



DEBT AND DEFICITS: THE SYMPTOMS, NOT THE DISEASE

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Good Morning Chairman Camp, Ranking Member Levin, and distinguished members of the committee. It is a pleasure to be here this morning to discuss the most important topic of debt and deficits and how they relate to economic growth and job creation.

Deficits and debt matter. First, they matter politically. Polls show that debt and deficits are defining issues of American politics.¹ Washington should indeed be focusing on these important issues. Unfortunately, this focus is often misplaced as debt and deficit are the symptoms of government spending, not the disease. The disease is government spending. As a result, the only way to cure debt and deficits is to cut government spending.

Debt and deficits are the symptoms, not the disease, but the persistent failures of lawmakers to cut spending have resulted in a situation where these symptoms have started provoking other symptoms. Think of them like tumors. Tumors are a symptom of cancer. But independently tumors wreak all sorts of havoc on the body. They not only fuel their growth by stealing nutrients from other bodily purposes, but they also impinge on the function of vital organs like the brain, the lungs, and the liver.

So it is with debt and deficits. They hinder economic growth and destroy jobs. Besides being expensive and self-perpetuating, they increase the probability of a severe fiscal crisis and can signal to investors that the United States may be getting closer to the time when it won't be able to pay those investors back.

While economists understand the negative consequences of the failure to cut spending and the persistence of deficit and debt, they can't pinpoint at what point these debt levels become unacceptable to global credit markets. Economists can't reliably predict what the form the fiscal crisis will take. For instance, the fiscal crisis could be a slow, yet rampant destruction of our economy. It could also be more abrupt with creditors losing faith and pulling their money from

¹ Tony Blankley, "Debt Doom Refocuses Politics," *Washington Times*, February 21, 2011.

the United States overnight, throwing the country into a vicious debt spiral, another deep recession, and ultimately a lower standard of living here and presumably around the world.

But the main reason why deficit and debt matter is that American families will be the ones on the receiving end of economic uncertainty, higher interest rates, lower growth, higher unemployment rates, and lower standards of living. Maybe even more importantly, future generations will have to pay today's deficits. We are about to embark on the most massive transfer of wealth from younger taxpayers to older ones in American history. It will be not just unprecedented but also unfair: Our children will pay for the decisions we make today.

The solution is for Congress to act now and cut spending. In particular, Congress should reform Social Security, Medicare, and Medicaid, which are the main drivers of the spending explosion. The solution is also for Congress to resist the temptation to address these deficits by raising taxes. First, no amount of taxes could address the phenomenal fiscal imbalance that our country will face in the future. But, raising taxes would also add to our problems by hindering economic growth,² thereby reducing tax revenue and adding to the deficit.

SECTION 1: BUDGET PROSPECTS

America's financial situation is unsustainable. According to the Congressional Budget Office's analysis of the President's Budget, in 2011 the federal government will spend \$3.7 trillion but will collect only \$2.2 trillion in revenue.³ The result is a \$1.4 trillion deficit, or 9.5% of gross domestic product (GDP), up from \$1.29 trillion in 2010. Worse, Congressional Budget Office projections show that we'll be drowning in red ink for the foreseeable future, with deficits averaging nearly \$1 trillion during each of the next 10 years.⁴

While these numbers are dramatic, they pale in comparison to what the federal government owes to foreign and domestic investors. According to the CBO, in 2011 America's public debt, which historically has averaged less than 40% of GDP, will reach \$10.4 trillion, or 69.1 percent of GDP, the highest it has been in 50 years.⁵ Based on these same estimates, the debt will cross the 90 percent threshold, a level at which many economists believe a country is putting itself in financial peril, by 2021.⁶

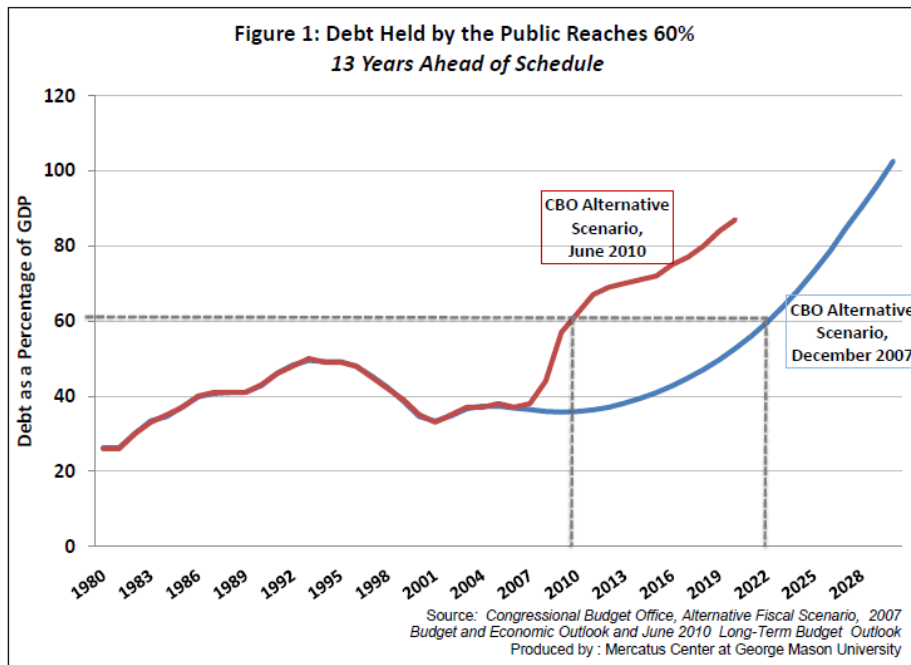
² Christina D. Romer & David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, American Economic Association, 100 (2010):763–801.

³ Congressional Budget Office, *Preliminary Analysis of the President's Budget for 2012* (Washington, DC: CBO, 2011): 16 <http://cbo.gov/ftpdocs/121xx/doc12103/2011-03-18-APB-PreliminaryReport.pdf>.

⁴ *Ibid.*

⁵ *Ibid.*, 6.

⁶ Congressional Budget Office, *Long-Term Budget Outlook, Supplemental Data* (Washington, DC: CBO, June 2010, <http://cbo.gov/doc.cfm?index=11579>); Carmen M. Reinhart & Kenneth S. Rogoff. "Growth in a Time of Debt," *American Economic Review*, 100 (May 2010): 573-78.



However, things are deteriorating quickly so these estimates should be taken with a grain of salt. This chart compares the CBO's long-term public debt projections from 2010⁷ with long-term projections calculated in 2007.⁸ Three years ago, the CBO projected that the debt held by the public would not surpass 60 percent until 2023.⁹

What's more, with the impending entitlement crisis requiring more future borrowing, by 2020 interest on our debt and autopilot programs like Social Security, Medicare, and Medicaid will consume 92 cents of every dollar of revenue raised by the federal government. These costs will also account for 65 cents of every dollar spent by the federal government in 2020, up from 45 cents today. In other words, starting now non-interest and non-autopilot programs will gradually be squeezed out. In 2020, if current trends continue, the country will owe more than \$17 trillion, or 87 percent of GDP.¹⁰ We would reach 100 percent by 2023 and 200 percent by 2037.¹¹

If we add to the debt held by the public the debt that the federal government owes to other accounts like Social Security, gross federal debt was \$13.6 trillion in fiscal year 2010, or roughly 90 percent of the United States' GDP.¹²

As large as they are though, these debt numbers pale in comparison to the current unfunded liabilities. According the Financial Statement of the United States, in 2010 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 trillion.¹³

⁷ *Long-Term Budget Outlook 2010, Supplemental Data*

⁸ Congressional Budget Office, *Long-Term Budget Outlook, Supplemental Data* (Washington, DC: CBO, December 2007), <http://cbo.gov/doc.cfm?index=8877>

⁹ *Ibid.*

¹⁰ Congressional Budget Office, *Long-Term Budget Outlook 2010, Supplemental Data*.

¹¹ Congressional Budget Office, *Long-Term Budget Outlook 2010, Supplemental Data*.

¹² U.S. Department of Treasury, *Monthly Statement of the Public Debt of the United States*, September 30, 2010, <http://www.treasurydirect.gov/govt/reports/pd/mspd/2010/opds092010.pdf>.

¹³ U.S. Department of Treasury, *Financial Statement of the United States FY2010*, <http://www.gao.gov/financial/fy2010/10frusg.pdf>.

Needless to say, even ignoring the distortions and anti-growth effect of tax increases, no level of taxes could address today and tomorrow's fiscal imbalance.

SECTION 2: DEFICITS AND DEBT MATTER

There are several reasons why these deficits and debts matter.

1. Deficit and Debt are the Symptoms of Overspending

Deficits and debt are the symptoms of our overspending problem. Excessive government spending cripples economic growth.

Government spending can be paid with three sources: debt, new money, or taxes (or a combination of these). All three of these methods of payment remove real resources from the private economy. In other words, the government can't inject money *into* the economy without first taking money *out* of the economy.

For instance, if the government borrows money, there will likely be less capital available for the private sector to borrow for its own consumption or investment. If the government prints money, it will create inflation that reduces the value of the money and decreases purchasing power of those whose salaries and wages aren't indexed to inflation.

Finally, the government can collect money from present or future taxes. But taxes simply transfer resources from consumers to government, displacing private spending and investment. Families whose taxes have increased will have less money to spend on items for themselves and their children. They are poorer and will consume less. Also, it means they save less money, which in turn, reduces the amount of resources available for lending. In short, taxation reduces taxpayers' income.

In addition, taxation (like every other source of revenue) comes with costs. First, higher taxation encourages people to change their behaviors to avoid taxes. They might switch their efforts to non-taxed activities, such as household production, or underground activities. Economists call this a deadweight loss. Because people give up the taxed activity or good they prefer, this loss is like deadweight on the economy.

In addition, government injections of money into the economy have a direct impact on the economy. While often people who receive government money feel its positive impact on their lives (receiving an unemployment check or a government contract to build a road), it often has longer term negative consequences that overwhelms the initial benefits. It is difficult to get solid evidence on the economy's response to changes in government spending. Direct reporting measures—such as those employed by the Administration to measure the impact of the American Recovery and Reinvestment Act of 2009 through Recovery.gov, the U.S. government's website for tracking stimulus spending—capture the direct and observable effects of government spending on economic activity. These measures can be helpful, but they fail to account for the indirect, less-easily observable effects of government spending. To capture the big-picture effect of government spending, economists turn to the *spending multiplier*.

The *multiplier effect* or *spending multiplier* refers to the idea that an initial amount of government spending leads to a change in the activity of the larger economy. In other words, an initial change in the total demand for goods and services (what economists term aggregate demand) causes a

change in total output for the economy that is a multiple of the initial change. For example, if the government spends one dollar, and as a result of this spending, the economy (as expressed by the Gross Domestic Product, or GDP) grows by two dollars, the spending multiplier is 2. If the economy grows by \$1.50, the spending multiplier is 1.5. However, if the economy only grows by 50 cents (which, in the case of government purchases, means that the government spending actually shrank the private economy), the spending multiplier is 0.5.

A recent review of the empirical literature reveals a lack of consensus among economists about the actual value of the multiplier.¹⁴ Some find large multipliers; some find small ones. Clearly, the size of the multiplier depends on the type of estimation techniques and assumptions built in the models. However, when we look at the multipliers found by leading figures in the profession, we find that in most cases a dollar in government spending produces *less* than a dollar in economic growth—and these findings often don't even take into account the impact of paying for that government dollar via increased taxes.

For instance, Harvard economists Robert Barro and Charles Redlick estimate that the multiplier for stimulus spending is between 0.4 and 0.7.¹⁵ In addition, they calculate the impact on the economy if the government funds the spending with taxes. They find that the tax multiplier—the effect on GDP of an increase in taxes—is -1.1 . This means that if the government raises taxes by \$1, the economy will shrink by \$1.1. When this tax multiplier is combined with the effects of the spending multiplier, the overall effect is negative.

Economist Valerie Ramey's work on how U.S. military spending influences GDP gives a preferred estimate of 1.2, but she also finds evidence that consumer and business spending fall after a rise in government purchases.¹⁶ Thus, the paper suggests an overall negative impact on the economy. Clinton Administration economist Brad DeLong reports a short-run multiplier of only 0.5: a dollar of government spending shrinks the private sector by 50 cents.¹⁷

Another recent study by John Cogan, Tobias Cwik, John Taylor, and Volker Wieland concluded that the stimulus package couldn't have had a multiplier much greater than zero.¹⁸ More recently, the Dartmouth economists James Feyrer and Bruce Sacerdote, who supported the stimulus, acknowledged that it didn't boost the economy nearly as much as the administration models claimed it would because most of the spending had a multiplier smaller than 1.¹⁹

This conclusion was also reached by the International Monetary Fund.²⁰ The paper concluded that a one percent increase in government purchases (as a share of GDP) increases GDP by a

¹⁴ Patrick van Brusselen, "Fiscal Stabilisation Plans and the Outlook for the World Economy" (working paper, European Network of Economic Policy Research Institutes, Brussels, 2009), http://www.plan.be/admin/uploaded/200906111040040.nime_01_09.pdf.

¹⁵ Robert Barro and Charles Redlick, "Macroeconomic Effects from Government Purchases and Taxes," (working paper, Mercatus Center at George Mason University, 2010), <http://mercatus.org/publication/macroeconomic-effects-government-purchases-and-taxes>.

¹⁶ Valerie Ramey, "Identifying Government Spending Shocks: It's All in the Timing," (working paper, University of California, San Diego, 2008)

¹⁷ Brad DeLong sums up a number of multiplier estimates in "Deficit Spending and the Recovery" (lecture, KQED Forum, San Francisco, September 4, 2009), <http://delong.typepad.com/sdj/2009/09/deficit-spending-and-the-recovery-talking-points-for-kqed-forum-morning-appearance-september-5-2009-9-am-pdt.html>.

¹⁸ "New Keynesian Versus Old Keynesian Government Spending Multipliers" – John Cogan, Tobias Cwik, John Taylor and Volker Wieland – NBER Working Paper 14782

¹⁹ James Feyrer and Bruce Sacerdote, "Did the Stimulus Stimulate? Real Time Estimates of the Effects of the American Readjustment and Recovery Act," NBER Working Paper No. 16759 February 2011, <http://www.nasbo.org/LinkClick.aspx?fileticket=H6sHQ5MhK5o%3D&tabid=81>

²⁰ Charles Freedman, Michael Kumhof, Douglas Laxton, Dirk Muir, Susanna Mursula, "Global Effects of Fiscal Stimulus 1 During the Crisis," International Monetary Fund, February 25, 2010, <http://www.stanford.edu/~johntayl/carnegie1march.pdf>.

maximum of 0.7 percent and then fades out rapidly. This means that government spending crowds out other components of GDP (investment, consumption, net exports) immediately and by a large amount.

Finally, recent research from Lauren Cohen, Joshua Coval, and Christopher Malloy of Harvard Business School shows that federal spending in the states causes local businesses to cut back rather than grow.²¹ In other words, when government spending grows, the private sector shrinks. The study found:

1. The average state experiences a 40 to 50 percent increase in earmark spending if one of its senators becomes chair of one of the top-three congressional committees. In the House, the average is around 20 percent.
2. For broader measures of spending, such as discretionary state-level federal transfers, the increase from being represented by a powerful senator is around 10 percent.
3. In the year that follows a congressman's ascendancy, the average firm in his state cuts back capital expenditures by roughly 15 percent.
4. There is some evidence that firms scale back their employment and experience a decline in sales growth.

In other words, the evidence tends to suggest that in most cases government spending cripples economic growth.

2. Large and sustained deficits and debt inevitably cripple economic growth.

In a much cited empirical research study, economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard examine the consequences of public debt on economic growth.²² Using a historical data set spanning forty-four countries and two hundred years, their findings are startling. Across wealthy and poor countries, the median growth rates for countries with publicly held debt exceeding 90 percent of gross domestic product are roughly *one percent lower* than they would be otherwise. They find slightly different results for emerging markets.

The following table from their paper nicely illustrates their growth findings:

Table 1: Real GDP Growth as the Level of Debt Varies: Summary (annual percent change)

Measure	Period	Below 30 percent	30 to 60 percent	60 to 90 percent	90 percent and above
Central (Federal) government debt/ GDP-					
Advanced economies					
Average	1946-2009	4.1	2.8	2.8	-0.1
Median	1946-2009	4.2	3.0	2.9	1.6
Emerging Markets					
Average	1946-2009	4.3	4.8	4.1	1.3
Median	1946-2009	5.0	4.7	4.6	2.9
Total (public plus private) Gross External Debt/GDP					
Average	1970-2009	5.2	4.9	2.5	-0.2
Median	1970-2009	5.1	5.0	3.2	2.4

Source: Reinhart and Rogoff, "Growth in a Time of Debt."

²¹ Lauren Cohen, Joshua Coval, and Christopher Malloy "Do Powerful Politicians Cause Corporate Downsizing?" <http://www.people.hbs.edu/cmally/pdf/renvaloy.pdf>

²² Carmen M. Reinhart & Kenneth S. Rogoff. "Growth in a Time of Debt."

These results are particularly important today given the rapid growth in government debts around the world. In the United States, for example, debt will be at 69 percent this year. This is still relatively far from the 90% level that Reinhart and Rogoff identify as problematic. Unfortunately, according to CBO, current policies will get us to that level in 2021.²³

To put Reinhart and Rogoff's results in context, if the United States doesn't change course, in 2021 the United States economy could lose \$200 billion in economic growth simply from an irresponsible level of debt.

Reinhart and Rogoff are not the only scholars warning about the damaging impact of increasing debt ratios on economic growth. In their *Long Term Budget Outlook*, the CBO makes the same predictions.²⁴ It writes: "CBO's analysis suggests that delaying action for 10 years—and thus allowing the debt-to-GDP ratio to rise by an additional 30 percentage points under the assumptions of the analysis—would cause output to be about 2 percent to 4 percent lower in the long run than it would be if the ratio was stabilized earlier at lower levels, depending on the policy used to stabilize the debt."

Why does this contraction happen? Economists use the term "crowding out" to refer to the contraction in economic activity associated with deficit-financed spending. The Mercatus Center at George Mason University's Matt Mitchell and Jakina Debnam explain, "Though the costs of borrowing may be less-conspicuous than the costs of taxing, they are no less real."²⁵

How does the crowding out happen? Robert Barro explains that when members of the economy view increased spending financed by deficit, they assume that taxes will ultimately need to be raised.²⁶ As a result, they reduce their private consumption today and increase their savings to prepare for the increase in future taxes. But as the CBO explains, "the offsetting rise in private saving is generally smaller than the change in the deficit, so greater government borrowing leads to lower national saving."²⁷

It means that if economic actors were completely rational (as assumed in the Barro paper) then deficit-financed spending will have zero impact on the economy. But if, however, the offsetting rise in private savings is smaller than the change in the deficit—which is what most studies seem to show—then deficit-financed spending can have a short-term positive effect on growth, but it will come at a longer-term cost because it will shrink the capital stock. Over the longer run, it also means that capital stock will be smaller and so future economic growth will be harmed.

In layman's terms, that means that the money the federal government borrows comes from Americans' savings as does the money that Americans invest in the private sector's growth. There comes a point where there just aren't enough savings to satisfy both masters. So if the government borrows more money, domestic investment will go down. In addition, the competition between public and private borrowing raises interest rates for all borrowers, including the government, making it more expensive for domestic investors to start or complete projects.

²³ Congressional Budget Office, *Long-Term Budget Outlook*, June 2010, Supplemental Data <http://cbo.gov/doc.cfm?index=11579>

²⁴ Congressional Budget Office, *Long-Term Budget Outlook*.

²⁵ Matt Mitchell and Jakina Debnam, "In the End, We're all Crowded Out," (working paper, Mercatus Center at George Mason University, 2010), <http://mercatus.org/publication/long-run-we-re-all-crowded-out#cit7>.

²⁶ Robert Barro, *Macroeconomics* (New York: John Wiley & Sons, 1987), 403.

²⁷ Congressional Budget Office, the *Long-Term Budget Outlook*, June 2010, page 18-19; and 20.

Concretely, this means American companies will build fewer factories, cut back on research and development, and generate fewer innovations. As a result our nation's future earnings prospects will dim, and our future living standards will suffer.

Of course, the government can borrow more money from foreign lenders. In fact, the theory is that higher interest rates attract more foreign capital to the United States and induce U.S. savers to keep more of their money at home, enabling the United States to afford more domestic investment today.

However, the U.S. government will eventually have to repay that money (plus interest). As a result, more of our future income will have to be sent overseas—and again, our living standards will decline.

There is just no way around it: The more money we borrow now, either from investors, foreign or domestic, the less we will have in the future.

Does it mean that spending should be paid for by increasing taxes? No, it doesn't: tax-financed spending cripples the economy too. An important paper by former Chairman of the Council of Economic Advisors Christina Romer and her economist husband David Romer shows that when taxes are raised by 1 percent of GDP to reduce the deficit will shrink the economy by 3 percent.²⁸

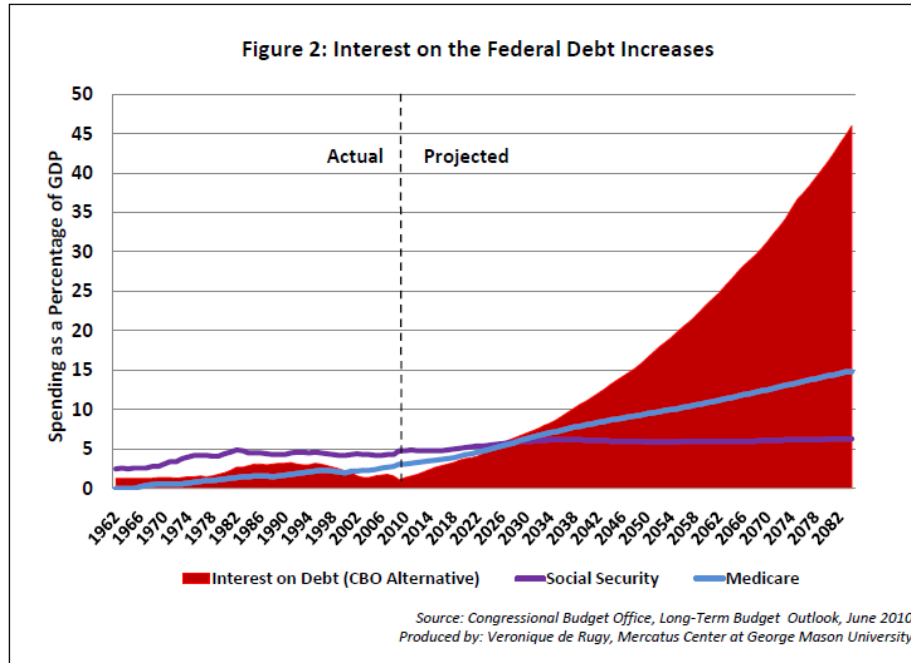
3. Debt is very expensive.

The more we borrow, the bigger our interest payments are. In spite of historically low interest rates, by 2020, the federal government will spend a projected \$866 billion each year just to pay interest on our debt.²⁹ That's more than what the U.S. spends right now on two wars, plus the Departments of Defense, Education, Energy, and Homeland Security combined.

The chart below shows the projected interest the government will pay on the federal debt as a percentage of GDP between 1962 and 2082. The projections follow what the CBO calls its "alternative" (and generally more realistic) scenario. It assumes, for instance, that George W. Bush's tax cuts will not expire. This chart also shows the CBO's projections for the cost of Medicare and Social Security as a percentage of GDP. As you can see, the cost of debt (net interest payments) rivals the cost of two of our nation's most expensive social programs.

²⁸ Romer & Romer, "The Macroeconomic Effects of Tax Changes."

²⁹ Congressional Budget Office, *Preliminary Analysis 2012*: 16, Table 2, <http://cbo.gov/doc.cfm?index=12103>.



Another way to put it is that deficit and debts have unfortunate tendencies to self-perpetuate. As our deficit grows, the interest on our debt grows too. Soon we end up in a situation where we have to borrow money to pay for the interest on our debt. That grows the deficit and the interest we owe thanks to compounding interest. If persistent deficits—through a combination of concerns about inflation and potential default and the potential of increasing government debt driving up market interest rates—lead to higher interest rates, those can magnify the power of compound interest. In other words, deficits financed at low rates today can lead to more deficits, financed at higher rates, in the future.

4. Things will get worse: A growing debt sends signals to investors that we are becoming riskier borrowers.

A growing debt exposes America to greater “rollover” risk. Much of U.S. debt is what we call short-term debt. The average maturity of the U.S. debt is 4.4 years, which is unlike most other countries’. For instance, according to the International Monetary Fund’s latest *Fiscal Monitor* study, Portugal, Italy, Ireland, and Spain have maturities that range from 6.2 to 7.4 years; the U.K.’s average debt maturity is 12.8 years.³⁰

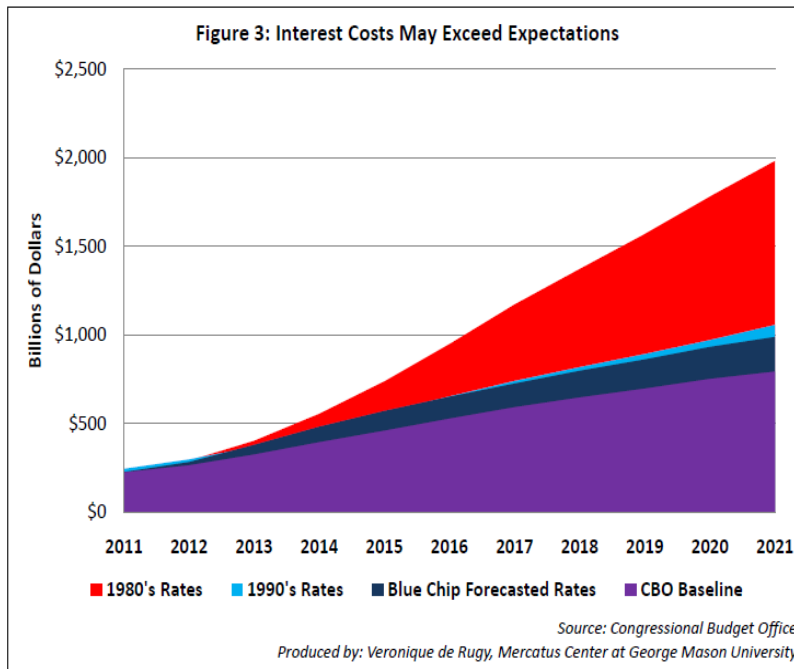
What’s good about having short-term debt is that, in good times, the United States has been able to roll over the debt and benefit from very low interest rates. That’s the benefit of refinancing. The problem with short-term debt is that it must be refinanced regularly. Basically, the United States is constantly asking the financial markets to roll over its debt.

Over the long run, the real risk comes from a large exposure to sudden increase in interest rates. For instance, at some point U.S. lenders might wise up and increase the interest rates—which, on such a large amount of money, would be painful.³¹

³⁰ International Monetary Fund, *Fiscal Monitor*, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>.

³¹ Thomas Stratmann and Gabriel Okolski, “Interest Payments of the Federal Debt” (working paper, Mercatus Center at George Mason University, 2010), http://mercatus.org/sites/default/files/publication/Stratmann_Int.%20Payments.pdf.

Using data from the CBO’s “January 2011 Budget and Economic Outlook” and “Analysis of the Effects of Three Interest Rate Scenarios on the Federal Budget Deficit,”³² the chart below shows the changes that will occur when the CBO’s interest-rate assumptions are modified three interest-rate scenarios: 1) a scenario similar to that experienced in the 1980s; 2) a scenario similar to that experienced in the 1990s; and 3) a scenario consistent with the ten highest projections found in *Blue Chip Economic Indicators*. Under each of these scenarios, the cost of servicing our debt exceeds the costs projected in the CBO baseline.



This suggests that CBO baseline projections, which already show an explosion in the cost of servicing our debt, may in fact be an *underestimate*.

For instance, if interest rates were modified to reflect the average rates in the 1980s — a time in U.S. history when interest rates were driven up by inflation and economic uncertainty — in 2021 our interest payments would nearly triple from CBO’s projection of \$749 billion to \$2.0 trillion. Accumulated interest payments over this period would double from their current projected level of \$5.7 trillion to \$11.0 trillion.

In addition to the impact of higher deficit and debt listed above, higher interest rates would have a real impact on American families, and it would make it harder and more expensive for them to borrow money and invest. The economy would slow down further, and standards of living would be lower.

5. Inflation

To get deficits under control the federal government could cut spending, increase taxes, or do some of both. Neither of these policies is popular; hence the temptation to print money (or “monetize the debt”) to pay the bills. The resulting inflation would reduce the value of each

³² Congressional Budget Office, “Analysis of the Effects of Three Interest Rate Scenarios on the Federal Budget Deficit,” February 24, 2011, http://www.cbo.gov/ftpdocs/120xx/doc12081/Ryan_Letter_Interest_Rates_2-24-2011.pdf.

dollar, and it would introduce high levels of uncertainty into the economy. Imagine what it would be like to try to calculate the net present value of your investment in an environment where you can't predict what your dollars will be worth tomorrow. Such circumstances mean less innovation and less entrepreneurship, and therefore less economic growth and more hardship.

The Federal Reserve is unwilling to take the inflationary route today. But investors know that other central banks have done so in the past and that such a scenario could happen again. In exchange for extending more loans to a federal government that has become a riskier borrower, lenders will ask for an inflation premium. American families and businesses will pay those prices, further hindering economic growth.

6. Deficit and debt make it harder to address emergencies and increase the likelihood of a fiscal crisis.

In December, the Congressional Budget Office released a study on “Economic Impacts of the Long-Term Budget Imbalance.”³³ The CBO noted that, in addition to reducing the amount of saving devoted to productive capital and to increasing interest payments, higher debt would make it harder for policy makers to respond to unexpected problems—such as financial crises, recessions, and wars—and it would increase the likelihood of a fiscal crisis.

7. Deficits and debt will hinder economic growth, destroy jobs, and hurt American families

Deficits and debt matter for budgetary and economic reasons. However, they really matter because the real consequences will affect American families.

First, spending and its symptoms (debt and deficit) often signal to consumers, businesses, and investors that taxes are likely to go up in the future. This prospect tends to inject a significant amount of uncertainty into the economy and weakens confidence. That uncertainty means that investors don't invest; employers don't hire; and consumers save, rather than spend, money. People can't find jobs; unemployment grows. This, in turn, hurts an already sluggish economy and has a negative impact on job creation.

If and when interest rates go up—caused by a lack of investments, crowding out, and/or the lenders asking for a debt premium—they will also stunt growth. Increased interest rates mean that it will be harder for families and businesses to borrow money, lowering standards of living for everyone.

In addition, as mentioned above, a few programs will become overwhelmingly large, including interest on the debt and spending on programs like Medicare. Because resources are limited, even with the ability to run deficit, Congress will have to cut drastically all other programs, such as education, infrastructure, or defense. It also means that there will be less money to deal with emergencies like natural disasters or terrorist attacks.

Maybe even more importantly, future generations will have to pay today's deficits. We are about to embark on the most massive transfer of wealth from younger taxpayers to older ones in American history. It will be not just unprecedented but unfair: Our children will pay for the decisions we make today. The CBO for instance, explains that “[...] those generations born after

³³ Congressional Budget Office, “Economic Impacts of Waiting to Resolve the Long Term Budget Imbalance,” December 2010, <http://www.cbo.gov/doc.cfm?index=11998>.

about 2015 would be worse off if action to stabilize the debt-to-GDP ratio was postponed from 2015 to 2025.”³⁴

Finally, while not everyone will be impacted by the fiscal crisis in the same way, everyone will be affected. When interest rates go up, taxes go up and spending is cut. These changes will affect everyone. In all likelihood, there won't be much time to adjust to the changes, which means that the measures required at that point will be harsh and inequitable.

SECTION III: THE QUESTION IS NOT IF DEFICITS WILL HAVE TERRIBLE CONSEQUENCES, BUT WHEN THEY WILL MANIFEST THEMSELVES.

Going back to Reinhart and Rogoff, as we get closer to the infamous 90 percent threshold, the United States is likely to start seeing a significant impact on our economic growth. What we don't know is the form the crisis will take. For instance, the fiscal crisis could be a slow, yet rampant, destruction of our economy. With the massive debt load standing in the way of a real economic recovery, general uncertainty would cause consumers and businesses to hold back from spending and investing. The crisis could also be more abrupt with creditors losing faith and pulling their money from the United States. Interest rates would spike, causing interest payments to grow, forcing the government to borrow more, which would push rates up even higher. The result would be a vicious debt spiral, another deep recession, and ultimately a lower standard of living in the United States and presumably around the world.

We don't know exactly either at what point these debt levels become unacceptable to global credit markets. Among other reasons, much of that timing depends on the characteristics of each individual country. For instance, the United States, despite a dangerous debt burden relative to GDP (69 percent) and a structural deficit among the highest of developed countries (almost 4 percent), has so far escaped investor censure, thanks to the fact that dollar remains the world's reserve currency (for now). Also, Japan has the world's biggest debt as a percentage of GDP at 227 percent. But it has gotten away with its carelessness without risking default because the country relies more heavily than most on domestic investors to fund its spending.

For a long time, economists argued that there was no evidence that deficits ever lead to higher interest rates. In 1993, North Carolina State University economist John Seater surveyed the literature on deficits and interest rates and concluded that the data “are inconsistent with the traditional view that government debt is positively related to interest rates.”³⁵ But economist Arnold Kling argues that economists haven't seen a correlation between budget deficits and interest rates because foreign investment in U.S. assets has increased over the years, dulling the impact of fiscal policy.³⁶ The real question is what happens if that investment slows or stops.

Moreover, deficits have reached a level that economists haven't really studied before. Current circumstances remind Kling of “a guy jumping out of a building from the 10th floor, passing the third floor, and saying, ‘It's all fine so far.’” Deficits do not matter up to a certain level. But at which level do we hit the ground with a splat? Ten percent of GDP? Twenty percent?

Economists do know that, while debt to GDP ratios are important indicators of a country's fiscal health, they are not the only factor investors use to judge sovereign default risks based on public debt as a percentage of gross domestic product. Instead, bond professionals grade countries on a

³⁴ Congressional Budget Office, *Long-Term Budget Outlook*, 20.

³⁵ John Seater, “Ricardian Equivalence,” *Journal of Economic Literature* (March 1993): 176.

³⁶ Arnold Kling quoted in Veronique de Rugy, “When Do Deficit Matter?” *Reason* (April 2009), <http://reason.org/news/show/when-do-deficits-matter>.

curve, assessing one country's fiscal behavior against another's. When investors lose confidence in a government's fiscal rectitude relative to its competitors, they withdraw, and the snubbed country suffers. Capital being a scarce good, the result is increased interest rates and a higher price for debt. Economic literature dubs this phenomenon "the flight to safety."³⁷

Luckily for the United States, so far world markets continue to regard U.S. Treasuries as the safest investment out there. The full coercive power of the United States government still backs treasuries; and the United States is still doing relatively better than other nations. As a result, this perceived safe investment became particularly attractive to investors during the recession.³⁸ Even as the Federal Reserve increased the supply of treasuries, interest rates went down further still. This anomalous behavior has suppressed the cost of servicing the debt. And in fact, a look at the Department of the Treasury's Daily Treasury Yield Curve Rates shows that interest rates are at extraordinarily low levels.³⁹ Once this anomalous behavior passes and we return to more normal economic times, it is actually likely that our borrowing terms will grow worse not better.

Another key signaling device for international investors is how a government behaves under financial duress—how it balances the demands of its debtors with those of the domestic recipients of government spending. Announcements of lower spending and higher taxes tell investors a country is willing to go to great lengths in order to avoid defaulting on its debt obligations. If the government instead focuses on preserving its high spending pattern and very generous public employee benefits, investors know default is more likely and will shy away from that country's bonds.

For that reason, the United States must signal early on to its investors that it is serious about addressing its fiscal imbalance. At the very least, it would be beneficial to signal to investors that when the time of a fiscal crunch comes, the US will prioritize its spending and will pay bondholders first.

All these factors mean that things can change quickly. Europeans getting in better fiscal shape or some disaster happening in the United States that changes the way investors look at our ability to repay them may activate the flight to safety instinct. When that happens, our economy will suffer beyond the GDP losses due to the crowding out of private investments by government borrowing.

Perhaps more importantly, even if little happens in the short run and investors remain loyal to us for now, things will change in the long or even medium run. According to the CBO, driven by explosion in the autopilot programs like Social Security, Medicare, Medicaid, and interest on the debt, U.S. debt as a percent of GDP will reach 200 percent by 2037. However, these projections, while possible on a computer-generated paper, are unlikely to materialize in a world populated by people. In the real world, the economy could collapse before we could ever get to the levels of debt and deficits CBO is forecasting.

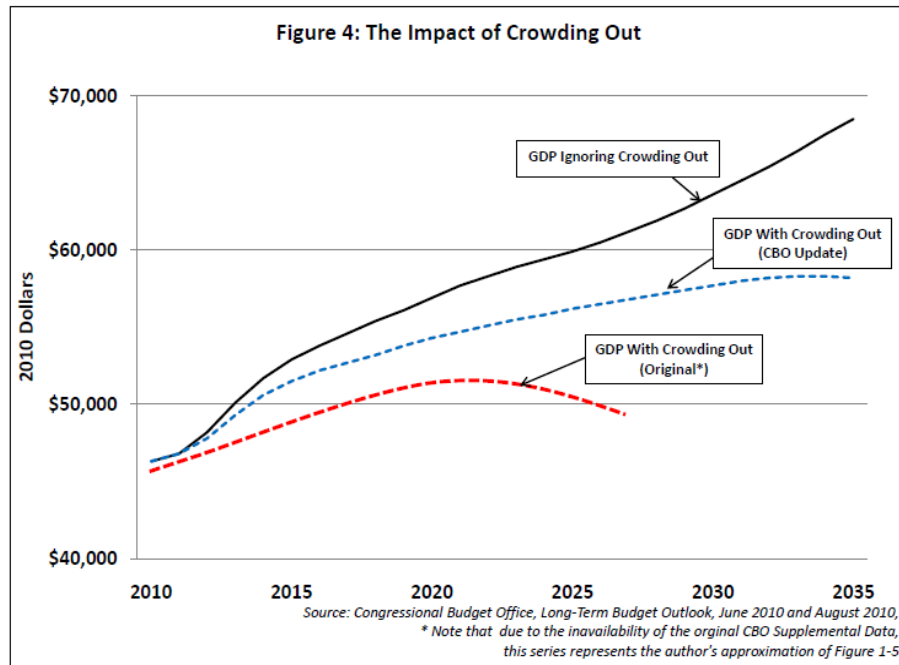
Even the CBO acknowledges that possibility. The chart below uses data from two CBO papers forecasting the effect on GDP per capita that crowding out may have and contrasting it with its commonly used projections. The data from a presentation to the Fiscal Commission in June 2010

³⁷ Bryan Noeth and Ragdeep Sengupta, "Flight to Safety and U.S. Treasury Securities," *The Regional Economist* (July 2010): 18–19, http://research.stlouisfed.org/publications/regional/10/07/treasury_securities.pdf.

³⁸ *Ibid.*

³⁹ US Department of Treasury, Daily Treasury Yield Curve Rates, <http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield>.

(red line) shows per capita GDP growth simply shrinking around year 2022 due to crowding out. The blue line shows another projection of the impact of crowding out that starts shrinking GDP per capita in 2034. The contrast with the data (black line) generally referenced by scholars and government officials is striking.



In other words, whether it is CBO's original or updated predictions that materialize, it is very likely that the people of the United States will feel the negative impacts of high debt and deficits driven by overspending long before the United States reaches a debt ratio of 200 percent. When that happens, our country will be caught in a downward, potentially unmanageable spiral.

CONCLUSION

Congress should care about addressing deficits and debt because of the effect they will have on American families. American families, American workers, and American children will be the first recipients of the bad things that will happen if Congress doesn't address the underlying causes of these deficits. They will suffer from economic uncertainty, higher interest rates, higher taxes, lower growth, higher unemployment rates, and lower standards of living. The children in particular will pay for the decisions we make today.

Congress is the representative of the American taxpayers and the steward of the nation's finances. As such, Congress must start cutting spending today. It should reform Social Security, Medicare, and Medicaid, which are the main drivers of the spending explosion. But these programs shouldn't be the only ones targeted for evaluations and potential cuts. Rather, *all* spending should be on the table. Congress needs to make sure no areas of the budget are untouchable. Not entitlements. Not defense. *All* parts of the budget must be on the table for review and potential cuts. And of course, Congress needs to put into place *now* serious, strict, and unavoidable budget rules that tie Congress's hands and restore fiscal discipline.

Congress also needs to resist the temptation to address these deficits by raising taxes. First, no amount of taxes could address the phenomenal fiscal imbalance that our country will face in the future. But, raising taxes would also add to our problems by hindering economic growth,⁴⁰ which would reduce tax revenue and add to the deficit.

With the right reforms, Congress could avoid putting the United States in this terrible position and thereby give the American people some renewed confidence in their futures and place the country on the road to recovery and prosperity.

Thank you for your attention. I look forward to your questions.

⁴⁰ Christina D. Romer & David H. Romer, 2010. "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, American Economic Association, vol. 100(3), pages 763-801, June.