smoothly repurchasing over time the majority of Treasury's long term debt at market level prices.<sup>23</sup>

He maintained that the Treasury could discontinue issuance of any new longer-term debt, continue to buy back long-term debt, and begin exchanging short-term debt for long-term outstanding debt.<sup>24</sup> Furthermore, he stated that the Treasury could discontinue issuing special non-marketable securities for state and local governments, which then would invest in alternative debt instruments.<sup>25</sup> Lastly, he asserted that the Thrift Savings Plan for federal employees (equivalent to a 401K program) could replace its Treasury securities fund option with a new private bond fund.<sup>26</sup>

### **Return of Deficits.**

During fiscal year 2001, the U.S. government had a budget surplus of \$127 billion, which was below CBO and OMB projections for three primary reasons. First, in March 2001, a recession started that lowered revenues and raised expenditures. Second, revenue growth was reduced by tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), which was signed by President Bush in June 2001. Third, the terrorist attacks on September 11, 2001, had negative effects on the budget and further lowered the surplus at the end of fiscal year 2001. All three of these factors have carried over into fiscal year 2002.

On January 23, 2002, Dan L. Crippen, Director of CBO, stated the new CBO baseline projected deficits for fiscal years 2002 and 2003.<sup>27</sup> CBO's baseline projections

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<sup>22</sup> Testimony of Alan Greenspan, Chairman of the Federal Reserve Board of Governors, before the House Budget Committee on March 2, 2001.

<sup>23</sup> Letter from Gary Gensler, former Treasury Undersecretary for Domestic Finance in the Clinton Administration, to Rep. John Spratt on Feb. 27, 2001.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal years 2003-2012*, (continued...)

“are constructed according to rules set forth in law and long-standing practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged.”<sup>28</sup> But, on January 23, 2002, President Bush stated that his 2003 budget would include a large increase in spending on defense and homeland security.<sup>29</sup> He indicated that the federal budget would incur a deficit of \$106 billion for fiscal year 2002 and \$80 billion for fiscal year 2003.<sup>30</sup> Mitch Daniels, Director of OMB, said that the return of deficit spending would cause the federal government’s pay down of the debt to be stopped temporarily.<sup>31</sup> Both CBO’s baseline projections and OMB’s budget proposals indicate that surpluses reoccur; consequently, within several years, the Treasury may again begin reducing the publicly held debt.

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<sup>27</sup> (...continued)

Statement of Dan L. Crippen, Director, before the Senate Committee on the Budget, Washington, Jan. 23, 2002, p. 1.

<sup>28</sup> Ibid., p. 2.

<sup>29</sup> Nancy Ognanovich, “Bush Proposing \$50 Billion Defense Hike in Plan Marking Return to Deficit Spending,” *Daily Tax Report*, no. 14, Jan. 24, 2002, p. G9.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.