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Before the Joint Economic Committee

*"The Way Forward From Government Shutdown and Debt-Ceiling Confrontation
Toward Long-Term Fiscal Sustainability and Economic Growth"*

October 11, 2013

The impasse in Washington over funding the federal government and increasing the Treasury debt ceiling is significantly damaging the economy. Stock prices are grinding lower and consumer confidence is weakening. The economic harm will mount significantly each day the government remains shut and the debt ceiling is not raised. If policymakers are unable to reach agreement on these issues by the end of October, the economy will face another severe recession.

To resolve the budget impasse, policymakers should not add to the significant fiscal austerity already in place, which is set to last through mid-decade. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. In 2013, this fiscal drag is as large as it has been since the defense drawdown after World War II.

Moreover, because of fiscal austerity and the economic recovery, the federal government's fiscal situation has improved markedly. The budget deficit in just-ended fiscal 2013 was less than half its size at the recession's deepest point in 2009. Under current law and using reasonable economic assumptions, the deficit will continue to narrow through mid-decade, causing the debt-to-GDP ratio to stabilize.

As part of any budget deal, lawmakers should reverse the sequester. The second year of budget sequestration will likely have greater consequences than the first, affecting many government programs in ways that nearly all agree are not desirable. A sizable share of the sequestration cuts to date has involved one-off adjustments, but future cuts will have to come from lasting reductions in operational budgets.

It would of course also be desirable for lawmakers to address the nation's long-term fiscal challenges. Although the fiscal situation should be stable through the end of this decade, the long-term outlook remains disconcerting. If Congress does not make significant changes to the entitlement programs and tax code, rising healthcare costs and an aging population will swamp the budget in the 2020s and 2030s. Both cuts in government spending and increases in tax revenues will be necessary to reasonably solve these long-term fiscal problems.

A grand bargain with comprehensive entitlement and tax reform is likely too much to hope for, but lawmakers can do some things now to address our long-term fiscal issues and help resolve the current impasse.

Revenue-neutral corporate tax reform that scales back tax expenditures in exchange for a lower top marginal corporate tax rate would also be a significant policy achievement. This would significantly improve the competitiveness of U.S. businesses and the economy's long-term growth. Much of the hard intellectual work necessary to accomplish this has been done, and there is general agreement among economists that this would provide a meaningful boost. As part of corporate tax reform, multinationals could be encouraged to repatriate their overseas profits with a temporarily lower tax rate. The resulting onetime boost to tax revenues could be used to finance infrastructure development here at home, also improving U.S. competitiveness and long-term growth.

New budget rules that recognize the magnitude of our long-term problems and encourage solutions would be especially helpful. These could include incorporating fiscal-gap accounting and generational accounting in the budget process, and significantly extending the current 10-year budget horizon to facilitate entitlement and tax reform.

Congress should also use this opportunity to eliminate the statutory debt ceiling. It is an idiosyncratic, anachronistic and, as has been demonstrated, potentially destructive rule that is detrimental to sound economic policy. Absent repeal, an alternative would be to require debt-ceiling increases when spending, taxation and appropriations bills are passed. Another alternative would be to cap the ratio of the structural deficit to potential GDP for the coming year; as long as this remains below an agreed-upon threshold, the debt limit increase would be automatic. Taking these steps would restore the fundamental economic relationship between budgeting and borrowing and reduce the risk that political brinkmanship could damage the full faith and credit of the United States or the stability of world financial markets.

The U.S. economy remains frustratingly far from full employment. While there are many reasons for this, political brinkmanship around the federal budget and Treasury debt ceiling has been a significant contributing factor. Much progress has been made since the Great Recession, and the economy's prospects are improving, but this will continue only if policymakers can resolve their differences in the next few days.

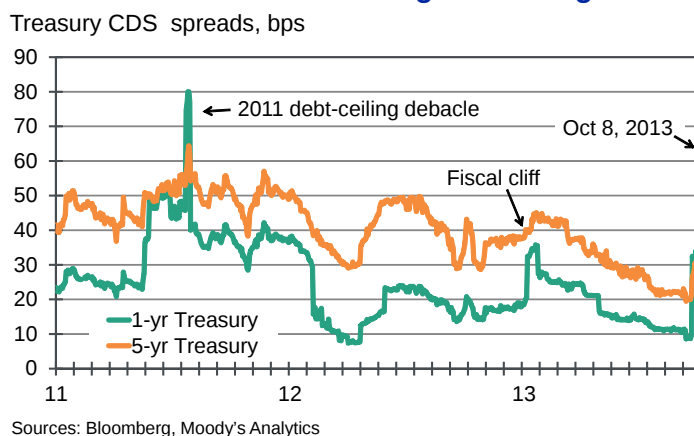
Economic cost

Financial market reaction to the events in Washington has been muted so far. It has become typical for Congress to run down the clock, but in the end it has never failed to

raise the debt ceiling when necessary. The motivation is clear: Any delay would have dire economic and political consequences. It is thus widely expected that Congress will do so again. Indeed, after several rounds of fiscal brinkmanship over the last few years, financial markets have become increasingly desensitized to it.

Nonetheless, anxiety over the budget battles in Washington is building in financial markets. Notably, the price of a credit default swap on a one-year Treasury bill has surged above 60 basis points, up from 10 basis points just a couple of weeks ago. For context, during the showdown over the debt limit in summer 2011, one-year CDS spreads rose to 80 basis points (see Chart 1). CDS spreads on five-year Treasuries are also on the rise.

Chart 1: Financial Market Angst Is Rising



Yields are also increasing on short-term Treasury bills that mature after October 17. Investors are requiring compensation for the possibility that the Treasury might not pay on time. While equities have held up better than bonds, they have been slowly grinding lower since mid-September. The Standard & Poor's 500 is off some 4% over this period.

Unfortunately, it appears that it will take a more substantial selloff in financial markets to give Washington the political will to reach agreement. A couple of days with the Dow Jones Industrial Average dropping several hundred points should generate enough heat for lawmakers to settle the conflict. Given investors' current complacency, however, this may not occur until just before October 17.

Consumer confidence has also begun to weaken. Daily surveys from Gallup and Rasmussen show a sharp decline in sentiment in recent days. Private sector data on retail activity and anecdotal evidence indicate that consumers' darkening mood has begun to weigh on sales.

It is important to note that with the federal government's statistical mills shuttered, it will become increasingly difficult to gauge the economy's strength. The Bureau of Labor Statistics did not release September job numbers, the first such interruption in data since the last government shutdown in 1996. The longer the government shutdown drags on, the greater the disruption to the data collection process and the quality of the information available when operations restart. The muddled data will be difficult to interpret, at a time when it will be critical to know what economic damage political brinkmanship is doing.

Even assuming lawmakers reopen the government and raise the debt ceiling just before the Treasury's announced deadline of October 17, the hit to fourth-quarter real GDP growth will be approximately half a percentage point. Instead of picking up pace at the end of the year as previously expected, the economy will remain stuck near a lackluster 2% real GDP growth rate.

Government shutdown

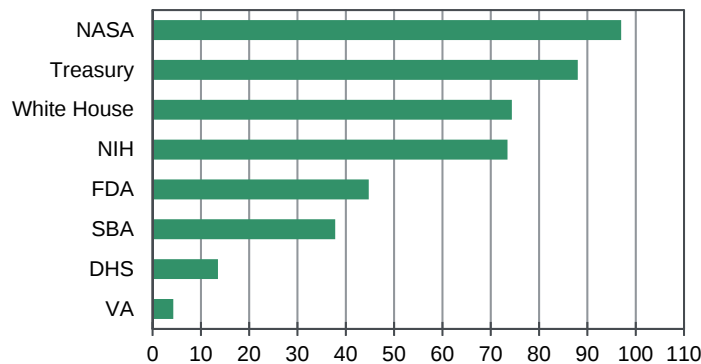
But if the government shutdown lasts longer, even assuming the debt limit is increased by October 17, the economic damage will mount quickly. A shutdown lasting through the end of October would by itself reduce real GDP growth as much as 1.5 percentage points in the fourth quarter. An interruption longer than one month would likely cause growth to stall in the quarter, and one longer than two months could precipitate another recession.¹

For context, the government shutdown in late 1995 and early 1996, the longest on record, lasted about three weeks. The economy's growth slowed notably as a result, even though the technology boom of that time made underlying growth much stronger than it is today.

Although the shutdown only affects nonessential discretionary spending, or about a fifth of total federal spending, it is becoming increasingly disruptive to the economy.² Some 400,000 government employees have been furloughed, and while they will ultimately receive retroactive pay, this will not happen until after the government is reopened (see Chart 2). The same delays in pay affect another 800,000 employees who are still working. Not getting paid for a few days or even a couple of weeks will not make a big difference in their spending behavior, but these workers will likely turn much more cautious if this drags on much longer. Many do not have the financial resources to maintain spending for very long without current income.

Chart 2: Government Shutdown Is Disruptive

% of agency employees furloughed



Sources: OMB, Moody's Analytics

Tourist destinations across the country from the Grand Canyon to Gettysburg PA are suffering. International trade is being impeded as exporters and importers are unable to get the requisite government permits needed to ship their goods. The housing recovery is increasingly at risk as lending by the Federal Housing Administration slows and other lenders have trouble getting tax and Social Security information needed to close mortgage loans. Small-business lending is also being hampered by the closing of the Small Business Administration.

Treasury debt ceiling

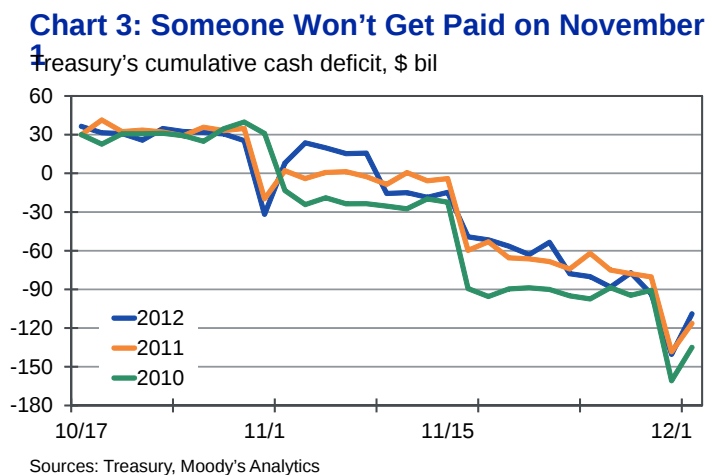
The economic cost of the government shutdown is significant, but it is small in comparison to the cost of not increasing the \$16.7 trillion debt limit in a timely way. According to Treasury Secretary Jack Lew, October 17 is when the extraordinary measures the Treasury has been using since May to stay under the limit will no longer work.³ Unable to borrow at that point, the government will only be able to pay bills with the cash it has on hand, about \$30 billion per day.

The Treasury might be able to pay holders of U.S. government securities first, as those payments are handled by a different computer system than other government obligations. But the Treasury believes it is not legally viable to do so, and politically it would be very difficult to pay bond investors before Social Security recipients. Even if the Treasury did pay bond investors first, this would not stop investors demanding a much higher interest rate for the legal uncertainty and the real possibility that they may not get paid on time in the future. Bond investors, especially those overseas, would reasonably ask whether Congress would actually allow them to be paid ahead of

American seniors. The Federal Reserve could increase its bond buying, but any benefits would likely be overwhelmed as global investors sold U.S. securities. Financial markets would surely be spooked. Sometime in late October, there would be a TARP moment, harkening back to that day in October 2008 when Congress failed to pass the Troubled Asset Relief Program and stock prices cratered.

Deciding which other bills receive priority would be all but impossible, as the Treasury could not sort through the blizzard of payments due each day. More likely, the Treasury would delay all payments until it received enough cash to pay a specific day's bills, as outlined in a 2012 report by the inspector general. Based on the timing of outlays and tax receipts, this would probably mean delaying more than a week more than \$60 billion in payments due November 1 to Social Security recipients, veterans and active-duty military. This would almost surely eviscerate consumer and business confidence.

If the impasse over the debt limit lasts through November, the Treasury will have no choice but to eliminate a cash deficit of approximately \$130 billion by slashing government spending (see Chart 3). This is approximately 9% of annual GDP.



In contrast with previous recessions, moreover, government would have no tools available to cushion the blow. With Congress and the administration still at loggerheads, there would be no fiscal policy response, and with short-term interest rates at zero and the Fed's balance sheet already bloated, it is unclear what the central bank could do to support the economy.

This would be a cataclysmic economic scenario. The downturn would be at least as severe as the Great Recession. That means real GDP would decline by about 5%, close to 10 million jobs would be lost, and unemployment would rise to 12%. With this economic backdrop, stock prices would likely be cut in half, wiping out about \$10 trillion in household wealth. Treasury yields would likely spike, at least until the debt limit is increased and debt payments are resumed.

Political uncertainty

Even if lawmakers come to terms in coming days, the harsh political vitriol and repeated threats to shut government or not pay its bills have weighed heavily on sentiment and meaningfully harmed economic growth. Businesses are more reluctant to invest and hire, and entrepreneurs are less likely to attempt startups. Financial institutions are more circumspect about lending and households are more cautious about spending. While many factors are at work here, Washington's heated budget battles are a significant contributor.

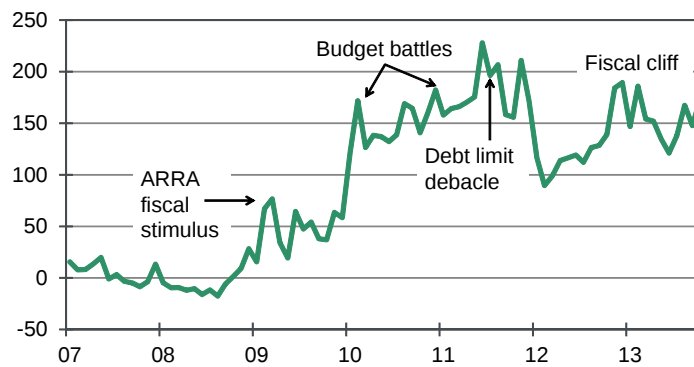
Half the CEOs in the Business Roundtable's third-quarter outlook survey said Washington's battles have affected their hiring plans over the next six months. Shaky nerves stifle risk-taking and entrepreneurship, which is key to stronger growth.

The uncertainty created by Washington is evident in the Moody's Analytics political uncertainty index. The index is based on the credit default swap-implied expected default frequency for five-year Treasury bonds; the present value of future expiring tax provisions; and the share of businesses that cite legal and regulatory issues as their biggest problem in the Moody's Analytics weekly business survey. The index is set to equal 0 in 2007, the year before the recession. The higher the index, the greater the uncertainty.

The Moody's Analytics index rose significantly during the heated debate over the American Recovery and Reinvestment Act—the \$830 billion fiscal stimulus—in early 2009. It surged during the budget debate in early 2010 and rose to a record high during the Treasury debt-ceiling showdown in the summer of 2011(see Chart 4). Uncertainty also increased as the fiscal cliff approached in late 2012 and has been rising in recent weeks as the current fiscal impasse unfolded.

Chart 4: Political Uncertainty Remains High

Fiscal policy uncertainty, 2007Q4=0



Source: Moody's Analytics

Political uncertainty constrains business investment, especially in research and development, reduces hiring, and slows GDP growth. A statistical analysis shows that increased political uncertainty since the recession hit in 2008 has lowered real GDP by close to \$150 billion, reduced employment by 1.1 million jobs, and increased unemployment by 0.7 percentage point.⁴ If political uncertainty had simply remained unchanged from its 2007 level, the unemployment rate today would be 6.6% instead of 7.3%. If not for the logjam in Washington, the economy would now be much closer to full employment.⁵

No additional near-term fiscal austerity

In any agreement to increase the debt ceiling or extend funding for the federal government, lawmakers should avoid adding to the fiscal austerity in place through mid-decade. Congress has been appropriately focused on reducing the government's large budget deficits, but recent tax increases and government spending cuts have put a significant constraint on growth. Under current law, fiscal headwinds will continue to blow hard in 2014 and 2015. It would be wise not to add to those headwinds, and allow the private economy to gather momentum.

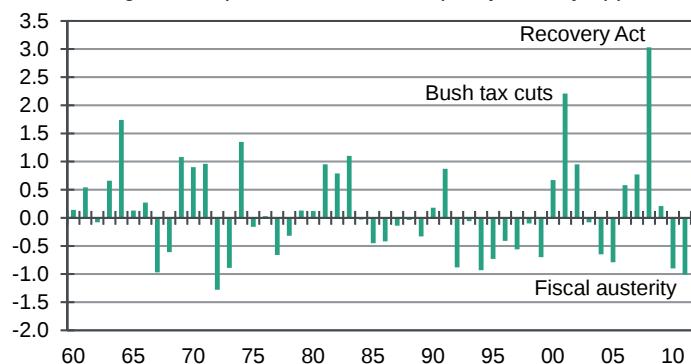
Although the U.S. economy has begun its fifth year of recovery from the debilitating Great Recession, it remains fragile. Growth has been modest, with real GDP expanding close to 2% per year since the recovery began, and payrolls are still nearly 2 million jobs shy of their prerecession peak. The nation's 7.3% unemployment rate remains well above most estimates of full employment, which is closer to 5.5%. And this understates the stress in the job market given the large number of potential workers who have left the labor force because of a lack of perceived job opportunities.

The private economy has made significant strides since the recession. American companies have strong balance sheets with low debt and lots of cash, and they have done an excellent job reducing their costs. By most measures, they are highly competitive. The financial system is much better capitalized and liquid, and increasingly willing and able to extend credit. Households have also significantly reduced their debt loads, which are now about as low as they have ever been. Higher house prices and stock values are also supporting households' better financial condition.

But the strengthening private economy is not evident in the nation's overall performance because of fiscal austerity. In calendar year 2013, the drag on the economy from federal tax increases and spending cuts will amount to 1.5 percentage points of real GDP growth. That is, if fiscal policy were simply neutral with respect to the economy, real GDP growth this year would be closer to a strong 3.5% (2 percentage points in real GDP growth plus 1.5 percentage points from the elimination of the fiscal drag). The fiscal drag will reach its apex in the current quarter, and over the course of 2013 will be greater than in any other year since the defense drawdown that followed World War II (see Chart 5).⁶

Chart 5: Fiscal Headwinds Are Blowing Hard

Real GDP growth impact of federal fiscal policy, fiscal yr, ppt



Source: Moody's Analytics

The federal government's improved fiscal situation also gives lawmakers some leeway. Tax revenues are rising at a double-digit pace and government spending is falling. The budget deficit for fiscal 2013 is set to come in well below \$700 billion.

This is still large, but it is half of what it was at its peak in fiscal 2009. Under current law and assuming the economic recovery stays intact, the deficit will continue to narrow through mid-decade. The nation's debt-to-GDP ratio, though uncomfortably high at more than 70%, will stabilize.

Given the still-fragile economic recovery, the austerity already in place, and a better near-term federal budget situation, policymakers should not add to the fiscal burden on the economy through mid-decade. This will help the private economy kick into higher gear, hasten a self-sustaining economic expansion, and promote a quicker return to full employment.

Replace the sequester

Policymakers should replace the cuts scheduled for the coming year as part of the sequester with other budget savings.

The impact of the current year's sequester, which began in March, is becoming more visible in the economic data. Hiring freezes announced early this year appear to have accelerated the decline in federal government employment. There has been an even larger impact on hours worked and personal income. Federal furloughs caused government wages and salaries to decline by half a percent in August alone. Cuts in procurement spending are also reducing support for private sector jobs, particularly among defense contractors, although the impact of the sequester on private employment is occurring gradually, with a significant lag.

A second year of sequestration will have greater consequences for the economy. The cuts will be larger and will start immediately, rather than beginning six months into the fiscal year as occurred this year. Because of lags between budgeting and actual spending, and between federal spending and its impact on the job market, the fallout from this year's cuts will carry over into 2014. A sizable share of the fiscal 2013 sequestration cuts was also made through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continuing the sequester would have particular implications for the Pentagon. While in fiscal 2013 sequestration cuts were divided evenly between security spending—on defense, homeland security and international affairs—and nonsecurity spending, in 2014 and beyond the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations. The potential for an escalation in military operations in Syria could increase the overseas contingency operations budget, which is not exempt.

Enact budget reforms

The statutory debt ceiling is an anachronistic law that if not repealed should be reformed so that it can no longer lead to a voluntary default on U.S. government obligations. Fiscal-gap and intergenerational accounting should also be adopted in the budget process.

Using the threat of a default on U.S. government obligations as a tool in fiscal policy negotiations has meaningful economic costs. Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing, tax and spending policy, by requiring “ability to pay” language in any legislation that adds to future deficits. Ability to pay is defined as sufficient projected tax revenue and borrowing authority to cover the current Congressional Budget Office deficit forecast. This requirement would be applied to all direct spending, taxation and annual appropriations bills. Any discrepancies that result from changes in the CBO forecast could be reconciled in the annual budget process.

The debt ceiling would still force lawmakers to think about the long-term fiscal impact of any legislation, but it would do so in the context of the spending and taxation bills that create the need for that debt. This proposal makes use of current CBO budget projections and scoring practices, and thus should cause no new compliance costs.

Policymakers should also adopt the INFORM Act, which would require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting.⁷ This provides a more accurate calculation of the nation’s long-term fiscal obligations and thus would create the basis for sounder budgeting and fiscal decision-making.

The fiscal gap describes the difference between the present value of projected government expenditures, including interest and principal payments on outstanding federal debt, and taxes and other receipts, including income accruing from the government's ownership of financial assets. Generational accounting measures the burden of closing the fiscal gap on today's and tomorrow's children, assuming they must do so on their own and that the burden on each generation is proportional to its labor earnings.

Fiscal-gap accounting and generational accounting are comprehensive and forward-looking, and determine the sustainability of fiscal policy and the burden of that policy on future generations. Fiscal-gap accounting has already been adopted by the Social Security Trustees and Medicare Trustees and is becoming more widely used in other countries.

Pass corporate tax reform

To break the budget impasse, policymakers should consider adopting revenue-neutral corporate tax reform. Reform that resulted in a lower marginal corporate tax rate would also help the competitiveness of U.S. companies and thus support stronger long-term economic growth.

Corporate tax reform, which involves reducing or eliminating tax expenditures in the corporate tax code and using the resulting additional revenues to reduce marginal rates for businesses, would also be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that result in lower effective tax rates. All the loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus long-term economic growth.

As part of corporate tax reform, multinational corporations would be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. This would give a onetime boost to tax revenues that could be used to finance needed infrastructure development in the U.S. This too would help the competitiveness of U.S. companies and thus long-term economic growth.

Conclusions

Washington's recent budget battles have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and anxiety among consumers, businesses and investors, weighing on their willingness to spend, hire and invest.

Despite this, the economic recovery is more than four years old, and the private economy has made enormous strides. Business balance sheets are about as strong as they have ever been, the banking system is well capitalized, and households have significantly reduced their debt loads. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is Congress' willingness to fund the government and make sure all its bills can be paid. If policymakers can find a way to do these things in the next few days, almost regardless of how awkward the process is, the still-fragile recovery will quickly become a self-sustaining expansion.

We are close to finally breaking free from the black hole of the Great Recession. All it takes is for Washington to come together.

¹ A thorough analysis of the causes, processes and effects of federal government shutdowns, including potential issues for Congress, can be found in “Shutdown of the Federal Government: Causes, Processes and Effect.” *Congressional Research Service Report for Congress*. August 6, 2013. <http://www.fas.org/sgp/crs/misc/RL34680.pdf>

² This includes programs that are funded through congressional appropriations, but are not considered vital such as national security, air traffic control, law enforcement, or the processing of benefit payments. Mandatory spending is not affected.

³ Secretary Lew’s letter to Congress can be found at <http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf>

⁴ These results are based on a structural vector autoregressive model of the U.S. economy. The model is used to estimate the extent to which surprise changes in political uncertainty produce changes in GDP, unemployment, the hiring rate, investment, jobs, and several other economic variables.

⁵ It is difficult to statistically distinguish between political uncertainty and policy uncertainty. Political uncertainty is created by political brinkmanship and dysfunction in government. Policy uncertainty is created by potential changes in government spending, taxes and regulation. The 2011 showdown over the Treasury debt limit was especially hard on the economy as it created a great deal of political uncertainty, but also involved large changes to spending and tax policy. The current government funding and debt limit debates may have less economic impact, as they appear to involve more political than policy uncertainty. Despite current legislative efforts to defund Obamacare, such defunding seems very unlikely, and no other major policy changes are being debated, at least so far. Also mitigating the economic impact of the current debate is that businesspeople, consumers and investors appear to be increasingly desensitized to the political vitriol with each budget battle.

⁶ If fiscal austerity measures had not been implemented since early 2011, making federal fiscal policy neutral with respect to the economy, then real GDP would be nearly \$300 billion greater, there would be almost 2 million more jobs, and the unemployment rate would be more than a percentage point lower. This is based on a simulation of the Moody’s Analytics structural model of the U.S. economy. The simulation assumes that monetary policy would not have changed; that is, the Federal Reserve would have engaged in the same amount of quantitative easing despite the stronger economy.

⁷ The INFORM Act is described in detail at <http://www.theinformact.org/content/text-bill>