Congressional Testimony

Flirting with Disaster: Solving the Federal Debt Crisis

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Testimony submitted to Joint Economic Committee of Congress, hearing on "Flirting with Disaster: Solving the Federal Debt Crisis," March 14, 2013.

Note: This testimony draws on *White House Burning: The Founding Fathers, Our National Debt, and Why It Matters to You*, coauthored with James Kwak. The Systemic Risk Council is a private group founded and chaired by Sheila Bair. All views expressed here are personal.

A. Main Points

1) A sudden move towards further tightening fiscal policy in the United States would undermine our economic recovery and has the potential to destabilize financial markets. We are moving in a precipitate manner towards an excessive and inappropriate degree of immediate austerity.
2) Now is a good time to discuss longer-term issues that will drive budget outcomes in future decades, particularly the paramount importance of the likely rising cost of healthcare (meaning all healthcare costs, not just those paid by the government). But this potentially sensible debate about healthcare has become very confused.
3) For example, significantly cutting federal discretionary domestic spending below current projected levels will weaken our education system, undermine our future human capital, and further fray our physical infrastructure—i.e., actually reduce attainable growth rates in the United States. This is not a good time to squeeze the provision of essential public goods.
4) There is no meaningful evidence that we "need" to cut federal deficits dramatically this year or next year or even over the next five years. It is far more important to get the economy back onto a sustainable growth path—and this includes not disrupting the private sector with damaging or disruptive public spending cuts.
5) The ongoing sequester is a perfect example of how not to manage fiscal policy. Combined with repeated confrontations over the debt ceiling and the possibility of a government shutdown, arbitrary and across the board cuts are hardly likely to help boost growth either in the short term or the longer term. Nor do they help boost confidence in the private sector.
6) More broadly, the rhetoric around supposedly "excessive" government spending has itself become excessive. The longstanding project to shrink the federal government—sometimes known as a strategy of "starve the beast"—has reached a new and very dangerous phase.[1]
7) To be precise, the disaster with which we now flirt is that we will inflict upon ourselves unnecessary and damaging austerity. We should instead be building an economy within which federal revenue can be robust and public spending growth can be contained over the

[1] For more historical background and relevant details on the development of this strategy since the 1970s, see chapter 3 in *White House Burning*.

next decade. A separate, but very important, issue is how to limit healthcare spending as a percent of GDP over the next 20 to 50 years.

B. Do We Have a "Fiscal Crisis"?

Standard solvency analysis—including, for example, the tools used by the International Monetary Fund (IMF)—confirms there is no prospect of an immediate fiscal crisis in the United States. We currently have "fiscal space," in the sense there is strong global demand for Treasury obligations in the foreseeable future.[2]

Long-term interest rates are low and remarkably stable. Partly this is due to actions by the Federal Reserve through various forms of "quantitative easing," but US government securities are also seen as a safe haven for international investors. However, this safe haven status will be jeopardized if markets perceive a significant probability that we will not pay our debts as contracted—or if we create the perception that our economy will be thrown into repeated turmoil through regular showdowns over the debt ceiling or through dramatic cuts in government spending.

Over the 10-year forecast window of the Congressional Budget Office (CBO), with the partial expiration of the Bush-era tax cuts, there is no insurmountable budget problem.[3] There is no fiscal emergency over this time horizon.

Our most important budget problems come *after* the 10-year horizon, because Medicare spending accelerates due to an aging population and increasing healthcare costs. The real issue here is containing healthcare costs—i.e., schemes that cut Medicare in such a way as to shift healthcare costs onto families do not offer an appealing solution, particularly as this would likely raise healthcare spending as a percent of GDP.[4]

We should aim to find a way to limit healthcare costs as soon as possible—every year of high healthcare cost inflation makes the problem worse. Our competitors are controlling healthcare costs much more effectively than we are; within the set of advanced countries, the United States stands out as having the worst (highest) projections for rising healthcare costs through 2030 or 2050.[5]

The United States is in the midst of a significant demographic transition, in the sense that our population is ageing. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the proportion of older Americans increases. Ultimately, higher productivity is necessary—although not sufficient—to ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).

In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. An important part of that should include additional tax revenues.[6] The

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[2] Comparative cross-country estimates are provided in Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Qureshi, "Fiscal Space," IMF Staff Position Note, September 1, 2010, SPN/10/11.

[3] See James Kwak, "The Weirdness of 10-Year Deficit Reduction," http://baselinescenario.com/2011/07/21/the-weirdness-of-10-year-deficit-reduction/.

[4] For more detail, see the CBO assessment of the budget proposal put forward by Congressman Paul Ryan, http://cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12128/04-05-ryan_letter.pdf.

[5] See the IMF's Fiscal Monitor (October 2012), Statistical Table 12a, columns 3 and 4.

[6] For more details on the viable options, see *White House Burning*, particularly chapter 7. Reducing tax expenditures is part of the sensible route to follow. These reductions can be phased in gradually.

Bush-era tax cuts reduced revenue to an excessive degree, given the ageing of society. We are still struggling to recover from that flawed way of thinking about our public finances.

It is striking the extent to which income inequality has increased dramatically since the last tax reform in 1986.[7] According to the latest available data, from 1993 to 2011, average real income for the bottom 99 percent of the population (by income) rose by 5.8 percent, while the top 1 percent experienced real income growth of 57.5 percent. The top 1 percent captured 62 percent of all income growth over this period.[8]

The returns to higher education have greatly increased in recent decades and, on average, income prospects are not good for those with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive—and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to childhood asthma).

At the same time, we must not lose sight of the very large fiscal risks posed by the nature and structure of our financial system. Our worsening budget picture since 2000 is due to a combination of factors—including large tax cuts, two foreign wars, and the introduction of Medicare Part D. The recent increase in government spending as a percent of GDP is due almost entirely to the way the financial sector imploded and damaged the rest of the private sector in 2007–08.[9]

To see the fiscal impact of the last finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23 percent of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to $13.7 trillion (over 65 percent of GDP)—a difference of $8.6 trillion.

Most of this fiscal impact is not due to the Troubled Assets Relief Program—and definitely not due to the part of that program that injected capital into failing banks. Of the change in the CBO baseline, 57 percent is due to decreased tax revenues resulting from the financial crisis and recession; 17 percent is due to increases in discretionary spending, some of it being the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14 percent is due to increased interest payments on the debt—because we now have more debt.[10]

[7] For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, "Skills, Tasks and Technologies: Implications for Employment and Earnings," http://econ-www.mit.edu/files/5571.

[8] This is from data on Emmanuel Saez's website, http://elsa.berkeley.edu/~saez/, downloaded on March 12, 2013. See the first item under "Income and Wealth Inequality"; the link to his spreadsheet is called "(Tables and Figures Updated to 2011 in Excel format, January 2013)."

[9] Over the past decade, foreign wars also contributed to increased government spending. But the negative fiscal effect of the financial crisis was much larger than the cost of the Iraq and Afghanistan wars combined.

[10] See also the May 2010 edition of the IMF's cross-country Fiscal Monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus accounts for only 1/10th of the increase in debt in advanced G-20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the United States provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.[11] The fact that this is not currently scored by the CBO does not reduce this risk or make it any smaller.

In effect, a financial system with dangerously low capital levels—hence prone to major collapses—creates a nontransparent contingent liability for the federal budget in the United States.[12] This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what senior officials at the Bank of England refer to as a "doom loop."

The remainder of this testimony reviews in more detail why spending cuts—either from a government shutdown or from some other form of immediate austerity—will be contractionary in the current US context, and how to think about our debt levels in a cross-country perspective.

C. Spending Cuts Would Be Contractionary

Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."[13]

The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today. If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the United States is currently perceived as one of the lowest risk countries in the world—hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the United States today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 3 percent below its precrisis level. The United States still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the United States today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates

[11] See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Pantheon, 2010.

[12] See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," Stanford University, March 2011 (revised), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf. See also Anat Admati and Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about it*, Princeton University Press, 2013, forthcoming.

[13] *World Economic Outlook*, October 2010, chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again—for example, because fiscal contraction involves laying off government workers.

Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency—thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control—and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

The available evidence, including international experience, suggests it is very unlikely that the United States could experience an "expansionary fiscal contraction" as a result of short-term cuts in discretionary federal government spending. Recent experience with austerity in the United Kingdom should also not inspire to head rapidly in the same direction.

D. Fiscal Crises in Comparative Perspective

The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-to-GDP level at which a crisis is triggered, but with net debt relative to GDP in or above the range of 90 to 100 percent, a country becomes much more vulnerable to external shocks—particularly if it is relying on foreign investors to buy a substantial part of its debt.

If any shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect—as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious—or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

It is important not to oversimply fiscal concerns into precise cut-offs for "dangerous" debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

Greece ran into trouble in 2010 with gross debt relative to GDP of 144.5 percent; its debt levels in 2006 and 2007 were around 107 percent.[14] This is a classic case of too much debt by any measure—although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece. In addition, an important part of the problems in Greece is structural—both in terms of how the euro area functions as a monetary area and in terms of the longer-run failure of productivity to converge towards levels in northern, higher-income European countries.

Portugal faced a fiscal crisis with gross debt at 107.8 percent of GDP in 2011, but its gross debt was only 68.3 percent in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits—the markets have become unwilling to support debt that continues to increase as a percent of GDP.

[14] These data are from the latest available Fiscal Monitor, published by the IMF in October 2012 (http://www.imf.org/external/pubs/ft/fm/2012/02/pdf/fm1202.pdf); see Statistical Table 4. An updated version should appear in April 2013. International comparisons of fiscal accounts are difficult; we recommend using the gross general government debt numbers from the IMF's Fiscal Monitor.

Ireland, another euro area country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on–balance sheet government debt was low (25 percent of GDP in 2007 for gross debt), but there was a big buildup in off–balance sheet obligations—in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 106.5 percent of GDP in 2011 and debt levels will reach nearly 120 percent (in official estimates) before stabilizing.

In the United Kingdom, gross debt was 43 percent of GDP in 2006 (low relative to other industrialized countries at that time). Gross general government debt reached 75 percent of GDP in 2010, when the new Conservative government decided to adopt relatively austere budget policies. However, growth since that time has been lackluster and debt continues on an upward path. In the latest official projections, it will peak at 96.6 percent of GDP in 2015. Given that Britain does not belong to the euro area and still has its own central bank, the wisdom of its current fiscal policy stance has increasingly been called into question.

Compared with other industrialized countries, Japan stands out as an extreme. Government debt relative to GDP is expected to reach 245 percent in 2013 (on a gross basis) and rise to 248.8 percent in 2016. On a net basis—taking out government debt held by other parts of the public sector—the equivalent figures are 144.7 percent in 2013 and 155.6 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents—and, at least for the time being, Japanese household and business savings remain high.

Countries with greater reliance on foreign savers, such as the United States (where nonresidents held 30.2 percent of general government debt and 47.9 percent of marketable central government debt in 2012) and the United Kingdom (nonresidents held 31.1 percent of general government debt in 2012) need to be much more careful. Within the euro area, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40 to 90 percent of all outstanding government debt (mostly held by other euro area financial institutions).

Debt relative to GDP in industrialized countries increased from 77.2 percent in 2006 to 110.7 percent in 2012 (this is general government gross debt as a percent of GDP, calculated by the IMF as an unweighted average across countries). Most of this increase was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

Seen in that context, the increase in the US general government gross debt—from 66.6 percent of GDP in 2006 to 98.6 percent at the end of 2010 and 107.2 percent at the end of 2012—was very much in line with experience in other countries.[15]

In terms of net general government debt held by the private sector, at the end of 2012, the United States was around 83.8 percent of GDP—up from 48.2 percent in 2007. This is not yet at a dangerous level but the future projections are not encouraging—this number will rise to 89.6 percent in 2016 and 89.4 percent in 2017, according to the IMF. And in the CBO's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

The role of the US dollar as the world's preeminent reserve currency means there is a strong demand for our government securities in the foreseeable future. In 1948 and 1968, world holdings of US dollar assets in the form of reserves were worth about 2 percent of GDP. Now

[15] These gross and net debt numbers are taken from the IMF's Fiscal Monitor, October 2012, Statistical Table 4. The 2012 data are a forecast.

world reserve holdings of dollar assets are worth at least 15 percent of GDP—and some would put this as high as 30 percent of GDP.

But it is not clear how far this will carry us—particularly as alternative reserve assets typically develop in a diverse world economy with competing national interests. It would be wise to undertake medium-term fiscal consolidation, i.e., over the next two decades. Rising healthcare costs, a weak tax base, and deteriorating public goods could well undermine our long-term potential growth.

In addition, the United States continues to face very large potential fiscal liabilities in the form of implicit support available to the financial sector, both directly—if “too big to fail” global banks get into trouble—and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector executives and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage.

If sharp spending cuts follow that reduce essential public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for “too big to fail” global financial institutions. Such firms are likely to damage themselves with some regularity—their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce. Unfortunately, this is the trajectory on which we currently find ourselves.