Joint Economic Committee
Republicans
Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Republican Staff Commentary

A Debt Crisis Looms . . .

- *Interest costs on the national debt now threaten a US Government credit downgrade—á la Greece—within five years.*
- *To avert this crisis, we must begin serious and credible fiscal adjustments soon.*
- *The best options are policies that restrain federal spending and promote economic growth.*

2015: Downgrade Day
Avoiding Europe's Fate

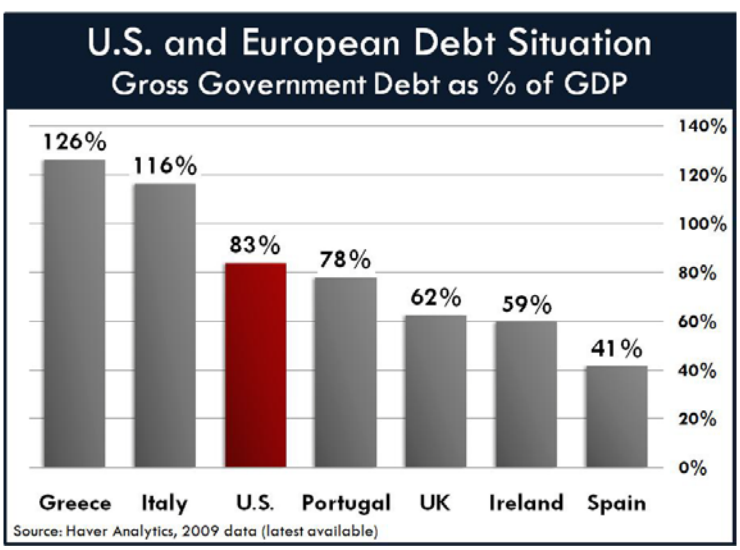
May 28, 2010

Is the United States immune from the sovereign debt crisis now roiling Europe? The unfolding troubles would suggest that no nation with high debt levels, no matter how "safe," can indefinitely escape the remorseless discipline of the global bond market. In this commentary, we discuss why a U.S. downgrade is possible and how to avert it.

No One Is Safe

"The U.S. sovereign debt crisis may be a mere five years away."

In the past few months, Greece, Spain, and Portugal have all seen their credit downgraded and their costs of borrowing driven upward by international investors wary of high levels of government spending and debt service. Attempts to restore confidence in Greece—its gross government debt equaled 126% of GDP last year[1]—by means of fiscal austerity have provoked fierce resistance from public employees and middle-class voters, who resent being asked to sacrifice for problems they see as not of their making. A European Union bailout led by Germany may help the beleaguered governments impose austerity more gradually. But if the contagion spreads, for example, to Italy (116% of GDP), Portugal (78%), or the United Kingdom (62%), EU coffers may tap out. In that event, even such traditional safe havens as Japan (183%[2]) and the U.S. (83% last year, rising to 91% this year) may no longer be immune. Downgrades of these leading governments would doubtless herald significant disruption and slower worldwide economic growth.



The Debt Monster

In 2009 and 2010, the U.S. will run real budget deficits equal to approximately 10% of GDP, a level unprecedented in peacetime.[3] The gross government debt, currently growing at about $192 million an hour, will reach $13.2 trillion this year, on its way to $21.4 trillion in 2020.[4] In percentage terms, the gross government debt will grow from 91% of GDP in 2010 to 95% in 2020.[5] A recent study suggests that, above 90% of GDP, gross government debt significantly hampers an economy's ability to grow; countries with such a high debt load average GDP growth 4 percentage points below that of less-indebted countries.[6] The U.S. will cross that ominous threshold sometime this year.

More useful than the debt-to-GDP ratio for measuring the manageability of debt is the ratio of interest payments to revenue. By the latter metric, according to a March report by the Moody's credit rating agency, the U.S. sovereign debt crisis may be a mere five years away. That is when federal interest payments are projected to exceed 14% of revenues, the level the agency regards as the point of no return for America—when debt service begins to constrain our government's ability to change its financial course.[7] In reality, the pressure will mount sooner than that, as the approach of "Downgrade Day" precipitates a crisis, especially if interest rates turn out to be higher than currently expected. The U.S., like Greece, will have to make wrenching decisions about how to avert the reduction of its government debt instruments to junk-bond status.[8]

What Can Be Done?

How can we avoid this fate? Experience shows governments have four basic options for reducing their debt burden: economic growth, increased tax revenue, reduced expenditures, or inflation. Federal policymakers will doubtless make use of all of the above, especially inflation, which is economically harmful, as are tax hikes. Economic growth, though more welcome, is too unpredictable to be counted on and is unlikely to increase at a rate fast enough to offset the debt. Additional impediments to growth gains include the Obama Administration's relentless efforts to expand the size and reach of the U.S. government to levels not seen since World War II, via major spending and tax increases, a cap-and-trade energy bill, and sector-wide takeovers of autos, health care, college loans, and home mortgages—all of which will undoubtedly raise costs for businesses and individuals and reduce economic activity. Of the four options, only spending control is both fiscally helpful and fully within government's power.

Spending control is also the logical option, since America's current fiscal imbalance results almost entirely from excessive spending. During the next ten years, while federal revenues will average a hefty 18.8% of GDP—the post-World War II norm has been about 17.7%—outlays will average 24.1% of GDP, almost one-fourth higher than the 20.2% postwar average.[9] Meanwhile, federal interest payments are set to triple over the next ten years, rising from 5% of outlays this year to more than 15% in 2020.[10] Most of that growth in debt service costs is driven by mandatory spending programs which currently make up 57% of outlays.[11] The bulk of mandatory spending is in the three largest entitlements, Social Security, Medicare, and Medicaid—soon to be joined by a fourth, Obamacare. Clearly, fiscal restraint means spending restraint, which in turn must include entitlement reforms.

Is "Fiscal Adjustment" Possible?

But can spending really be cut? President Obama must believe that it can, because he has appointed a bipartisan Commission on Fiscal Responsibility and Reform, and charged it with reporting, after this year's elections, on how to eliminate the primary budget deficit (that is, the deficit minus interest on the debt) by 2015. Under a realistic projection of current policies, the U.S. is headed toward a real budget deficit of 6.7% and a primary deficit of roughly 3.9% of GDP in that year, necessitating budget cuts of about $690 billion or 16.7% of federal outlays. Nothing in American experience suggests cuts of that magnitude are likely to happen, absent a true crisis. The current partisan standoff—Democrats oppose spending cuts, Republicans oppose tax hikes—means the Commission will almost certainly fail to meet its charge. It may take a full-blown financial crisis to prompt meaningful action.

Fortunately, the evidence suggests meaningful action is possible. In the past two decades, when faced with structural budget deficits, Canada, Sweden, and Finland have all cut government spending by 20% within a few years, without societal upheaval.[12] Indeed, a recent study of OECD macroeconomic data from 1970 to 2007 finds that spending cuts are the key to successful fiscal adjustments—and are generally better for the economy than tax increases. The authors report that "fiscal adjustments . . . based upon spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those based upon tax increases. In addition, adjustments on the spending side rather than on the tax side are less likely to create recessions."[13]

The question, then, is how to incentivize policymakers to undertake the needed reforms. So long as vote-buyers in the political marketplace (i.e., politicians) perceive taxpayer money as an unlimited resource, they will have little incentive to risk their political lives supporting unpopular spending cuts. Indeed, they will tend to obey the laws laid down by political scientist Aaron Wildavsky, who famously explained why, in a non-zero-sum budgeting environment, addition is always easier than subtraction: (1) No category of people, once covered, may be denied future benefits. (2) No level of benefits, once raised, may be reduced. (3) It is better to give a benefit to a few unqualified recipients than to deny a benefit to even one qualified recipient.[14]

But create a new incentive structure—a zero-sum game—and politicians can find new and previously unknown reserves of courage. Successful budget cutting is possible, according to Wildavsky, provided it is shared, gradual, and unavoidable.[15]

Credibility Is Essential

A "shared, gradual, and unavoidable" fiscal adjustment program must also be credible to bond markets. Such a program must therefore go beyond existing, ineffectual budget process reforms, such as the statutory debt ceiling (invariably raised) and pay-as-you-go rules (routinely waived). (Indeed, in the three months since the enactment of the Democrats' vaunted "Statutory PAYGO" bill, which requires all new spending to be paid for with cuts elsewhere, they have already used the law's "emergency" escape clause to add a staggering $173 billion to the deficit.) A credible fiscal adjustment program must also go beyond familiar proposals like bipartisan budget summits and giving the President a line-item veto, which, whatever their merits, are unlikely to produce large or permanent savings.

More serious is the idea of a Balanced Budget Amendment, with a supermajority vote required to approve emergency spending. Most states have a BBA in some form. A federal BBA would enshrine the desirable goal of annual balance, but should be approached carefully and realistically, in light of the states' experience. For one thing, it is clear that focusing on balance unfortunately also encourages potentially harmful tax increases simply to achieve that accounting milestone. For another, with a BBA, sound draftsmanship and eternal vigilance are needed to thwart the inevitable attempts to redefine spending programs as "off" budget.

The most serious fiscal reform proposals involve direct limits on spending, or on revenue as a way to increase the pressure to reduce spending. For example, one popular way to limit revenue, employed in some states, is to entitle taxpayers to automatic tax cuts and rebates when revenue exceeds a certain threshold, usually defined as a percentage of personal income. Another popular approach is to require a legislative supermajority (say, two-thirds) for any tax increase.

As for spending limits, they could take the form of binding caps enforced by automatic, across-the-board cuts if outlays exceed a certain threshold (for example, 20% of GDP). Pegging limits on revenue or spending to GDP would in effect cap the federal share of the nation's resources and thus establish a salutary social contract between the private and public sectors. More important, it would incentivize lawmakers to promote GDP growth. Like the successful base-closure model, this idea is built on certain assumptions about what it takes to create a zero-sum budgeting environment and thus spur lawmakers to make tough decisions: (1) an upfront agreement to reduce spending in principle, before anyone knows what exactly will be cut; (2) a credible enforcement mechanism, in the event lawmakers fail to agree on specific cuts; and (3) shared sacrifice, spreading the reductions as broadly as possible. A fourth element that could lend strength to the idea would be serious negative consequences for failure; for example, the elimination of elected officials' salaries in years when the spending caps are breached. The threat of financial—and more important, political—embarrassment could help hesitant politicians overcome their differences and find needed consensus.

Two Visions

As lawmakers consider their options, they might do well to bear in mind the very different philosophies of public finance exemplified by William Ewart Gladstone and John Maynard Keynes, two Englishmen who may be described as the patron saints, respectively, of balanced budgets and of chronic deficits. For Gladstone, the great 19th century statesman, the principles of "economy in government" were biblical in their simplicity: limit spending, tax lightly, maintain a surplus, borrow the minimum, pay off debt.[16] By contrast, Keynes, perhaps the 20th century's most celebrated and influential economist, took each of these principles and more or less reversed it, in the cause of boosting aggregate demand, which he believed would promote permanent prosperity. Keynes's alluring vision may have displaced Gladstone's old-fashioned fiscal prudence, but history suggests it may be flashy Keynesianism's turn for a downgrade.

Conclusion

With its massive and rising debt, the United States faces the prospect of an economically devastating credit downgrade within the next five years. That crisis, however, can be averted. Congress can and should undertake a credible program of meaningful expenditure reductions, including entitlement reforms, preferably coupled with policies that promote economic growth and permanently improve policymakers' incentives to restrain spending in the future. These debt-besotted times call for less Keynes and more Gladstone.

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[1] Gross government debt" (also called "gross federal debt" or simply "gross debt") is one of two, sometimes confused measures of national debt. The other, "publicly held debt," is gross government debt minus intragovernmental liabilities, such as amounts owed by the U.S. Treasury to the Social Security trust funds. Official U.S. Government budget publications tend to focus on publicly held debt. In this paper, we use gross government debt in order to simplify international comparison. To give a sense of the difference, for example, while the U.S. gross government debt figures for 2009 and 2010 are 83% and 91%, respectively, the publicly held debt figures for those same years are 55% and 63%.

[2] While high, Japan's debt-to-GDP ratio has not led to a downgrade because most of Japan's government bonds are held by Japanese citizens.

[3] CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011," 03/10, table 1-2, p. 5

[4] CBO, "The Budget and Economic Outlook: Fiscal Years 2010 to 2010," 01/10, table D-2, p. 118. The comparable publicly held debt figures are $9.2 trillion (2010) and $20.3 trillion (2020).

[5] CBO, "The Budget and Economic Outlook," op. cit., table D-2, p. 118, and table 1-3, p. 8. The comparable publicly held debt figures are 63% (2010) and 90% (2020).

[6] Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," 12/ 31/09 draft, *American Economic Review Papers and Proceedings*.

[7] Moody's applies a more stringent rule of 10% to other economies. Moody's Investor Service, "Aaa Sovereign Monitor," 03/10.

[8] Douglas Holtz-Eakin, "America is on track for Downgrade Day," *Financial Times*, 3/31/10.

[9] Historical averages are from Budget of the U.S. Government, Fiscal Year 2011, Historical Tables, table 1.2, pp. 24-25. Future projections are from CBO, "An Analysis of the President's Budgetary Proposals," op. cit.

[10] Budget of the U.S. Government, Fiscal Year 2011, table S-3, p. 149.

[11] Budget of the U.S. Government, op. cit,

[12] Tyler Cowen, "Can't Cut Spending? Look Around the Globe," *New York Times*, 4/16/10.

[13] Alberto Alesina and Silvia Ardagna, Harvard University, "Large changes in fiscal policy: taxes versus spending," paper, 08/09. The authors add: "Fiscal stimuli based upon tax cuts are more likely to increase growth than those based upon spending increases."

[14] Aaron Wildavsky, *How to Limit Government Spending*, Univ. of Calif. Press, 1980, p. 64.

[15] Wildavsky, op. cit., p. 10.

[16] Carolyn C. Webber, "Development of Ideas About Balanced Budgets," Appendix D in Wildavsky, op. cit., p. 172.