Will It Take a Crisis to Fix Fiscal Policy?

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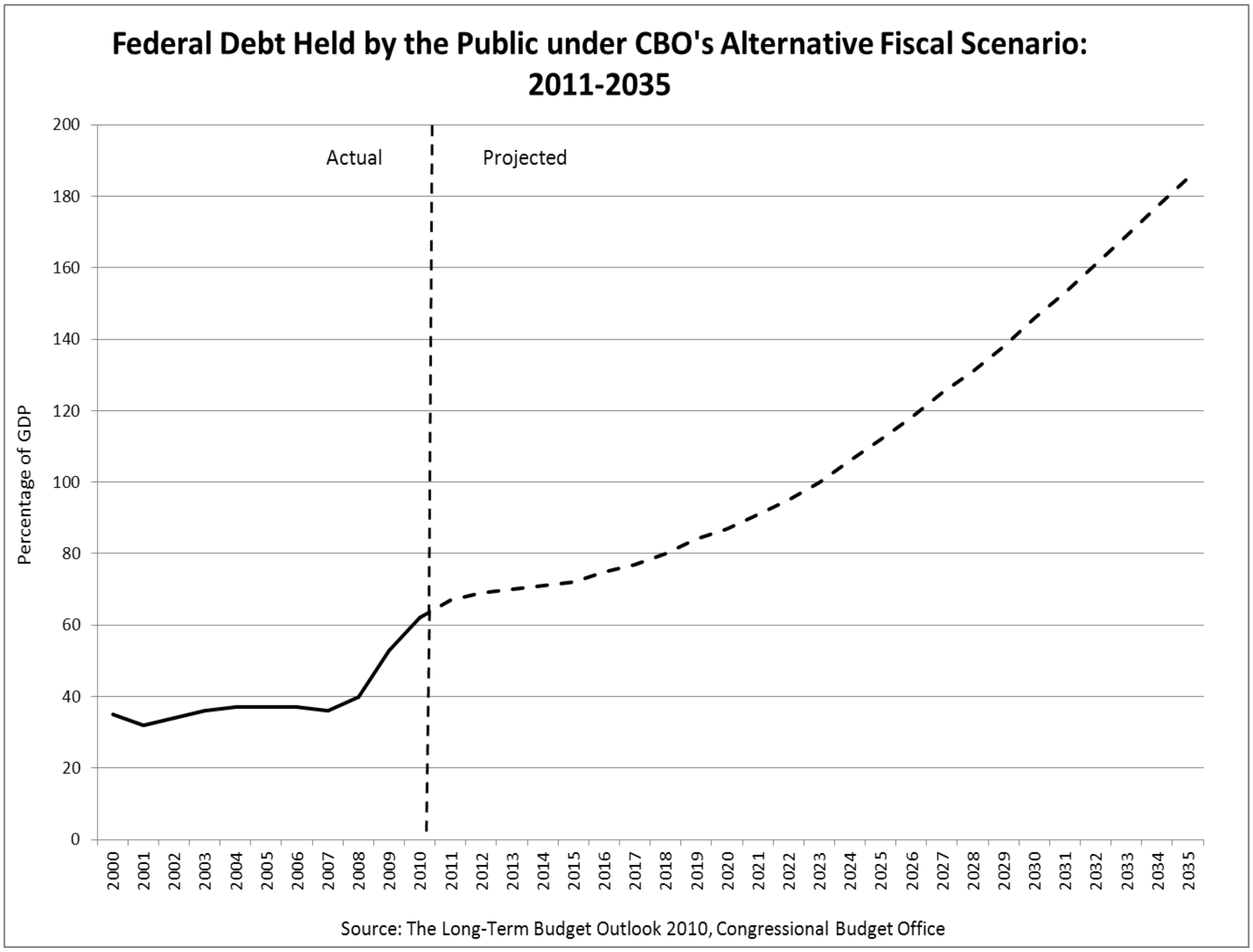
The Size of the Problem

It is not a pretty picture. Unless U.S. fiscal policy is changed dramatically, the national debt will grow at an increasing rate and far outpace economic growth. Using a reasonable definition of current policy, the Congressional Budget Office (CBO 2010) projects that the national debt in the hands of the public will reach 185 percent of the gross domestic product (GDP) by 2035. Of course, those buying our debt will likely go on strike long before we reach that point.

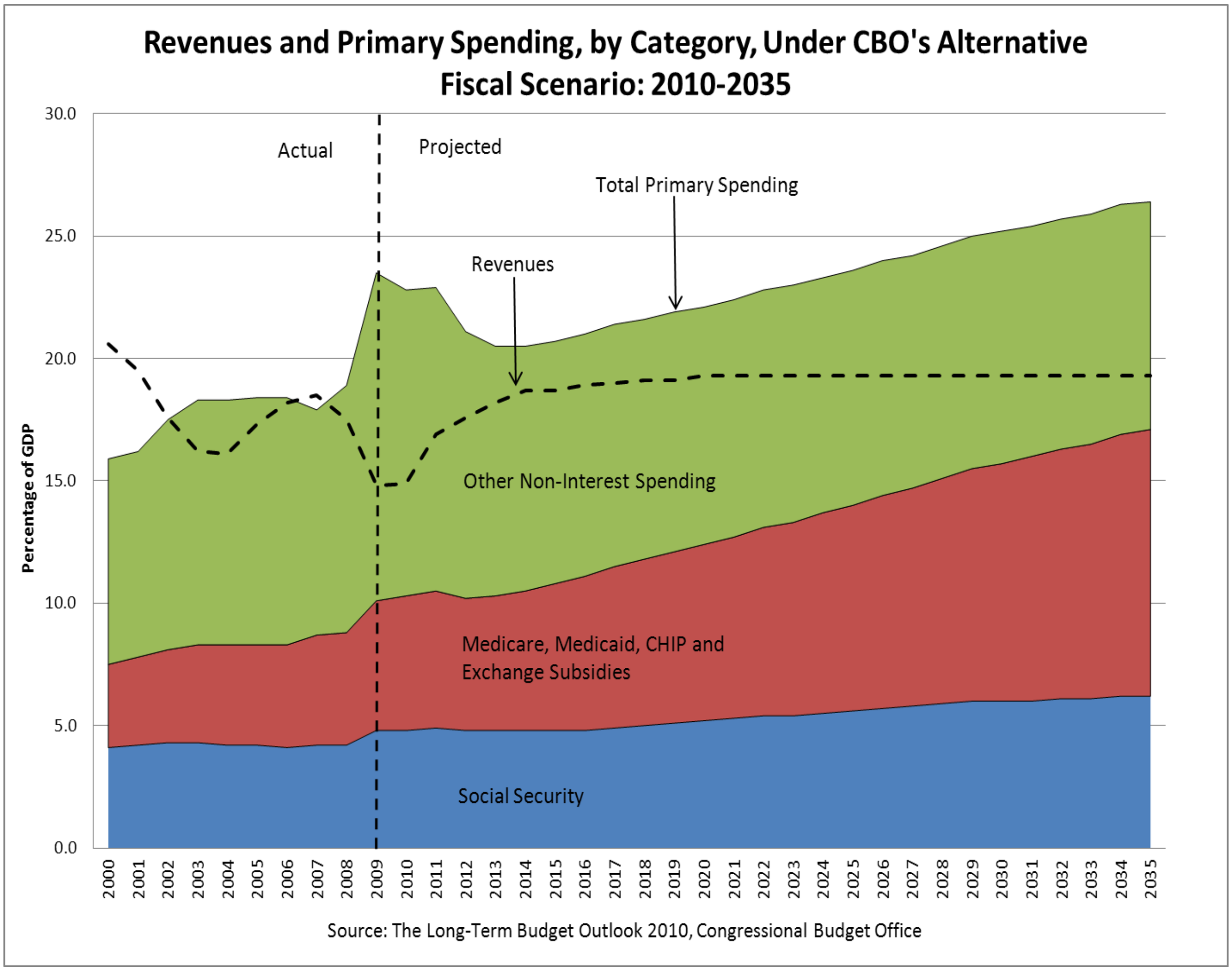
[1] This article is based on a speech delivered to the National Association of Business Economists Annual Meeting in Denver, October 10, 2010. The author is grateful to the John D. and Catherine T. MacArthur Foundation for financial support. The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Figure 1.



The arithmetic underlying CBO's projection is extremely simple. Two program areas—Social Security and health—will be responsible for about 50 percent of total federal spending once the stimulus program of 2009 phases out. Spending in both areas is rising faster than GDP and faster than tax revenues. Tax revenues, on the other hand, have been remarkably constant historically, varying between 17 and 19 percent of GDP for all but 11 of the past 50 years. If programs other than Social Security and health and the tax burden remain roughly constant relative to GDP, the deficit and the national debt will grow rapidly. Eventually, the interest cost of the debt begins to dominate the budget and ultimately the system explodes.

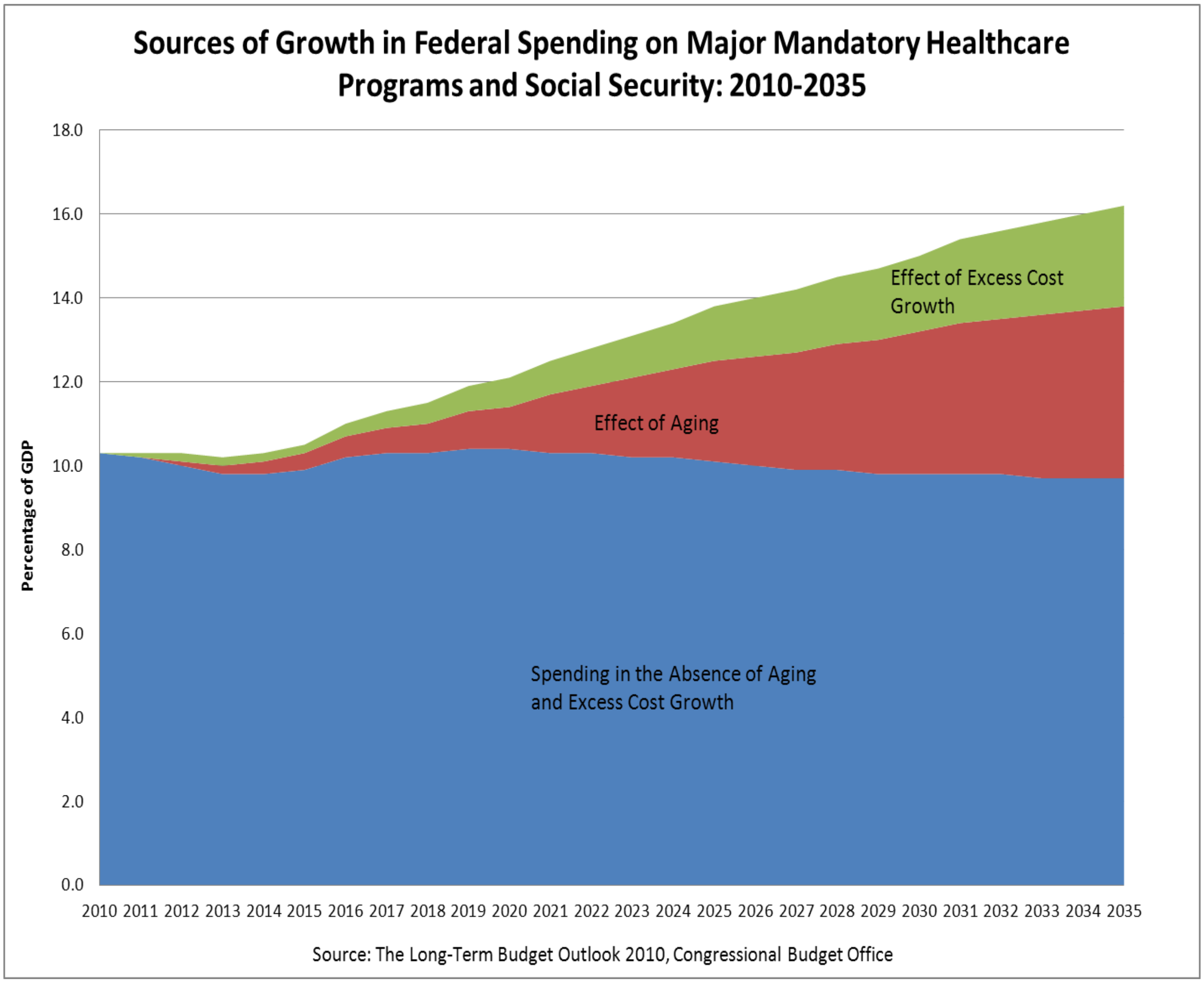
Figure 2.



Over the next three decades, the aging of the population is the most important driver of Social Security and health costs, as retiring baby boomers apply for Social Security, Medicaid, and Medicare in large numbers and then draw benefits for decades. But health programs face an additional problem. Health costs for every age group have been growing considerably faster than income. Although our health care system is incredibly inefficient, technological change is the most important source of cost growth in the long run. Medical research constantly develops new treatments and drugs, most of which are extremely valuable. Even when they are not effective, the consumer has little incentive to economize, because someone else, such as Medicare or employer-provided health insurance, appears to be paying most of the cost.

Generally, when we think about the aging of the population, we focus on the fact that there are more old people and they are living longer. But aging has another important dimension. The average age of the population is rising, not only because there are more old people, but because there are relatively fewer young people. Baby boomers and generation X-ers did not have enough children to support them well in their old age. Consequently, the growth of the labor force is slowing, and that implies that the growth of tax revenues is also slowing. That contributes significantly to our long-run budget problem.

Figure 3.



The existence of a long-run budget problem has been apparent for decades, ever since it became clear that the abrupt fall in birth rates that followed the baby boom was a long-lasting phenomenon. However, the problem did not seem that urgent until it worsened significantly as result of the Great Recession of 2008–09. The economic downturn caused revenues to plummet while spending on safety net programs soared. A massive stimulus program was enacted that further cut tax revenues and added to spending. A recent estimate put its cost at $814 billion. The national debt grew from 40 percent of GDP at the end of fiscal 2008 to 62 percent by the end of 2010.

Even with a slow economic recovery, the deficit is expected to decline between 2010 and 2014 given the budget policies that President Obama recommended in his 2011 budget. However, the debt will continue to rise relative to GDP, reaching 70 percent by the end of 2014. After that, the deficit is projected to rise again, even though it is assumed that the economic recovery continues. The increase accelerates after 2018, as interest costs become a major part of the budget problem. They are expected to rise 4-1/2 times between 2010 and 2020 as the debt grows and interest rates are projected to rise modestly. The debt could be as large as 90 percent of GDP by 2020 unless the newly elected Congress cuts back President Obama's spending plans significantly.

Is There Any Hope?

Some believe that the numbers just cited are far too pessimistic. They argue that the nation faced severe budget problems before and that we have done something about it. In 1990, when the deficit was rising at an alarming rate and blasting through the targets set by the Gramm-Rudman-Hollings law, the elder President Bush got together with a Democratic Congress and they fashioned a major, bi-partisan budget deal that very significantly reduced the deficit from where it would have been otherwise. Unfortunately, the deficit continued to rise rapidly because of the lingering effects of the 1990 recession and that induced President Clinton to negotiate another deal with Congress, almost as large as Bush's. Republican's refused to go along and the deal enacted in 1993 was supported only by Democrats.

Exogenous events also contributed to deficit reduction. The Cold War ended and defense spending was cut substantially. The tech boom on Wall Street helped bring in a flood of revenues, mostly from the very, very rich, and a budget surplus emerged in 1998 that caught everyone by surprise. It was the first surplus since 1969. The optimists argue that there is no good reason that we cannot combine good policy and a bit of good luck yet again and cure our fiscal woes.

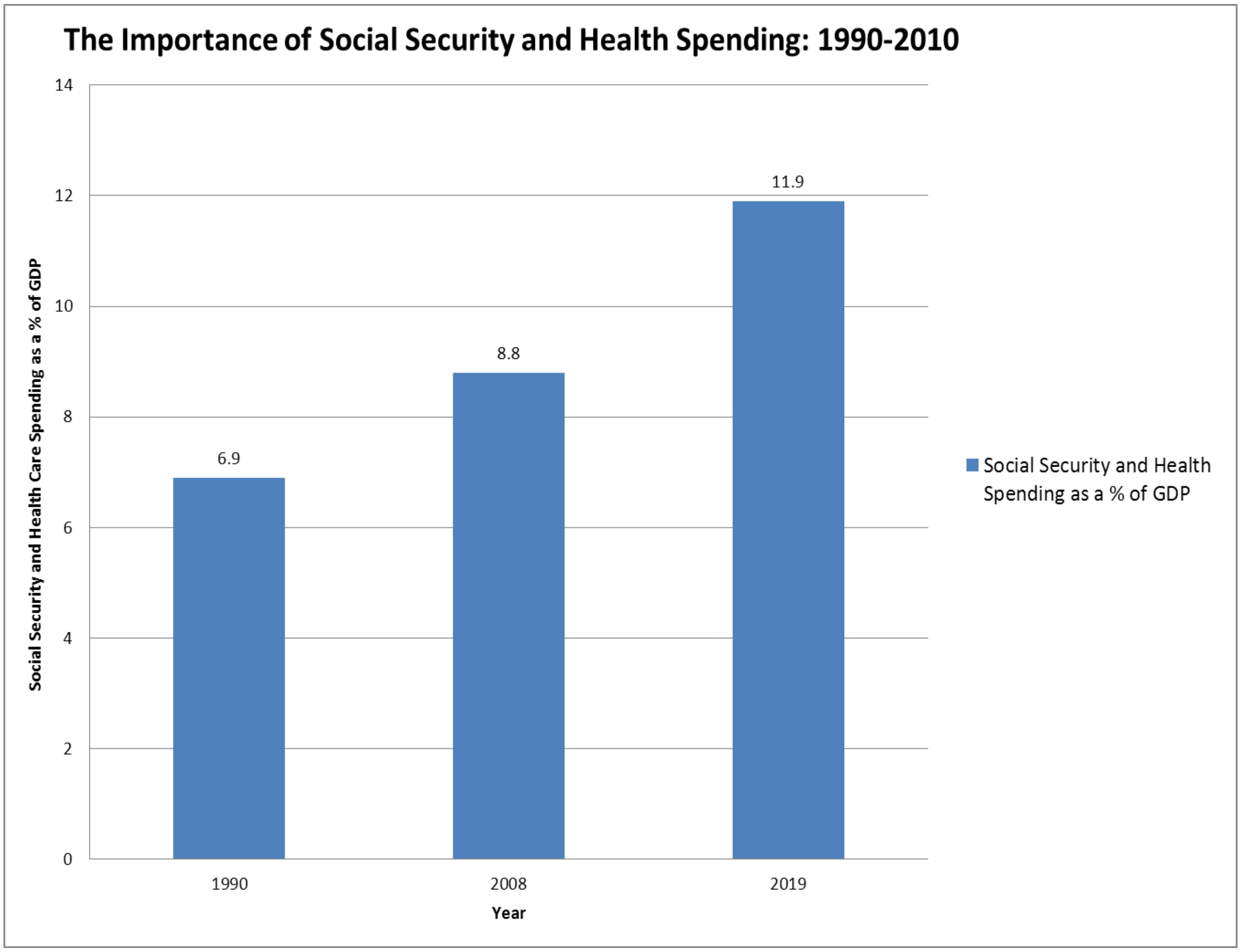
This Time It's Different[2]

I find it hard to believe that we can easily repeat the experiences of the 1990s. The world is now very different and the problems are much more challenging. First, we start off in much worse shape. In 1990, the debt in the hands of the public was 42 percent of GDP. By the end of 2012, the next fiscal year, it is expected to be over 70 percent of GDP. By 2020, with Obama budget policies, it is expected to approach 90 percent. The rapid growth in the debt implies that the policy changes necessary to achieve fiscal stability are now much more painful than they were in the early 1990s.

Second, the importance of Social Security and health programs has risen dramatically since the 1990s. In 1990, spending in the two areas was 6.9 percent of GDP. By 2008, it had grown to 8.8 percent of GDP. It is projected to be 11.9 percent of GDP in 2019. In other words, it is expected to grow about 70 percent in relative importance over 29 years. Social Security is probably the most politically popular program ever invented. It will not be reformed easily. Medicare is almost as popular politically. It accounts for the bulk of health spending.

[2] Apologies to Reinhart and Rogoff (2009), authors of *This Time Is Different: Eight Centuries of Financial Folly*.

Figure 4.



Third, Congress has recently been essentially dysfunctional when it comes to making fiscal policy. It was not able to pass a budget resolution for fiscal year 2011. It is the first time since the congressional budget process started in 1975 that the House has not been able to pass a budget. Also, Congress allowed the estate tax to expire in 2010, as if by accident, and was not able to decide the fate of the Bush tax cuts until they were on the verge of expiring. That created much uncertainty about tax policy in 2011, when additional uncertainty was the last thing needed during an anemic economic recovery. Even worse, important tax issues for 2010 were left unsettled until the year was almost over. No one knew for certain how much alternative minimum tax they would be paying, and it was unclear whether many temporary tax provisions, such as the research and experimentation tax credit, would be renewed.

As has become quite common, the appropriation process that funds the discretionary spending of the government was not completed by the beginning of the fiscal year. Indeed, none of the 12 necessary appropriation bills were passed in a timely manner and that is quite uncommon. Other important spending issues were left hanging. It was not clear whether the extension of unemployment insurance would be renewed or amended, and the law that required a cut in Medicare reimbursements for doctors of more than 20 percent was suspended in December, but only through January 1, 2011. All the tax and some of the spending issues were finally resolved in the middle of December as the result of a mega deal between Republican leaders and the president, but it should have been done months earlier.

Congress has not had a sorrier record in the 40 years that I have been watching the formulation of fiscal policy. It is not surprising that public approval of Congress is in the basement and that the electorate chose to "throw the bums out"—at least some of them—in the 2010 election. The solid Republican majority that resulted does not mean that the electorate loves Republicans. It mainly showed that they disliked many incumbents.

Almost a quarter of House members will be freshmen as the 112th Congress convenes in January 2011. That, of course, implies that three-quarters of the old guard will remain. Will the new members have enough clout to reform Congress and induce it to act more rationally? There is no doubt that the new Congress will be considerably more fiscally conservative than the old one. That is not only because so many new fiscal conservatives were elected. The public mood forced many older members, including some Democrats, to become much more conservative during the campaign than they would have been otherwise.

But fiscal conservatism will run head-on into budget arithmetic and political reality. It is safe to say that many new members—and quite a few old ones—do not understand that they will face budgets in which about 50 percent of total spending consists of Social Security and health benefits, with Medicare dominating the latter. Few chose to question these programs during the campaign and some who did, lost (e.g., Sharron Angel of Nevada). Also, it was not reassuring earlier in 2010 to see Republicans almost uniformly oppose every last dollar of Medicare cuts used to help finance health reform.

It does seem clear that we shall see extreme stringency toward both defense and civilian discretionary spending in the next Congress. Although that will help a little, discretionary cuts cannot stabilize the long-run fiscal situation by themselves. True fiscal consolidation will require Social Security and health reform and some revenue increases.

There is one faint ray of hope. Early in 2010, the president appointed a National Commission on Fiscal Responsibility and Reform, chaired by former Senator Alan Simpson and former White House chief of staff under President Clinton, Erskine Bowles. Republican and Democratic leaders in Congress each appointed three incumbent Senators and three House members. The president appointed six public members drawn from both political parties. The rules of the commission required that for the report to be put before Congress, 14 of the 18 members had to approve any recommendations. The probability of that happening was virtually zero, especially since congressional Republicans and Democrats appointed some members from the ideological extremes of their parties.

The members of the commission and their staffs knew that they faced daunting odds, but they worked very hard at their task. Discussions were congenial despite the ideological chasm among the members. It was an island of sanity in an otherwise crazy Washington. In the end, they produced a balanced report that had the potential to completely solve the long-run budget problem. Through 2020, roughly 70 percent of the solution came from slowing spending growth and 30 percent from revenue increases, not counting associated interest savings.[3]

[3] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, (Washington, DC, 2010).

Remarkably, 11 of the 18 members supported the recommendations. More remarkably, support covered the ideological spectrum from Senator Coburn, who may be the most conservative member of the Senate, to Senator Durbin, a solid liberal. Support also came from Senators Crapo and Gregg. I believe that it is the first time elected Republicans have explicitly endorsed revenue increases.

The work of the president's commission was complemented by a report from a private, bipartisan task force headed by former Senator Pete Domenici and former OMB and CBO director, Alice Rivlin. There was much overlap between their recommendations and those of the president's commission. Both advocated radical tax reform; both slowed the growth of Social Security benefits in a progressive manner; and both were hard on discretionary spending. The bipartisan task force solved a considerably higher portion of the budget problem with tax increases and advocated a 6.5 percent value added tax to do so.

The existence of the two important committees inspired many other groups, from the far right to the far left, to bring forth their own budget plans. Some members of the president's commission who dissented from the main report also felt the need to have their own plans.

Unfortunately, all this activity received only tepid support from our political leaders. Speaker Boehner thanked the president's commission for drawing attention to the budget problem and has referred to the need for Social Security reform without specifically mentioning any changes in the law. Former Speaker Pelosi called an earlier version of the commission's report "unacceptable." The president's budget for fiscal year 2012 has not yet been released as this is written, but it will be a huge surprise if it advocates specific policies aimed at solving the long-run problem. He will advocate significant restraints on discretionary spending, but as previously noted, that will only help a little in attacking our fiscal woes.

The president seems to be adopting a policy that is politically cautious and economically reckless. Although the public is concerned about the deficit, it is not at the top of their concerns. Moreover, there is strong public opposition to almost all possible major deficit reducing measures, whether they involve higher taxes or

Social Security and Medicare reform. Consequently, the president is concerned that if he advocates unpopular deficit reducing measures, the Republicans will demagogue him to death. At the same time, Republicans fear that if they take the initiative, they will be demagogued to death. It would seem a good time for the two parties to negotiate a solution that would allow them to jump off the cliff together, but that does not seem imminent.

The president and his economic advisors may be right in deciding that a fiscal crisis is highly unlikely before the next election. In fiscal year 2012, the Federal Reserve will be buying 40 to 50 percent of the debt issued to finance the deficit, and the amount left over will not be far above 5 percent of the GDP. One worries about what will happen when the Fed has to sell a significant portion of its Treasury holdings to sop up excess reserves while the Treasury still has to finance large deficits, but that day may be far away.

In summary, there is much more interest in our budget problems than ever before, and there will probably be even more interest in the future. Initially, the only action will involve curbs on discretionary spending. It appears as though policymakers and the public will only slowly accept the notion that budget reform requires Social Security and health policy reform along with tax increases affecting more than the "rich."

There is something of a race going on. Will budget reform occur before the United States faces a sovereign debt crisis? Or is a crisis the only thing that will provoke reform?

The debate over raising the debt limit will either just be over or in full swing as this article is published. The debate will create major risks as the contending parties play chicken over the possibility that the United States will default on the interest owed on its debt. However, the debate can also create an opportunity for negotiating meaningful budget reforms. At the moment, there appears to be little appetite for the latter, but we can hope. In 1985, a debt limit debate led to the

Gramm-Rudman-Hollings law of 1985, which set deficit targets and enforced them with sequesters.[4]

If Fiscal Policy Is So Bad, Why Are Interest Rates So Low?

It is gratifying, if somewhat puzzling, to see that foreign and domestic investors have sufficient confidence in future U.S. fiscal policies to have driven interest rates on U.S. Treasuries to extraordinarily low levels in 2010. But we should not be reassured. The history of sovereign debt crises teaches that it is not at all uncommon for financial markets to remain calm while the fiscal situation deteriorates. Then suddenly, bond prices collapse and interest rates can go up 300 to 400 basis points in a matter of days.

There is no way of predicting when such a crisis will occur. It happens at wildly different debt-to-GDP ratios. Reinhart and Rogoff (2009) point out that more than half the countries experiencing debt crises had debt-to-GDP ratios less than 60 percent—a level that we now exceed. Niall Ferguson (2010) has noted "that news—bad news—on a quiet news day can cause market sentiment to change."

Having just said that crises are impossible to forecast, it is hard to resist speculating on what might set one off in the United States. Might it be a downgrade of Treasury debt by S&P or Moody's? Or might a worsening of the sovereign debt crises in Europe draw more attention to the fact that, by many measures, our debt situation is just as bad? Or maybe the United States will be worse off if Europe solves its debt crisis. We could be left as the only major, truly irresponsible country left in the world, and there would be plenty of other places for investors to take their money safely.

It has already been noted that the debate over the debt limit will create significant risks. Inherently, it is a totally irrational debate. Congress will be

[4] I would not argue that Gramm-Rudman-Hollings (GRH) was particularly successful in that its deficit targets were soon made more lenient and then the process collapsed when it proved impossible to meet the more lenient targets. However, the collapse of GRH inspired the 1990 budget deal that massively reduced the deficit, and the deal was enforced by the Budget Enforcement Act that provided considerable budget discipline until a budget surplus emerged by total surprise in 1998.

debating whether to finance tax and spending decisions that are already on the books. A domestic or foreign investor in U.S. debt witnessing this spectacle might decide that it is time to dump Treasuries. But luckily, Congress has always been brow beaten into passing an increase in the limit just before the nation plunges over a cliff.[5] Hopefully, investors will assume that history will repeat itself and that all will be well. But it is the sort of thing that could be a catalyst for financial instability. It is a debate that we could easily do without.

[5] There have been times that delays in passing a new limit have forced the Treasury to resort to creative financing, such as delaying the deposit of bonds purchased by civil servants for their pension accounts..

Reaction to a Crisis

How might the United States react if interest rates suddenly soared three or four hundred basis points, the stock market crashed, and the dollar plummeted?

Inflation—Many governments have tried to inflate their way out of fiscal difficulties. It works, albeit with great pain. The real value of the national debt is reduced, but more important, the budget is reformed. A hyperinflation reduces the real pay of civil servants to almost nothing. It does the same to appropriations for discretionary programs and to the value of many social benefits. Even where benefits are indexed, lags in the indexing process make COLA adjustments ineffective. At the same time, seigniorage and the implied tax on assets denominated in money terms provide resources that the government can use.

The problem is that it is hard to run a hyperinflation for much more than a year. After that people stop using money. But at that point, the compensation systems for civil servants and social programs have essentially been destroyed. They can then be reformed from scratch.

Needless to say, it is a terrible way to cure a fiscal crisis. Many countries that emerged as the result of the disintegration of the Soviet Union used it, including Russia. Emerging economies and even sophisticated countries, such as Israel, have used it. But I take some comfort from the fact that serious inflation has been avoided by democracies similar to the United States when they confronted fiscal crises. For example, Canada, Sweden, Australia, and New Zealand escaped fiscal crises with rational cuts in spending and tax increases and did not succumb to high inflation.

It may be tempting to run a more modest inflation to erode the real value of the debt slowly. However, that would not work well in the United States because the average maturity of our debt is short. Roughly 30 percent of our debt must be refinanced every year. That implies that an increase in inflation would increase debt servicing costs very quickly and would not help much in resolving our fiscal problems.

In addition, it would be necessary to destroy the independence of the Federal Reserve System to engineer a significant inflation. Although the Fed is less politically popular than it has ever been in my memory, it is primarily because many critics worry that it risks too much inflation with quantitative easing and its various bailouts. Its most vociferous critic, Rep. Ron Paul, wants to substitute a gold standard. Whatever its other characteristics, a gold standard would not be conducive to inflation.

Social Security and health reform—As noted above, spending in these two areas is the main reason that our budget is out of control. I noted that it is extremely difficult to reform these programs, but could we do it if forced by a crisis? Under such conditions, reform is possible, but it is difficult to reduce spending growth quickly. Most of the benefits go to retired people and very abrupt changes in the programs would wreak havoc with retirement planning. Therefore, most reform proposals phase in changes slowly. For example, the Social Security reforms recommended by the president's fiscal commission will be phased in over the next 50 years. Health spending growth is not significantly slowed until 2020, and no definite plan is put forth to achieve the slowing—only a number of options.

In a crisis, potential buyers of our debt are likely to demand that we save more money in the short run than is possible with entitlement reform. They may not be confident that we have the discipline to go through with benefit reductions and tax increases scheduled for the long run. Shorter-run deficit reductions will be necessary. Nevertheless, Social Security and health reform has to be part of any fiscal consolidation. Politicians can use a crisis as an excuse for doing things that would be too painful otherwise. Canada and Sweden enacted far reaching Social Security reforms that did little to reduce deficits in the short run, but that greatly improved their long-run fiscal health.

Discretionary spending—Because it is so difficult to reduce the growth of Social Security and health spending quickly, cuts in discretionary spending will have to be part of any fiscal reform, especially one that occurs in response to a crisis. That way, the deficit can be lowered quickly without large tax increases. Cuts in discretionary spending for defense will be necessary to persuade liberals to go along with cuts in nondefense spending.

While cuts in discretionary spending would be essential if the country faces a crisis, they are likely to occur even without a crisis. President Obama will propose a five-year freeze on nonsecurity spending in his 2012 budget. He has already suggested a two-year freeze in civil service pay. The newly elected Republican majority in the House vows to return discretionary spending to 2008 levels. New members affiliated with the Tea Party would like to cut even more.

Although the long-run budget problem cannot be solved solely with cuts in discretionary spending, every little bit helps. Such cuts can delay the time at which we pass through certain thresholds, such as exceeding a debt-to-GDP ratio of 100 percent.

Revenue increases—Whether fiscal consolidation comes as a result of a crisis or a more deliberative process, it is hard to imagine a resolution of our budget problems without some increase in revenues, especially if the goal is to balance the budget so that the debt-to-GDP ratio declines in the long run. The cuts in spending necessary to avoid any revenue increase are too draconian to be politically plausible.[6] A few conservatives may accept such cuts, but there is little chance that they would be approved by a majority of Congress.

However, Republicans have been adamantly opposed to any increase in the tax burden, and that is a major reason for being pessimistic about solving our budget problems without a crisis. Recently, there have been a few cracks in the Republican wall of opposition, but the cracks are still pretty thin. It was earlier noted that three Republican Senators—Coburn, Crapo, and Gregg—who served on the president's commission backed the commission recommendations, which included a revenue-raising tax reform and a 15 cent per gallon increase in the gas

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[6] For an example of a policy package that solves the budget problem while avoiding any tax increase, see National Research Council and National Academy of Public Administration (2010), Chapter 4. I have testified (Penner 2009, 2010, see below) that the spending path specified in this package is implausible politically. The spending path is particularly harsh, because the committee set a goal of stabilizing the debt at 60 percent of GDP by 2022. That required large spending cuts quickly. The president's commission was not that ambitious and still has a debt-to-GDP ratio higher than 60 percent well into the 2020s.

tax. It is significant that Gregg has retired and Coburn will not be running for re-election.

More generally, many conservatives are recognizing that many of the deductions, tax credits, and exclusions in our tax code are simply expenditure programs in disguise. They do not like spending programs and may be willing to contemplate revenue-raising eliminations of tax expenditures. But the base broadening would have to be sufficient to allow more revenues to be raised with lower marginal tax rates. That is likely to involve attacking and limiting some sacred cows, such as the mortgage interest deduction, and many political moderates may not be too thrilled about that.

Radical tax reform is a complex and contentious endeavor, especially if it involves raising more revenue than the current system provides. It is hard to imagine getting a radical reform done fast enough to quell a budget crisis. It is also hard to imagine raising significant revenues by simply raising tax rates in the current system. It is too inequitable and inefficient. That leaves the possibility of a new tax, such as a carbon tax or a value added tax (VAT). It could be argued that a new tax would also be hard to design in a timely fashion, but that may not be true of a VAT. There is plenty of European experience and there are groups in Washington working on the technical details involved in creating a VAT for the United States.[7]

Conclusions

It is difficult to be optimistic that our budget problems can be fixed without a crisis. The policy changes necessary to avoid a debt explosion are large and painful. They are, in fact, more painful than they would have been earlier because Social Security and health costs have become overwhelmingly important on the spending side of the budget, and they are growing rapidly. Moreover, Social Security and Medicare, the dominant program in health care, may be the two most politically popular programs provided by the U.S. government.

[7] See "Symposium on Designing a Federal VAT," Parts I and II, *Tax Law Review* 63, no. 2 and no. 3 (Spring 2010 and Winter 2010): 285–516 and 517–770.

Solving the problem will take strong leadership and bipartisan cooperation. The two parties will have to join hands and jump off the cliff together. At this moment, it does not look like they will join hands until the nation is already over the edge.

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