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TESTIMONY

FUNDAMENTAL SPENDING REFORM: THE SOLUTION TO THE DEBT CEILING DEBATE

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Chairman Duffy, Ranking Member Green, and members of the subcommittee: Thank you for the opportunity to testify today.

After offering a brief look at how we arrived at our current state, I would like to make the following points:

1. High and increasing debt has adverse consequences for our economy.
2. There are a number of institutional reforms that can be implemented to check the spending that drives this growth in debt.
3. Entitlement reform is essential, as rapidly burgeoning growth in entitlements is driving the growth in spending.
4. The latest increase in the debt ceiling gives us some time to reach an agreement that reflects real reform, and there are sufficient assets available that default is not a concern.

1. THE INCREASING FEDERAL DEBT

The origins of the federal government's statutory debt limit can be traced back to 1917, when the country borrowed money to finance World War I.[1] Limitations on federal borrowing were intended to control congressional spending by limiting the amount of debt that the federal government could accumulate. Policymakers have routinely

1. Congressional Research Service, "The Debt Limit: History and Recent Increases," October 1, 2015, 5.

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pushed the debt limit ever higher ever since. Indeed, the limit has been increased almost 20 times since 1993,[2] and the federal debt has ballooned from less than $5 trillion to $19 trillion. That figure continues to rise, thanks to the Bipartisan Budget Act of 2015, which passed in October and suspended the debt limit until March 16, 2017.[3]

It is ironic that the suspension of the debt limit was part of a deal to increase spending above the Budget Control Act of 2011's intended spending caps (for the second time). Despite the popular perception of Republicans and Democrats caught in gridlock, the truth is that after the political dust settles, the end result is always the same: a bipartisan agreement on more spending and more debt.

This needs to change. According to the most recent 10-year fiscal forecast from the Congressional Budget Office (CBO), "federal outlays remain near 21 percent of GDP for the next few years—higher than their average of 20.2 percent over the past 50 years . . . [and] if current laws generally remained the same, growth in outlays would outstrip growth in the economy, and outlays would rise to 23 percent of GDP by 2026."[4]

CBO projections also show that federal debt held by the public will reach 76 percent of GDP by the end of 2016—a full two percentage points higher than 2014. It is also expected to grow from $14 trillion this year to $24 trillion by 2026.

That's probably an underestimate since it is a projection based on the assumption that policymakers will keep their promises to cut spending and raise taxes. Based on Congress's termination of the sequester years ahead of schedule and its historical propensity to spend more and more each year, such an assumption is unlikely to come true. The projections also assume that the economy will grow at current projected rates and without any recessions. This, too, is unlikely, since the country tends to go into recession every five to six years.

Deficits are also going to go up to $544 billion from last year's $439 billion. Over the coming decade, the size of the federal deficit will double to reach an annual gap of almost 5 percent of GDP. CBO predicts that deficits will total $9.4 trillion. That's up $1.5 trillion from its August report. It also notes that under the alternative scenario budget projection, spending will increase to 21.9 percent of GDP in 2020, to 25.8 percent in 2030, and to 30.4 percent in 2040.

The expansion of mandatory programs—such as Medicare, Medicaid, Affordable Care Act subsidies, and Social Security—is the driving force behind this spending growth and our exploding debt. These entitlements will trigger even higher levels of debt in the years outside the 10-year budget window.

Unfortunately, as the debt grows, the interest payments on that debt will grow as well. If the United States does not change course, interest on the debt will end up as one of its biggest budget items. Our unfunded liabilities keep going up, too. The net present value of the promises made to the American people for which the United States does not have the money to pay is roughly $75.5 trillion, according to the Treasury Department.

High debt levels are problematic. As CBO explained a few years ago,

> Such high and rising debt later in the coming decade would have serious negative consequences: When interest rates return to higher (more typical) levels, federal spending on interest payments would increase substantially. Moreover, because federal borrowing reduces national saving, over time the capital stock would be smaller and total wages would be lower than they would be if the debt was reduced. In addition, lawmakers would have less flexibility than they would have if debt levels were lower to use tax and spending policy to respond to unexpected challenges. Finally, a large debt increases the risk of a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates.[5]

2. Ibid, 11.
3. Veronique de Rugy, "Budget Deal Is Business-as-Usual in Washington," Mercatus Center at George Mason University, November 18, 2015.
4. Congressional Budget Office, "The Budget and Economic Outlook: 2016 to 2026," January 2016, 4.
5. Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 2013.

These numbers are important to keep in mind when discussing the next debt ceiling deadline. Indeed, when March 2017 comes around we can expect that Washington will once again have the same debate it has had for the last few years about whether or not to raise the debt ceiling and under what circumstances. On one side you will find those who want to raise the limit without questions asked. On the other side, you will find those who will demand reforms in exchange for yet another increase in the debt ceiling.

Continuing to pass debt ceiling increases without proper spending reforms would be irresponsible. It is also irresponsible to signal to the international community that the US government could possibly default on its debt obligations while Washington works through whether it will raise the debt limit before or after it formulates a plan to reduce government spending.

WHAT'S AT STAKE

To be sure, default should not be an option on the table. However, raising the debt ceiling without a commitment to improve our long-term debt problem has adverse consequences. In 2011, the rating agency Fitch warned the US government that while it supported raising the debt ceiling, it also wanted the government to come up with a credible medium-term deficit-reduction plan.[6] Other rating agencies at the time also warned the United States of the negative consequences of not dealing with the country's long-term debt.

If Congress does not address our debt problem before March 2017, the optimal outcome would then be to raise the debt limit while Congress and the president pass a credible plan to reduce near- and long-term spending at the same time.

Fortunately, if an agreement to control spending and raise the debt limit is not reached, the United States need not risk defaulting on its debt. The Treasury Department has the legal authority to prioritize interest payments on the debt above all other obligations, whether that means delaying payments to contractors or managing other obligations. But Congress should not be forced to raise the debt ceiling under false pretenses.

As was the case in 2011, the United States will have enough expected cash flow (tax revenue) and assets on hand to avoid either of these unattractive options. Managing payments in this manner is by no means optimal, and Treasury officials have indicated that this will be difficult owing to payment automation. That said, it is important to recognize the options that are available to prevent a default. While Washington has difficult choices to make, defaulting on its debt obligations should not be part of the discussion about how to handle the debt limit or reduce long-term government spending.

2. REAL INSTITUTIONAL REFORM

The heated rhetoric coming in March 2017 about whether Congress should raise the debt ceiling will obscure the federal government's real problem: an unprecedented increase in government spending and the future explosion of entitlement spending has created a fiscal imbalance today and for the years to come. No matter what Congress decides to do about the debt ceiling, the United States must implement institutional reforms that constrain government spending and return the country to a sustainable fiscal position.

Real institutional reforms, as opposed to onetime cuts, would change the trajectory of fiscal policy and put the United States on a more sustainable path. Such reforms could include:

1. *A constitutional amendment to limit spending*. The inability of lawmakers to constrain their own spending makes spending limits enforced through the US Constitution preferable.[7]

6. Veronique de Rugy, "Policy Implications of the S&P Warnings," *The Corner*, *National Review*, July 22, 2011. Also see Jeannette Neumann, "Fitch Unveils Two Possible Routes to Downgrading US Debt Rating," *Wall Street Journal*, January 15, 2013.
7. David M. Primo, "Constitution Is Only Way to Cut US Deficit," *Bloomberg Business*, February 24, 2011.

2. *Meaningful budget reforms that limit lawmakers' tendency to spend*. In the absence of constitutional rules, budget rules should have broad scope, few and high-hurdle escape clauses, and minimal accounting discretion.[8]

3. *The end of budget gimmicks*. Creative bookkeeping is at the center of many countries' financial troubles. Congress should institute a transparent budget process and end abuse of the emergency spending rule, reliance on overly rosy scenarios, and all other gimmicks.[9]

4. *A strict cut-as-you-go system*. This system should apply to the entire federal budget, not just to a small portion of it. There should be no new spending without offsetting cuts.[10]

5. *A BRAC-like commission for discretionary spending*. Commissions composed of independent experts often tackle intractable political problems successfully.[11]

3. REAL ENTITLEMENT REFORMS

As mentioned earlier, the drivers of our future debt are spending on Medicare, Medicaid, Affordable Care Act subsidies, and Social Security. Without reforms today, vast tax increases will be needed to pay for the unfunded promises made to a steadily growing cohort of seniors.

While economists disagree when it comes to fiscal policy, a consensus has emerged that spending-based fiscal adjustments are not only more likely to reduce the debt-to-GDP ratio than tax-based ones but are also less likely to trigger a recession.[12] In fact, if accompanied by the right type of policies (especially changes to public employees' pay and public pension reforms), spending-based adjustments can actually be associated with economic growth.

Fortunately, numerous workable solutions are available to lawmakers, including adding a system of personal savings accounts to Social Security, liberalizing medical savings accounts, and making the latter permanent to reduce healthcare costs by increasing competition between providers and making consumers more responsive to tradeoffs.[13]

These options are supposed to encourage families to save more and also to use their money more responsibly and in a manner more consistent with their long-term needs. And since taxpayers remain in control of their cash, they can also pass it along if they don't use it all before they die—giving the next generation a head start when it comes to building assets.

Better yet, we should free the healthcare supply from the many constraints imposed by federal and state governments and the special interests they serve.[14] The stakes are high: Bringing revolutionary innovation to this industry could mean not just bending the healthcare cost curve but breaking it to bits—making the need for health insurance much less important, if not moot, in many cases.

8. David M. Primo, "Making Budget Rules Bite" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, March 2010).
9. Veronique de Rugy, "Budget Gimmicks or the Destructive Art of Creative Accounting" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, June 2010).
10. Veronique de Rugy and David Bieler, "Is PAYGO a No-Go?" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, April 2010).
11. Jerry Brito, "The BRAC Model for Spending Reform" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, February 2010).
12. Veronique de Rugy, "The Effect of Tax Increases and Spending Cuts on Economic Growth" (Testimony before the Senate Committee on the Budget, Mercatus Center at George Mason University, Arlington, VA, May 22, 2013).
13. Chris Edwards and Tad DeHaven, "War Between Generations: Federal Spending on the Elderly Set to Explode" (Policy Analysis No. 488, Cato Institute, Washington, DC, September 16, 2003).
14. Robert Graboyes, "Fortress and Frontier in American Health Care" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2014).

4. REVENUE AND ASSETS AVAILABLE TO FUND OUR COMMITMENT UNTIL AN AGREEMENT IS REACHED

With that in mind, let's think about what happens in March 2017. At that time, the government will reach the debt ceiling, and the Treasury will no longer be able to issue federal debt. The federal government could reduce spending, increase federal revenues by a corresponding amount to cover the gap, or find other funding mechanisms. This would allow time for Congress and the president to reach an agreement to change the country's financial path before raising the debt ceiling.

At that time, the Treasury Department will have several financial management options to continue paying the government's obligations. These include (1) prioritizing payments;[15] (2) taking financial steps, including permitting the suspension of investments in, and the redemption of securities held by, certain government trust funds or postponing the sale of nonmarketable debt;[16] (3) liquidating some assets to pay government bills;[17] and (4) using the Social Security Trust Fund to continue paying Social Security benefits.[18]

PRIORITIZING PAYMENTS

The Secretary of the Treasury has long-standing authority to prioritize payments and does not have to pay bills in the order in which they are received. The US Government Accountability Office found that

> the Secretary of the Treasury has the authority to determine the order in which obligations are to be paid should the Congress fail to raise the statutory debt ceiling and revenues are inadequate to cover all required payments. There is no statute or other basis for concluding that the Treasury must pay outstanding obligations in the order they are presented for payment. Treasury is free to liquidate obligations in any order it determines will best serve the interests of the United States.[19]

According to a report by the Treasury Department's Inspector General (IG), during the 2011 debt ceiling crisis the Treasury "considered a range of options with respect to how Treasury would operate if the debt ceiling was not raised." Further, the report notes that Treasury officials told the IG that "organizationally they viewed the option of delaying payments as the least harmful among the options under review" and that "the decision of how Treasury would have operated if the U.S. had exhausted its borrowing authority would have been made by the President in consultation with the Secretary of the Treasury."[20]

TEMPORARY MEASURES

During the last debt ceiling debate in 2011, my colleague Jason Fichtner and I listed all the assets that Treasury could tap into to avoid a default until an agreement between the president and Congress be reached.[21] We updated this report in 2013.[22] At the time we explained that Treasury was expected to collect $2.6 trillion in revenue. We wrote:

> That alone would be enough to cover interest on the debt ($218 billion), thereby avoiding any technical default of the US government on its debt obligations to Social Security ($809 billion), Medicare

15. Jason J. Fichtner and Veronique de Rugy, "The Debt Ceiling: What Is at Stake?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, April 2011).
16. Veronique de Rugy and Jason J. Fichtner, "The Debt Limit Debate" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, May 2011).
17. Fichtner and de Rugy, "The Debt Ceiling: What Is at Stake?"
18. The Social Security Trust Funds can only be used to pay Social Security benefits. See Glenn Kessler, "Can President Obama Keep Paying Social Security Benefits Even If the Debt Ceiling Is Reached?," *Washington Post*, July 13, 2011; Contract with America Advancement Act of 1996, Pub. L. No. 104-121 (1996).
19. US Government Accountability Office, Letter to Senator Bob Packwood, October 9, 1985.
20. Department of the Treasury, Office of Inspector General, Letter to Senator Orrin G. Hatch, OIG-CA-12-006, August 24, 2012.
21. Fichtner and de Rugy, "The Debt Ceiling: What Is at Stake?"
22. Jason J. Fichtner and Veronique de Rugy, "The Debt Ceiling: Assets Available to Prevent Default" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, January 2013).

($581 billion), and Medicaid ($267 billion), and it would leave approximately $725 billion for other priorities.

In addition, we noted that the Treasury Department had financial measures at its disposal to fund government operations temporarily without having to issue new debt. To be clear, our list was only meant to present the range of possible options available to Congress. But, as we noted then, those may not be good or desirable options.

These assets totaled $1.9 trillion and included $50.2 billion in nonrestricted cash on hand,[23] $121.1 billion in restricted cash and other monetary assets (gold, international monetary assets, foreign currency),[24] and the redemption of existing investments in other trust funds.[25]

We also noted that the government could rely on the determination of a "debt issuance suspension period." This determination would permit the redemption of existing, and the suspension of new, investments of the Civil Service Retirement and Disability Fund (CSRDF).[26] Right now there is $858.7 billion intergovernmental holdings in the CSRDF.

In March 2017, the numbers will be different, but the same assets may be used to avoid a default. Relying on any of these sources of funds or increasing the debt ceiling without reducing existing budget commitments illustrates the irresponsible path the country is on and the urgent need for institutional spending reform. Nonetheless, these assets could be used as a temporary measure to allow Congress and the administration to negotiate spending reductions and institutional reforms to the budget process to ensure the nation is put back on a sound fiscal path.

Thank you. I am happy to take your questions.

23. Department of the Treasury, "Daily Treasury Statement," January 14, 2013.
24. Department of the Treasury, *2012 Financial Report of the US Government*, 65. At the time, the Treasury owned approximately 261.4 million ounces of gold and marked the value of its gold holdings at $42 per ounce, giving a reported value of $11.1 billion. At a spot market price of $1,500 per ounce, Treasury's gold holdings could be valued near $400 billion.
25. Department of the Treasury, "Monthly Statement of the Public Debt of the United States," December 31, 2015.
26. In September 1985, the Treasury took the step of disinvesting the Civil Service Retirement and Disability Trust Fund, the Social Security Trust Funds, and several smaller trust funds.