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SUMMARY

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Debt Limit Policy Questions: What Are the Potential Economic Effects of a Binding Federal Debt Limit?

Federal law prohibits the "face amount of obligations whose principal and interest are guaranteed by the United States Government" from exceeding the statutory debt limit (31 U.S.C. §3101). The Department of the Treasury has the power to take some temporary "extraordinary measures" that extend the date on which the statutory limit is reached. In the event that the federal government reaches the statutory debt limit and exhausts extraordinary measures, the law prohibits Treasury from incurring any additional debt, and Treasury would be required to meet spending demands exclusively through money received from incoming revenues and existing debt. On January 21, 2025, Treasury began implementing "extraordinary measures" to prevent the debt limit from binding and allow the government to make its payments in full and on time.

How Treasury would respond under such a scenario is unclear. Among its options would be delaying payments until it is able to make them in full or making partial payments on time. Some have proposed that Treasury prioritize certain payments over others, though it is unclear whether Treasury has the capability to construct its payment systems to accommodate payment prioritization or if it has the legal authority to pursue that strategy under current law. The practical hurdles may be less significant for principal and interest payments on the national debt, which the government makes through a separate system managed by the Federal Reserve. Lawmakers have introduced legislation that would direct Treasury to prioritize certain payments in the event of a binding debt limit.

Financial institutions around the world perceive U.S. Treasury securities to be among the safest assets available. If investors became concerned that Treasury could not make timely and full payments on the federal debt—regardless of whether the United States actually defaults on debt payments—they will likely demand higher interest rates. An increase in interest costs would increase future government outlays and therefore cause the national debt to grow more quickly than it otherwise would.

Making partial or late payments on the national debt might also harm economic activity and the global financial system. Many financial institutions hold large amounts of Treasury securities to use as collateral in large transactions, making the perceived safety of those securities fundamental to the functioning of global financial markets and trade. A sudden perception that U.S. Treasury bonds are riskier would make these bonds less valuable, threatening the systems the bonds underpin. A decline in the value of federal bonds would also lead to a loss of wealth for the businesses, households, and foreign entities that hold these bonds. This decline could have unpredictable effects on the domestic and global economy.

Cuts to other federal spending might also threaten economic demand in the United States, which may reduce economic activity and increase both the likelihood and magnitude of a recession. The exact scale of this decline would depend on which payments the federal government does not make in full and on time; the duration of the debt limit episode; and the state of the economy and financial system at the time of the missed payments. A binding debt limit would also prevent the federal government from financing stimulus outlays or automatic stabilizers with new debt, leaving fiscal policy less capable of addressing an economic downturn.

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The Debt Limit

Under current law, the federal government's outlays are projected to exceed its revenues both this year and in the foreseeable future, according to the Congressional Budget Office (CBO). As a result, the federal government must finance its spending by borrowing money, which it does through debt issuances of Treasury securities, including Treasury notes, bills, and bonds (collectively known as "Treasuries"). The amount of money that the Department of the Treasury may borrow is restricted by a statutory limit on the debt, referred to as the *debt limit* or *debt ceiling* (codified at 31 U.S.C. §3101).

The statutory debt limit is currently set to $36.1 trillion. On January 21, 2025, Treasury began implementing "extraordinary measures" to prevent the debt limit from binding and allow the government to make its payments in full and on time.[1] Extraordinary measures temporarily delay when a debt limit will bind, but cannot do so indefinitely: when last implemented in January 2023, such measures were projected to be exhausted in June of that year.[2] Such estimates are subject to considerable uncertainty.

Effects on Spending of a Binding Debt Limit

In the event that the debt limit binds, Treasury could not legally borrow any new debt; it could only roll over existing debt. Treasury would then have several options available to finance outlays as they exceed amounts provided from incoming revenues.[3] First, Treasury might make partial payments on behalf of the federal government at the time those payments are due. Second, it might delay payment until Treasury had enough cash and deposits to make the payment in full. Some have suggested a third option; namely, that Treasury prioritize certain payments over others, although this raises practical and legal considerations (see "Prioritization" below). One outside analysis suggests that, if Treasury prioritized interest payments with a binding debt limit, noninterest outlays would immediately fall by roughly 25%.[4]

The scale of cuts or delays in payments necessary would depend on several factors. Longer debt limit episodes would require greater cuts or delays. Treasury would have to make larger changes in periods when net deficits (the amount by which outlays exceed receipts) are higher and smaller changes in periods when net deficits are lower. Receipts are typically highest in April, when individual income tax filings are due, and in September, when the government tends to receive income tax payments from filers who requested extensions. Similarly, outlays are typically highest when payments on certain broad benefits such as Social Security are due, as well as days on which the federal government pays its employees.

[1] Letter from Janet Yellen, Secretary of the Treasury, to Hon. Mike Johnson, Speaker of the House of Representatives, January 17, 2025, https://home.treasury.gov/system/files/136/Debt-Limit-Letter-to-Congress-1-17-25.pdf. For more on extraordinary measures, see CRS Insight IN10837, *Debt Limit Policy Questions: What Are Extraordinary Measures?*, by Grant A. Driessen.

[2] U.S. Treasury, "May 1, 2023 Letter to Congress," May 1, 2023, https://home.treasury.gov/system/files/136/Debt_Limit_Letter_Congress_Members_05012023.pdf.

[3] U.S. Treasury, Letter from Eric M. Thorson, Chair, Council of the Inspectors General on Financial Oversight, to Hon. Orrin G. Hatch, Ranking Member, Committee on Finance, August 24, 2012, Enclosure 1, pp. 3-6.

[4] Wendy Edelberg and Louise Sheiner, "How Worried Should We Be If the Debt Ceiling Isn't Lifted?" Brookings Institution, April 24, 2023, https://www.brookings.edu/2023/04/24/how-worried-should-we-be-if-the-debt-ceiling-isnt-lifted/.

Table 1. Federal Outlays, Receipts, and Deficits, February 2024-January 2025

(in billions of nominal dollars)

Month	Outlays	Receipts	Deficit (-) or Surplus (+)
February 2024	567	271	-296
March 2024	569	332	-237
April 2024	567	776	210
May 2024	671	324	-347
June 2024	537	466	-71
July 2024	574	330	-244
August 2024	687	307	-380
September 2024	462	527	65
October 2024	584	327	-257
November 2024	669	302	-367
December 2024	541	454	-87
January 2025	642	513	-129

Source: U.S. Treasury, *January 2025 Monthly Treasury Statement*, https://www.fiscal.treasury.gov/files/reports-statements/mts/mts0125.pdf.

Note: All figures rounded to the nearest billion.

Table 1 shows monthly federal receipts, outlays, and net deficit totals from February 2024 through January 2025. Sources of fluctuation include the timing of federal income tax payments and other revenues, seasonal patterns in outlays, and the enactment of new legislation and policies.

The federal government has never operated under a binding debt limit. Economic theory and available evidence from past incidences with anticipated binding debt limits indicate that the effects of a binding debt limit could include

- the direct effect of late or missed federal payments;
- financial market effects, both from federal security investors and in market transactions where federal securities play a prominent role; and
- indirect effects on borrowing and general economic confidence from households, businesses, and other governments.

The relative prominence of the federal government both in financial markets (43% of all 2023 U.S. fixed income issuances were U.S. Treasury securities)[5] and in general economic activity (federal spending is projected to equal 23% of U.S. GDP in FY2025)[6] suggests that even a brief breach of the debt limit might have significant effects on financial and economic performance.

[5] Securities Industry and Financial Markets Association, "Capital Markets Fact Book, 2024," July 2024, https://www.sifma.org/resources/research/fact-book/.

[6] Congressional Budget Office, *The Budget and Economic Outlook: 2025 to 2035*, January 2025, https://www.cbo.gov/publication/60870.

Prioritization

Some have suggested that Treasury could "prioritize" some payments over others. For example, Treasury could make payments on the national debt and/or to Social Security beneficiaries in full and on time, while making partial or delayed payments on other programs. At the height of the debt limit episode in August 2011, information from the Federal Reserve suggests that discussions occurred on the prioritization of payments—indicating that there may have been plans regarding a prioritization of payments on Treasury security principal and interest had the debt limit bound at that time.[7]

Prioritization faces both practical and legal challenges. Treasury has said it is unsure whether it has the technical capacity to prioritize certain types of payments over others. Generally, Treasury designed its systems to make payments automatically as they come due.[8] Payments on the national debt may be more feasible to prioritize than other payments, as the Federal Reserve pays these through a separate system, although Treasury expressed that doing so "would be entirely experimental and create unacceptable risks to both domestic and global financial markets."[9]

Even if prioritization is practically feasible, it is not clear whether Treasury has the legal authority to pursue it.[10] The executive branch is generally required to make payments in accordance with laws as enacted, and these laws did not expressly address prioritization. As such, it is unclear whether the executive branch has the legal authority to prioritize payments under current law. Legislation has been introduced in recent Congresses to prioritize certain payments.[11]

Potential Economic Effects of a Default on Treasuries

Perception of Risk

A debt limit episode's effect on financial markets and the broader economy would depend on whether investors perceived Treasuries as having become riskier. Though investors perceive the federal government as among the safest of major borrowing institutions,[12] expected or actual late or missed federal payments may risk causing a downgrade in that perception and increase the interest costs the government faces on its future debt issuances. Investors would likely demand higher interest rates to hold Treasuries that they think have a greater likelihood of defaulting.

Past debt limit episodes suggest that investors may perceive Treasuries as riskier even if they only anticipate the debt limit will become binding, regardless of whether it ultimately does.[13] Further,

[7] Federal Open Market Committee, "Conference Call of the Federal Open Market Committee on August 1, 2011," August 1, 2011, https://www.federalreserve.gov/monetarypolicy/files/fomc20110801confcall.pdf.

[8] U.S. Congress, Hearing of the Senate Committee on Finance, *The Debt Limit*, 113th Cong., 1st sess., October 10, 2013.

[9] Letter from Alastair M. Fitzpayne, Assistant Secretary for Legislative Affairs, to Hon. Jeb Hensarling, Chairman, Committee on Financial Services, May 7, 2014.

[10] See CRS Report R41633, *Reaching the Debt Limit: Background and Potential Effects on Government Operations*.

[11] An example from the 118th Congress is S. 82, the Full Faith and Credit Act. Lawmakers introduced similar bills during past debt limit debates.

[12] Zhiguo He, Arvind Krishnamurthy, and Konstantin Milbradt, "What Makes the US Government Bonds Safe Assets?" *American Economic Review*, vol. 106, no. 5 (2016), pp. 519-523.

[13] For an example of such effects from the 2013 debt limit episode, see Government Accountability Office, *Debt Limit: Market Response to Recent Impasses Underscores Need to Consider Alternative Approaches*, GAO-15-476, July 2015, https://www.gao.gov/products/gao-15-476.

investors may still view government securities as a riskier investment even if the government successfully prioritizes payments on Treasuries over other federal obligations if they believe that the debt limit breach signifies that the federal government is unreliable or unpredictable. In these cases, interest rates on Treasuries could rise even without a default on those vehicles. Research found that federal interest rates rose relative to other market transactions during debt limit episodes in 2011[14] and 2013,[15] when the federal government did not actually default on any securities. Interest rates recovered quickly after both episodes, but may not if a future episode affects investor confidence more significantly.

It is also possible, however, that investors will assume that Treasury will ultimately make full payments on any outstanding securities, and not react negatively to the potential for the debt limit to bind. If so, interest rates may rise little—if at all—even after a technical default. It is not clear how likely such a scenario would be, as it would require investors not only to remain calm in a crisis, but to assume that their fellow investors will do the same. This would be potentially inconsistent with market experiences during debt limit discussions in 2011 and 2013.

Effects on the Cost of Servicing the Federal Debt

If investors perceive Treasuries as riskier and demand higher interest rates to hold them, the federal government would have to make larger interest payments in the future. These higher payments would increase total federal outlays and net deficits moving forward.

Federal statutes contractually obligate the government to pay interest penalties if it does not make payments in a timely fashion. For example, the government must generally pay interest on tax refunds paid more than 45 days after the tax filing deadline.[16] The Prompt Payment Act generally requires the government to pay interest on other payments made after they are due, or more than 30 days after receiving an invoice.[17] Any debt limit breach that occurs when many such payments are due would likely impose additional costs on the government, thereby increasing total federal spending in the short run.

The future path of the federal debt is highly sensitive to changes to the interest rate. A 2024 CBO workbook suggested that, all else equal, increasing projected interest rates by 1.0 percentage points over the next 10 years would cause publicly held debt to rise by 8% of GDP ($3.3 trillion) in FY2034.[18]

Effects on Financial Markets and the Domestic Economy

Financial markets view federal securities as among the safest capital assets to hold, which combined with their broad availability makes them a critical part of investor portfolios.[19] Given

[14] Martin A. Sullivan, "The Great Debt Ceiling Showdown of 2023," *Tax Notes Federal*, vol. 178, January 23, 2023.

[15] Mark Zandi, "Debt Limit Brinksmanship (Again)," Moody's Analytics, January 23, 2023.

[16] Internal Revenue Service, *Interest*, updated January 10, 2023, https://www.irs.gov/payments/interest. See also 26 U.S.C. §6611.

[17] See CRS Report R41633, *Reaching the Debt Limit: Background and Potential Effects on Government Operations*, by D. Andrew Austin, Clinton T. Brass, and Dawn Nuschler.

[18] Congressional Budget Office, *Workbook for How Changes in Economic Conditions Might Affect the Federal Budget: 2024 to 2034*, April 2024, https://www.cbo.gov/publication/60074. The publication is intended to provide illustrative examples of the link between general economic and federal budget performance, and is not linked to proposed legislation.

[19] Moody's Analytics, "Going Down the Debt Limit Rabbit Hole," March 2023, https://www.moodysanalytics.com/-/media/article/2023/going-down-the-debt-limit-rabbit-hole.pdf.

this factor, along with the high volume of federal debt ($28.5 trillion in marketable debt as of January 2025), shifts in the perception of federal creditworthiness may disrupt the financial marketplace.[20]

A rise in the perceived riskiness of federal debt might also have consequences for routine financial transactions that often depend on the availability and reliability of Treasuries. Large financial actors in the United States and around the world often use Treasury securities as collateral for short-term transactions.[21] A rise in the likelihood of federal security default may delay or reduce the level of such transactions, which could lead to slowdowns or reductions in subsequent economic activity. There is evidence that investors avoided certain Treasury securities perceived to be "at risk" (those with maturity periods right around the expectation of a binding debt limit) during the debt limit episode of 2013 and moved their portfolios toward perceived safer investments. These types of movements increase the general volatility of the financial marketplace, which can lead to further financial and economic disruption.

The potential adverse effects of a binding debt limit could also include a wide range of ramifications for the households and businesses in the remainder of the economy. Any downgrade in the perceived value of federal securities would thereby decrease the value of domestic asset holdings. Domestic sources hold roughly 70% of federal publicly held debt,[22] meaning much of this sudden loss of wealth would affect households and businesses within the United States. The remainder would affect foreign asset holders, including foreign central banks.

Effects of Other Cuts to Federal Spending

Nonpayment of Treasuries and any resulting perception of riskiness are not the only ways a binding debt limit could affect the economy. If the federal government cut or delayed other spending to comply with the legal debt limit, these cuts or delays could inhibit economic demand and potentially trigger a recession.

Federal noninterest spending generally falls into four broad categories:

1. payments to individuals, such as Social Security and benefits for low-income people, such as the Supplemental Nutrition Assistance Program (SNAP);
2. salaries, pensions, and other compensation and retirement benefits for federal employees and members of the U.S. Armed Forces;
3. in-kind benefits such as Medicare and Medicaid; and
4. purchases for the government's use, such as military equipment and supplies for civilian offices.

Delaying these payments, or making them only in part, would likely reduce economic demand. Recipients of transfer benefits or federal employee benefits would receive less money in the short term, and would likely curtail their household spending as a result. The government itself would also demand less in-kind services, supplies, and equipment.

[20] U.S. Treasury, *Monthly Statement of the Public Debt, January 2025*, February 2025, https://fiscaldata.treasury.gov/datasets/monthly-statement-public-debt/summary-of-treasury-securities-outstanding.

[21] See CRS Report R41633, *Reaching the Debt Limit: Background and Potential Effects on Government Operations*, by D. Andrew Austin, Clinton T. Brass, and Dawn Nuschler.

[22] CRS calculations based on data from U.S. Treasury and Federal Reserve Board, "Major Foreign Holders of Treasury Securities," January 2023, https://ticdata.treasury.gov/Publish/mfh.txt.

Scale of the Reduction in Economic Activity

Estimating how much this drop in demand would reduce economic activity is difficult. Though there is considerable variation across studies, prominent estimates, including research from the Congressional Budget Office[23] and Moody's Analytics,[24] found that the spending cuts passed as part of the Budget Control Act of 2011 had short-run[25] fiscal multiplier effects that ranged from 1.1 to 2.3. These findings suggested that the cuts produced a short-run decline in output of $1.10 to $2.30 for every $1 reduction in government spending, depending on the macroeconomic assumptions used. The exact scale of the short-run fiscal multiplier will depend on which payments the government does not make in full or on time, how long the debt limit episode lasts, and the degree to which markets demand higher interest payments on federal debt.

The ultimate impact of these missed or incomplete payments could also depend on the condition of the economy when they occur. If government spending falls while economic demand is high, other buyers may fill the government's place in the market, buying many of the goods the government would otherwise buy (or fund the purchase of through transfer payments). If other buyers would partially offset the decline in economic demand, the resulting contraction would be less severe. However, if demand is soft, there may be fewer buyers to compensate for lost government spending.

Stimulus and Automatic Stabilizers

Lawmakers have addressed past recessions with fiscal stimulus to encourage individuals to spend. This has been done through the enactment of direct federal spending, transfers to individuals, or expanded liquidity. Fiscal stimulus of this type is most effective when financed by deficits, as raising taxes leaves households with less money to spend, undermining the goal of the stimulus.

However, under a binding debt limit, any new stimulus measures passed by Congress could not be deficit financed. Instead, other outlays would need to be cut or delayed even more than they otherwise would to leave funds available for the new stimulus measures.

Some federal programs, known as "automatic stabilizers," automatically expand deficits when the economy enters a recession, without the need for congressional action. For example, when households' incomes fall, more households qualify for means-tested benefits such as SNAP and Medicaid. Similarly, the progressive individual income tax collects less revenue when individuals' incomes fall.[26] In normal recessions, automatic stabilizers intentionally provide timely deficit-financed stimulus.

However, just as with other stimulus, a binding debt limit would inhibit automatic stabilizers, as the government could not finance them with new debt. Funding automatic stabilizers under a binding debt limit would require the government to cut other programs by larger amounts than they otherwise would.

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[23] Congressional Budget Office, "Economic Effects of Reducing the Fiscal Restraint that Is Scheduled to Occur in 2013," May 2012, https://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf.

[24] Mark Zandi, "U.S. Economic Outlook: Policymakers Must Get It Right," Moody's Analytics, July 2012.

[25] These multipliers measure the effect of government spending on economic activity in the "short run," meaning the period before which most prices have had time to adjust to reflect the change in economic demand. Economic theory suggests that with time, producers will raise prices to account for the increase in government spending, leading to no "long-term" change in economic output.

[26] See "Automatic Stabilizers" section in CRS Report R45780, *Fiscal Policy Considerations for the Next Recession*, by Mark P. Keightley.

While a debt-limit-induced recession would undermine fiscal policy's ability to respond to it, the Federal Reserve would still have the power to attempt to encourage demand by lowering interest rates. Given the uncertainty surrounding how the financial system would operate in the event of a binding debt limit, it is also uncertain how that system might react to the Federal Reserve's efforts. These efforts might also run counter to the Federal Reserve's recent focus on raising interest rates to slow economic demand.

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