

Economic Implications of the Fiscal Outlook

Testimony presented to the
U.S. Congress
Joint Economic Committee

Douglas Holtz-Eakin, President*
American Action Forum

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Introduction

Chairman Brady, Vice-Chairman Klobuchar and members of the Committee, I am pleased to have the opportunity to appear today. In this testimony, I wish to make three basic points:

- The level and projected growth of federal debt is a drag on current U.S. economic growth and a threat to future prosperity,
- The scale of needed debt reduction dwarfs the impending sequester and associated discretionary caps in the Budget Control Act, and
- A superior strategy for debt control and economic growth is to control the scale of spending, and pair entitlement reform with pro-growth tax reform.

I will pursue each in additional detail.

The Economic Consequences of Federal Debt

Earlier this month, the Congressional Budget Office (CBO) released its Budget and Economic Outlook for 2013-2023. This release is particularly significant. For the first time in over ten years, the current-law baseline offers a fairly reasonable projection of the nation's current budget policy over the next decade. With the enactment of the so-called "fiscal cliff" tax deal, current tax law is relatively stable – that is, largely free of scheduled expirations that are regularly overturned. On the spending side, the discretionary caps under the Budget Control Act of 2011 (BCA) give a realistic pathway for annual appropriations. Mandatory spending is, of course, guided by current law with the overall result that current law provides a good depiction of current budgetary intent over the next decade.

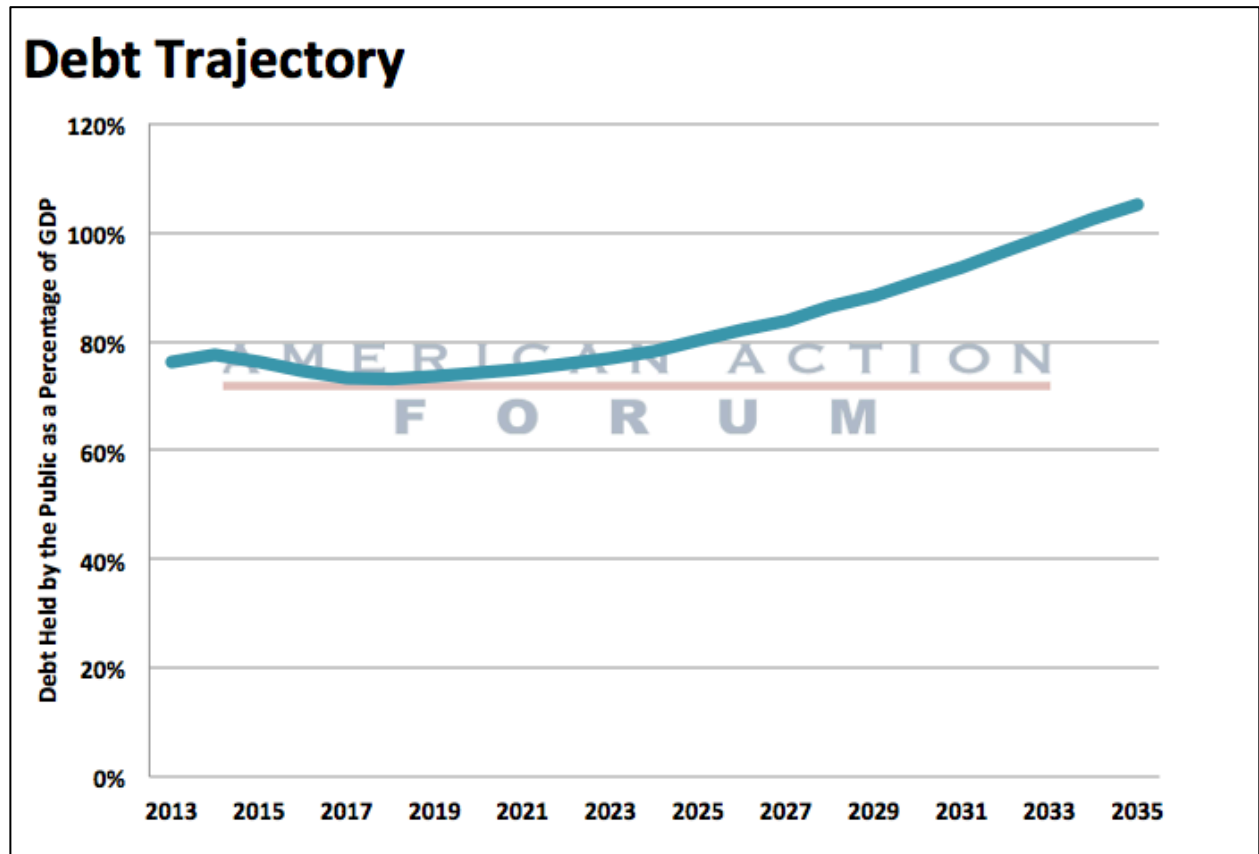
One would hope that outlook would reveal that existing deficit reduction measures (the BCA and the tax increases embedded in the American Taxpayer Relief Act (ATRA)) have improved the federal government's finances. Unfortunately, CBO's baseline confirms that the nation, despite and claims to the contrary, remains on a damaging debt pathway.

The Debt Trajectory (2013-2035)

Under current law debt held by the public – measured as a fraction of Gross Domestic Product (GDP) – will temporarily shrink during the ten-year budget window. Some will suggest that the absence of immediate and additional severe debt accumulation in the near-term provides the nation the freedom to forgo meaningful debt reduction. This ignores the fact that the debt outlook is but a temporary reprieve, as the debt burden begins to rise toward the end of the budget window. A conservative medium-term projection reveals that the debt held by the

public will continue to spiral upward and reach 105 percent of GDP by 2035 (see Figure 1).¹

Figure 1:



Federal Debt is a Drag on the Economy

It is often asserted that the economic downside to the level and projected excessive federal debt is a distant threat; indeed, that it is even more economically damaging to address the debt explosion than to accommodate it. This reasoning is 180 degrees from reality, as the U.S. is already paying an economic price for the excessive federal debt.

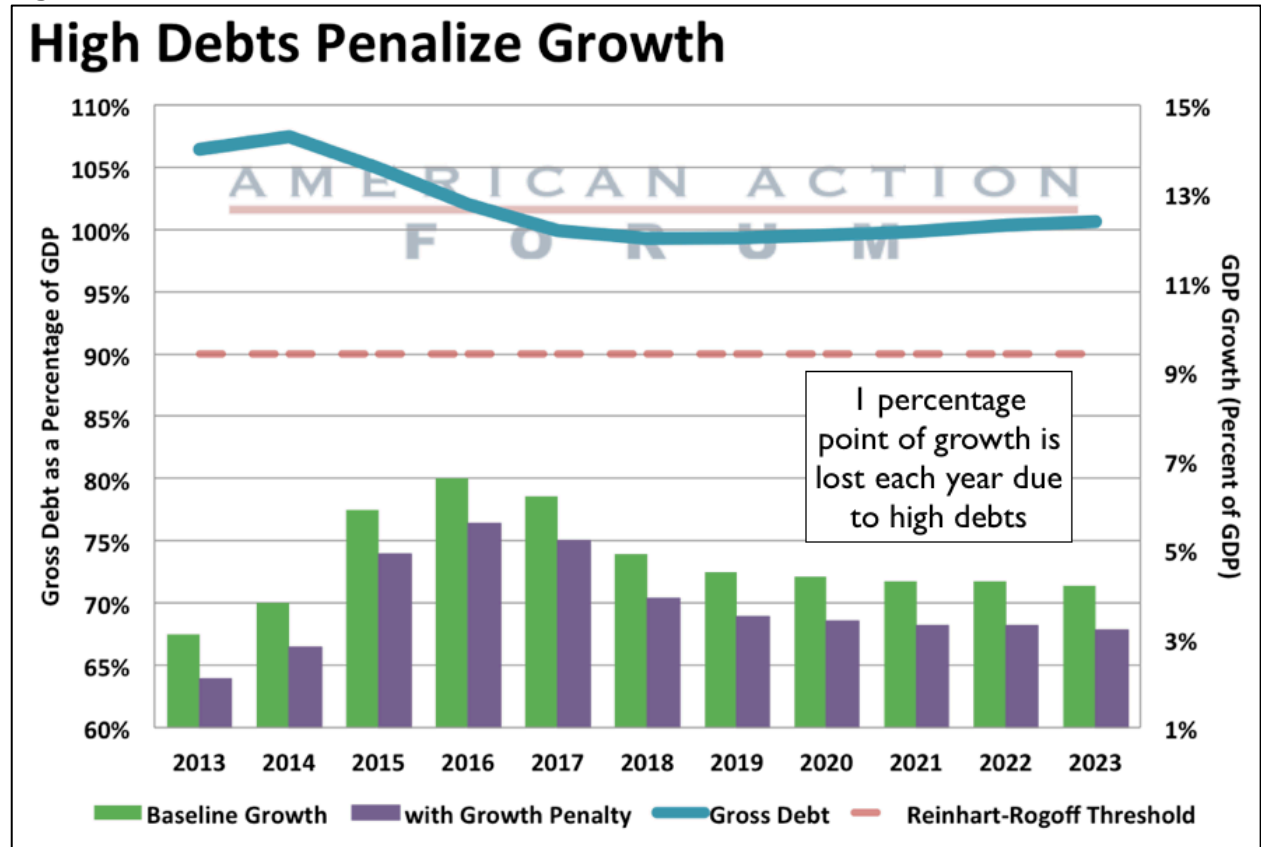
Research of Carmen Reinhart and Kenneth Rogoff – based on a careful empirical analysis of 44 countries over the past two centuries – indicates that when gross government debt (as a percent of GDP) exceeds 90 percent, median growth is roughly 1 percentage point lower annually than for comparable countries with lower debt burdens.²

¹ AAF calculations. Details available upon request.

² [http://www.economics.harvard.edu/faculty/rogooff/files/Growth in Time Debt.pdf](http://www.economics.harvard.edu/faculty/rogooff/files/Growth%20in%20Time%20Debt.pdf)

Gross federal debt already exceeds 100 percent of U.S. GDP, and under current law gross debt will remain above 90 percent over the entire 2013-2023 period.³ Applying the research rule of thumb indicates that the U.S. is right now paying a persistent growth penalty of 1 percentage point per year (see Figure 2). Accordingly, debt reduction is no mere arithmetic exercise – it is an economic imperative. Continued high levels of indebtedness will slow annual economic growth, and therefore slow job creation and wage growth.

Figure 2:



The administration has estimated that one percentage point in growth translates into approximately 1 million jobs created.⁴ Accordingly, over the period in the CBO baseline, a persistent 1 percentage point growth penalty should translate into an annual penalty of 1 million jobs forgone – or 11 million jobs over 2013-2023 (see Figure 3).

Slower job creation is only one metric of the price the U.S. is paying for its excessive federal debt. Over 2013-2023, CBO estimates growth of wages and salaries to average about 5 percent. Median household income was \$50,054 in 2011.⁵ Under

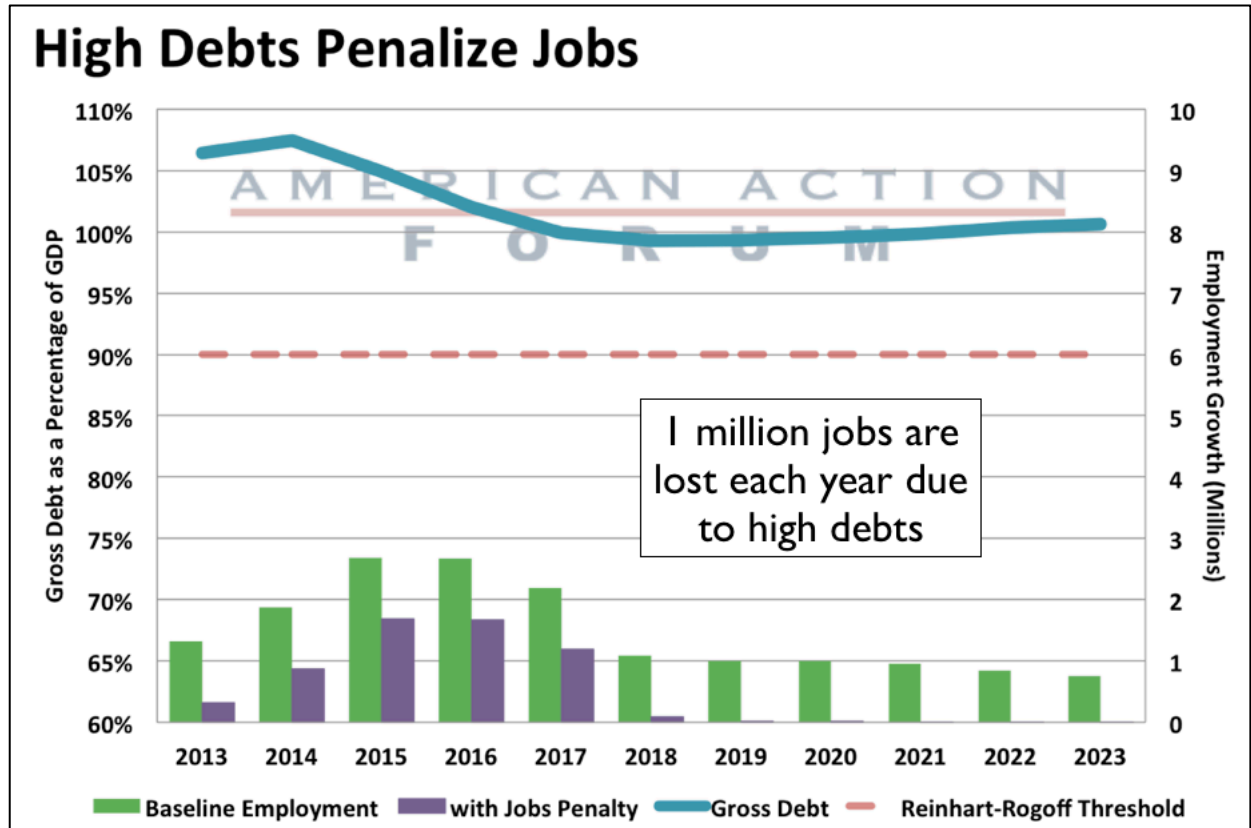
³ Gross federal debt is larger than the debt in the hands of the public. I focus on it in what follows to permit comparisons with the published research.

⁴ http://www.politico.com/pdf/PPM116_obamadoc.pdf

⁵ <http://www.census.gov/prod/2012pubs/p60-243.pdf>

CBO's projections, this should exceed \$86,000 by 2023. Assuming a growth penalty of 1 percent, however, indicates that this income growth would be penalized by as much as \$9,390 by 2035 under current law (see Figure 4).

Figure 3:



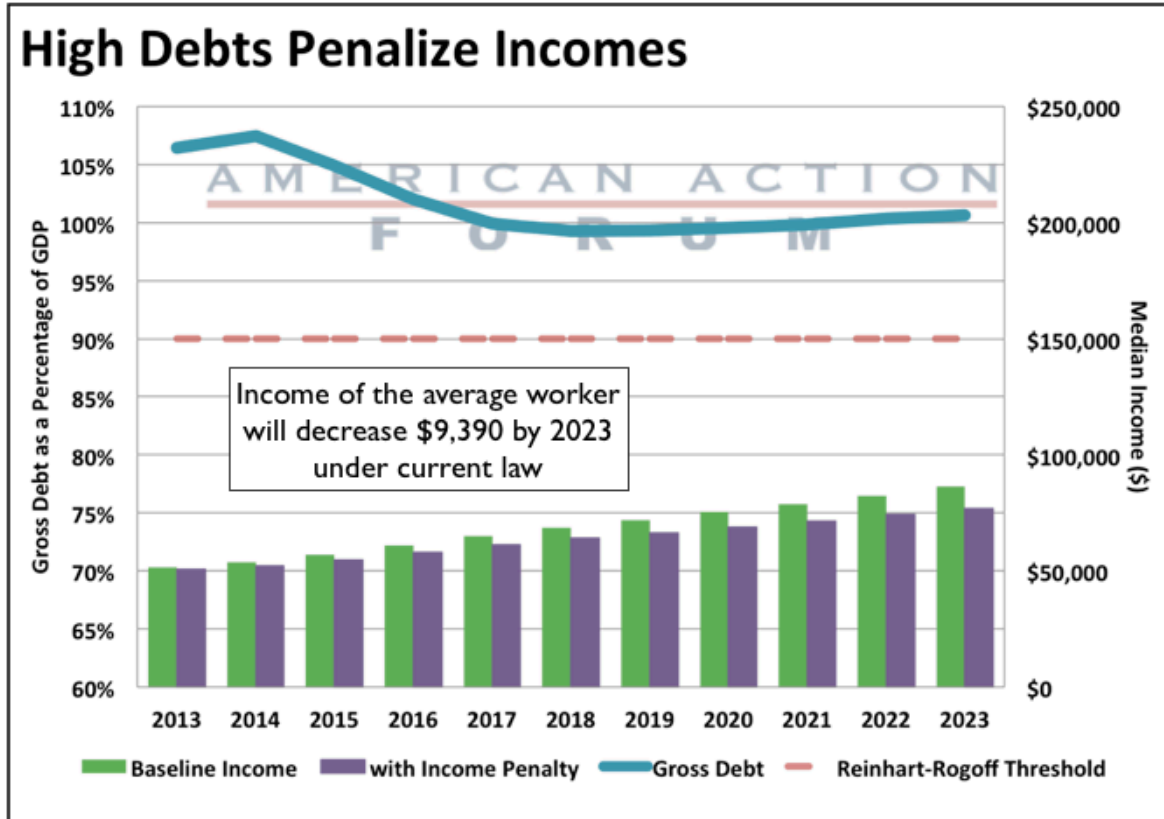
The Mechanisms of Slower Growth

One question that arises is the mechanism by which the deleterious growth effects occur. This is far from mysterious. In the worse case, a nation might be unwilling to undertake the tax and spending changes needed to stabilize its debt. A conscious strategy to sail straight toward a financial crisis would alarm small firms, large firms, and investors alike. Their unwillingness to hire, expand, and start new firms would immediately hamper growth.

Alternatively, the strategy might be dominated by an unwillingness to control spending and instead a commitment to dramatic tax increases as the means of reducing deficits and debt. The deleterious growth effects of anticipated sharply lower returns to work, saving and investment will become immediately apparent. These estimated penalties to growth, employment, and income penalties from high debt include the budgetary impacts of higher tax rates, lower discretionary spending, and the sequester enacted in recent years. The obvious conclusion is that additional deficit reduction is needed to avoid debt-driven economic stagnation.

There exist, however, important disagreements over just how much further deficit and debt reduction should be pursued.

Figure 4:

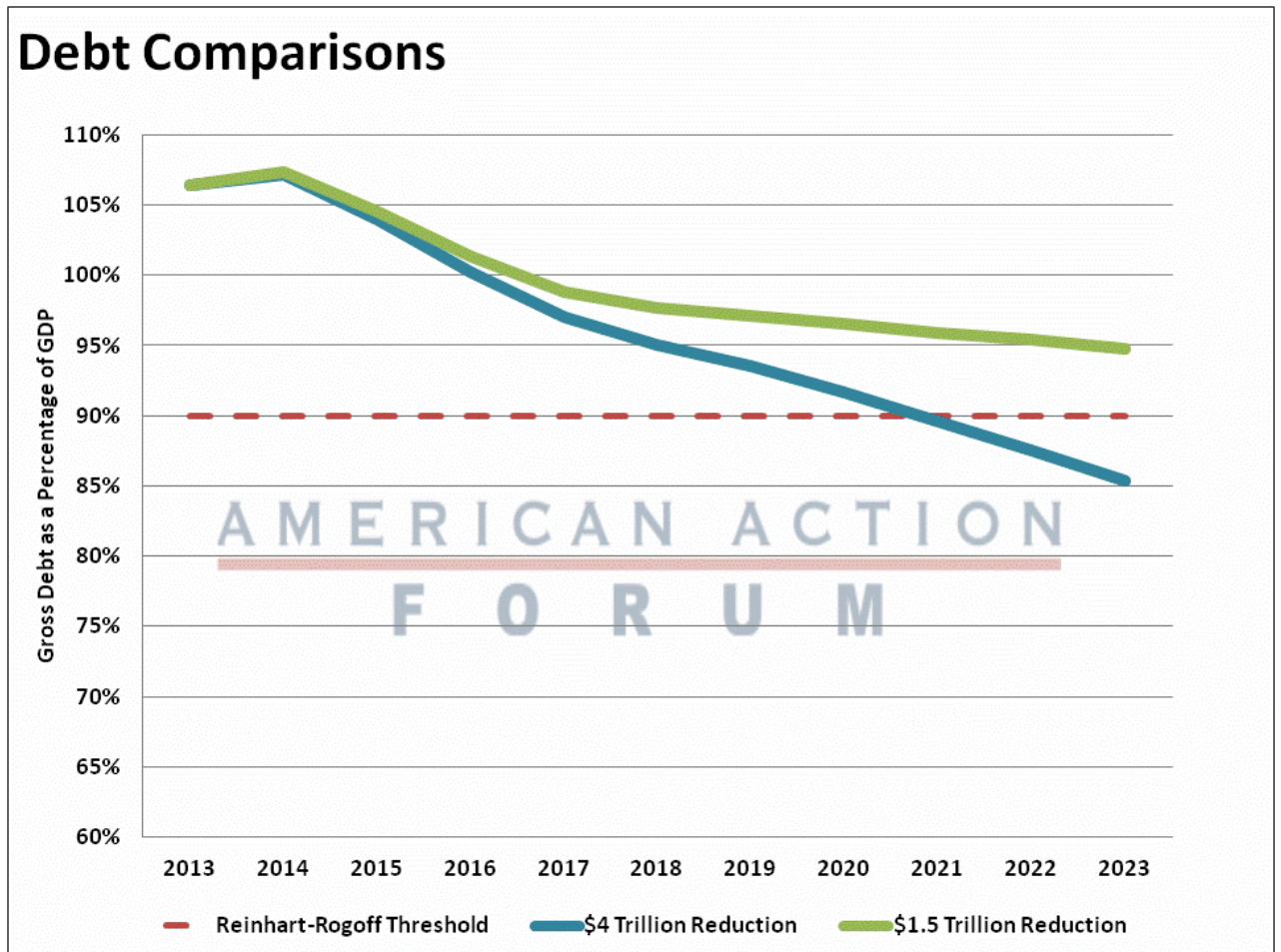


Targets for Debt Reduction

What is the right target for debt reduction? Many recent discussions on additional debt reduction have focused on “stabilizing” the debt as a share of GDP. That would be a sensible goal if it is stabilized at a level that is manageable and does not pose risks to the economy. Unfortunately, as noted above, the gross debt is currently above those levels – 90 percent of GDP. Stabilizing at or near the current levels of debt is a commitment to a future of slower growth and impending financial crisis.

A more sensible would be to reduce the debt to below the empirically observed threshold of 90 percent of gross debt as a share of GDP, thereby reducing the risk of financial crisis and stagnant growth. For example, choosing a gross debt-to-GDP ratio of 85 percent would require approximately \$4 trillion in additional deficit reduction over ten years (see figure 5).

Figure 5



In addition to maintaining the current anti-growth effects of high debt, any plan to merely stabilize the debt within ten years would contribute to a failure to restrain debt accumulation over the medium and long-term. The stability promised by a more modest (for example, \$1.5 trillion in 10 years) deficit reduction plan would persist for only a single year beyond the ten-year budget window. Thereafter, the debt would grow as a share of the economy to 87 percent by 2035 (see Figure 6).

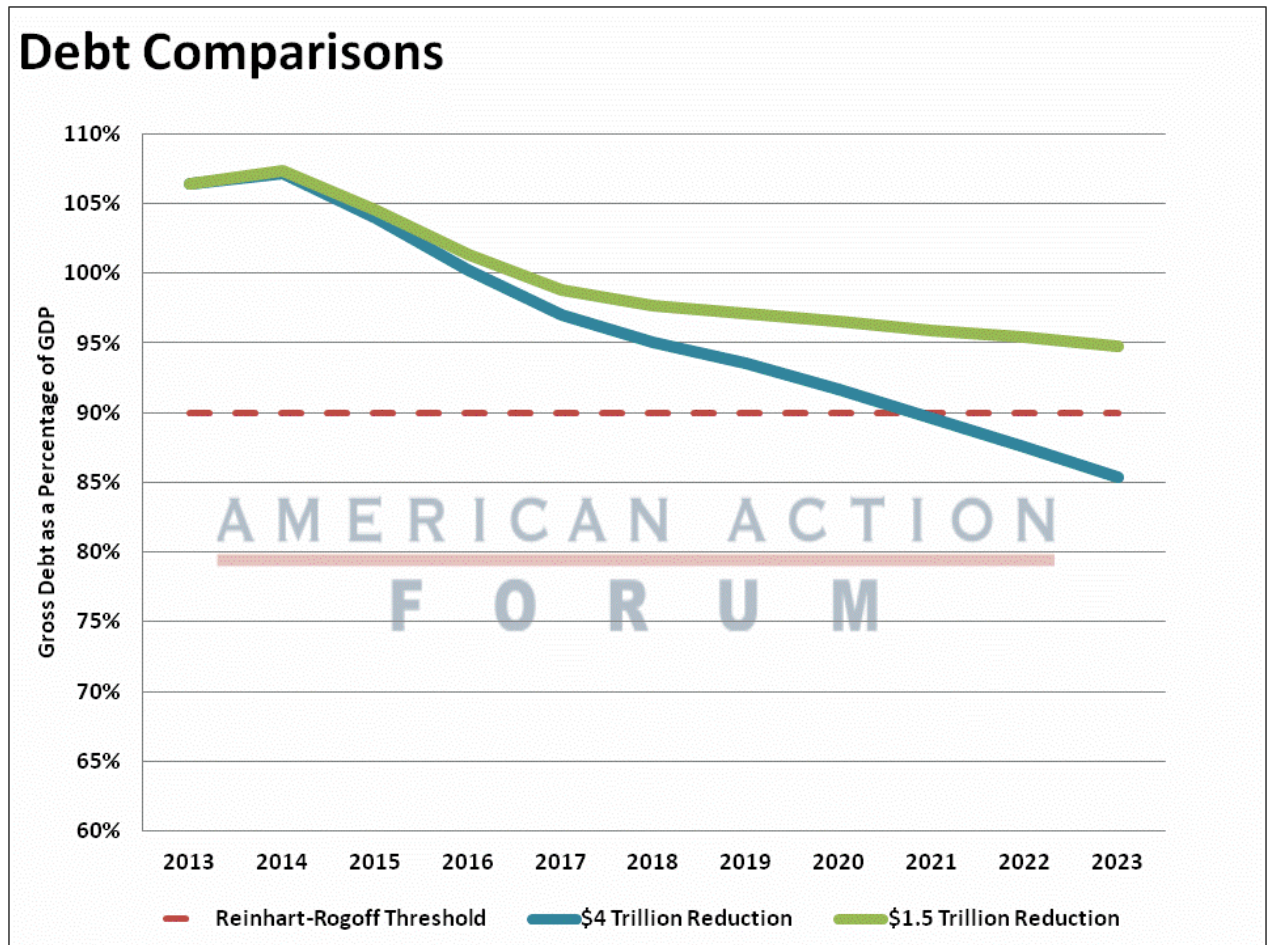
This is significant from a risk-management perspective. The longer that debt is preserved at high levels, the longer the risk remains that the United States would be vulnerable to a fiscal crisis.

Risk Management Issues and Debt Projections

The economic projections underlying the CBO baseline assume real GDP growth of 2.7 percent and 10-year interest rates of 4.4 percent over the next ten years. Plans to stabilize the debt-to-GDP using this projection are vulnerable to downside risks that would worsen the nation's debt outlook, and contribute to the well-understood mechanics of a fiscal spiral.

Slower growth or higher interest payments would be followed by higher debt, slower-yet growth, higher-yet interest rates and so on. Moreover, preserving debt held by the public at above 70 percent of GDP (or 100 percent in gross terms) leaves no cushion to absorb other adverse geopolitical or natural events. It assumes one can take comfort in the razor-thin margins embedded in necessarily- inexact projections.

Figure 6



Importantly, even a “stable” deficit reduction plan for the next 10 years does not contain the growth of the debt beyond the ten-year window.

Sequestration: A bad idea whose time has come

Of lesser consequence than the broader fiscal outlook, but perhaps greater immediacy, is the recently enacted sequester. The automatic enforcement mechanism of the failed “Super-Committee’s” goal \$1.2 trillion in deficit reduction is an admittedly blunt budgetary policy that is a poor substitute for meaningful reform, but is preferable to no spending reduction at all.

First, there is a need to demonstrate that spending will actually be controlled. CBO estimated that the discretionary spending caps in the BCA would reduce spending by \$756 billion over ten years, exclusive of debt service.⁶ However, these are only promises of reductions – they contain no programmatic changes that would guarantee lasting deficit reduction. Will these really occur?

Indeed, this past year has already seen Congress and the Executive branch willing to exceed the statutory caps for security spending, and supplement expenditures for Hurricane Sandy will increase budget authority by over \$50 billion in FY 2013.⁷ This increase nearly matches the entirety of the funding reduction of \$62 billion in FY2013 attributable to the discretionary caps imposed by the BCA, as estimated by CBO. I point this out only to emphasize that promised deficit reduction in the absence of programmatic change is ephemeral. CBO has echoed this sentiment, noting that “holding discretionary spending within the limits required under current law might be difficult...the original caps on discretionary budget authority established by that legislation would reduce such spending to an unusually small amount relative to the size of the economy.”

Sequestration will reduce the deficit modestly this year. Going forward, the mechanics of this automatic enforcement mechanism – essentially tighter discretionary caps married to a mandatory sequester – may only worsen the challenge of maintaining the discretionary caps. However, in the near term, the sequester will reduce outlays by \$44 billion this year.

A second issue is the impact on government services. These impacts are real and we are beginning to hear about potential service disruption. To the extent practicable, agencies should be allowed to mitigate service disruption through prioritization, but some diminution of federal services should be expected. The potential disruption to federal agencies is not insignificant, but also not insurmountable.

The final issue is the impact on economic growth. Obviously, I believe it is imperative to control the debt and that this will have beneficial impacts. At the same time, the near-term impacts of the sequester are far less consequential than many have portrayed. The sequester is an \$85 billion (roughly \$44 billion in actual outlays) cut in a \$3.6 trillion annual budget in a \$16 trillion economy. That is a slice representing one half of one percent of the pie. Economic calamity will not ensue.

The economy is growing at about \$630 billion per year. For the sequester to wipe out economic growth – as some rhetoric suggests – it would have to create roughly 7 times its size in economic impact, which far exceeds any realistic estimate of the size of economic multipliers.

⁶ <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/123xx/doc12357/budgetcontrolactaug1.pdf>

⁷ <http://www.cbo.gov/sites/default/files/cbofiles/attachments/SummaryDRAppropAct2013-HR152-PassedHouse.pdf>

Stepping back, the same Keynesian paradigm that emphasizes the near-term impacts of the sequester places a focus on the overall policy-induced changes in both taxes and spending. It seems incomplete at best to focus on the sequester when the ATRA imposes even larger tax burdens.

Thus, a more comprehensive estimate predicts modest near-term effects, that cannot be disentangled from the other policy decisions made this year. A reduction in federal expenditures now will add some impact to the ATRA effects on the economy. Even so, it is important to recognize the need for some near term reduction in current spending to offset the impact on economic growth that is risked by higher debt.

Better Strategies for Debt and Growth

As noted above, the nation faces a significant debt challenge, and existing measures to address it, though necessary, are inadequate. Removing the sequester would avoid some near-term discomfort, but the fiscal challenge confronting the United States is daunting and failure to address it in a credible way would likely generate negative economic effects. The CBO noted “eliminating or reducing the fiscal restraint scheduled to occur next year without imposing comparable restraint in future years would reduce output and income in the longer run relative to what would occur if the scheduled fiscal restraint remained in place.” It is therefore necessary to pair any mitigation of near-term fiscal tightening with meaningful budget restraint in future years.

The essence of a better strategy is to pair the entitlement reform with tax reform, thereby controlling the underlying source of debt explosion and supporting the most rapid pace of economic growth possible. As an example, the American Action Forum has formulated *Balanced*, a plan to navigate these dual challenges. *Balanced* reflects the principle that the United States is served best by a contained, efficient government focused on core national security and domestic activities, including a durable social safety net. It is guided by the lesson of history that the best approach to simultaneous poor growth and explosive debt is to keep taxes low, reform taxes to be more pro-growth, preserve core functions of government, and focus on transfer programs – entitlement programs in the United States – as the route to controlling debt.

Balanced includes several key priorities that reflect the right balance of near-term growth considerations and longer term debt challenges.

Fundamental Tax Reform

While the “fiscal cliff” tax deal established some degree of permanence to the tax code, it did little to otherwise improve it. Rather, it locked in higher rates and a narrower base than is optimal. Looking past the current tax code, there is wide agreement that the U.S. corporate tax is an international outlier and in need of reform. The end-of-year tax agreement left this outlier untouched.

Balanced incorporates a fundamental tax reform that would move the U.S. to a progressive consumed-income tax code. This plan would be pro-growth and not penalize savings and investment. Research suggests that implementing a progressive consumed-income tax consistent with AAF's tax plan would improve long-run economic growth by over 6 percent.⁸

Reprioritize the Sequester in Favor of Entitlement Reform

The sequester has been widely acknowledged as poor policy – a failed “stick” to induce more substantive reforms that the “Super-Committee” ultimately failed to deliver. *Balanced* would reprioritize sequestration with more lasting, mandatory savings through programmatic reforms.

Balanced takes on the budgetary challenge by reforming the projected growth in mandatory spending programs, specifically health and retirement entitlements. Accordingly, major reforms focus on these areas of the federal budget. Future social security benefits are reformed to reflect price, rather than wage growth, while a premium support model is phased into Medicare for future retirees. Medicaid is reformed to reflect cost efficiencies achievable through competitive bidding.

Balanced includes additional reforms to other major areas of spending. The plan keeps discretionary spending slightly above current law. However, the plan includes a repeal of the overreaching and broken Affordable Care Act.

Taken together, these changes would set forth a credible and gradual improvement in the U.S. fiscal position. The American Action Forum plan achieves balance in 2031, with debt to GDP of 60.2. Over the long term, the AAF plan pays down the debt going from 77.6 percent of GDP (in FY2013) to 40.1 by 2037. These are far better budgetary outcomes than those contemplated in either current law or modest deficit reduction plans, but through the right policy choices – fundamental tax reform paired with entitlement reform – are eminently achievable and would leave future generations with a higher standard of living, rather than a legacy of debt and poor economic growth.

Obviously, I have a preference for the proposals developed at AAF. However, more important than the particulars are a strategy that shifts the focus of spending control to the needed entitlement reforms and shifts the debate on taxes away from harmful higher marginal tax rates in favor of pro-growth tax reform.

Thank you for the opportunity to appear today. I look forward to answering your questions.

⁸ David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, “Simulating Fundamental Tax Reform in the United States,” *American Economic Review*, 91(3), June 2001, pp. 574-595.