Unsustainable Federal Spending and the Debt Limit

Testimony to Subcommittee on Oversight and Investigations

House Financial Service Committee

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Mr. Chairman and members of the Subcommittee, my name is Daniel Mitchell and I'm a Senior Fellow at the Cato Institute. Thank you for the opportunity to present my views on the very important issue of America's fiscal outlook and the role of the debt limit.

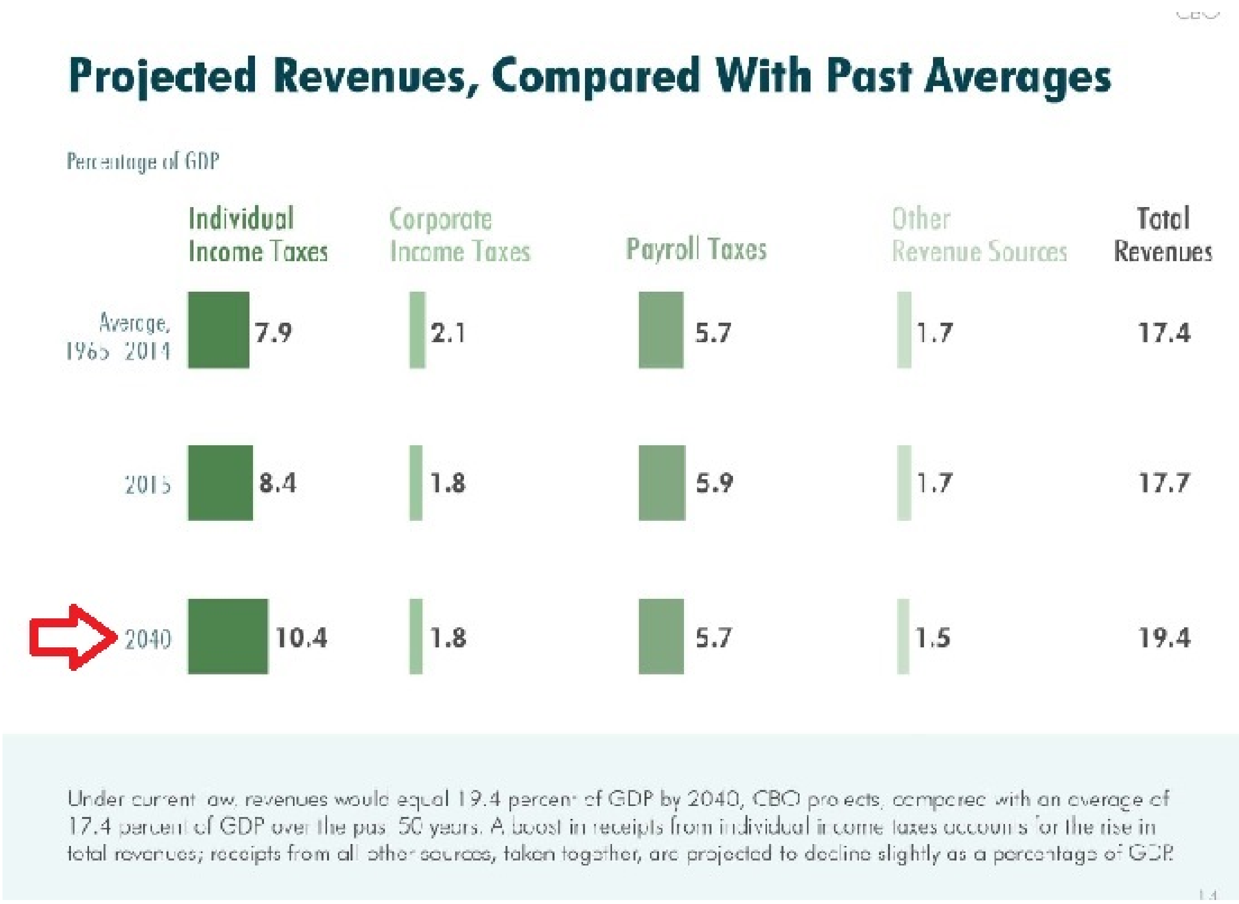
1. **The United States has a serious long-run spending problem**

Most people understand that our nation faces very serious long-run fiscal challenges thanks to changing demographics and poorly designed entitlement programs. We routinely get grim estimates from the Congressional Budget Office, the Office of Management and Budget, the Government Accountability Office, as well as private forecasters.

Most of these estimates focus on red ink, specifically what's happening to annual deficits in addition to what's happening to aggregate levels of publicly-held debt. This is useful information, but it's important to understand that red ink generally should be viewed as a symptom. The real issue is the overall burden of government spending because that's what requires the diversion of resources from the productive sector of the economy, regardless of whether outlays are financed by taxes, borrowing, or printing money.

It's also best to focus on government spending because projections of ever-larger levels of long-run debt are entirely the result of ever-expanding amounts of federal spending, not inadequate tax receipts.

Here are some numbers from a recent CBO forecast, which show that tax revenues already are above their long-run average and that the tax burden – even without any legislated tax hikes – will gradually increase over the next few decades. This is due to the fact that some parts of the tax code are not indexed for inflation and also because even modest levels of economic growth gradually push people into higher tax brackets.

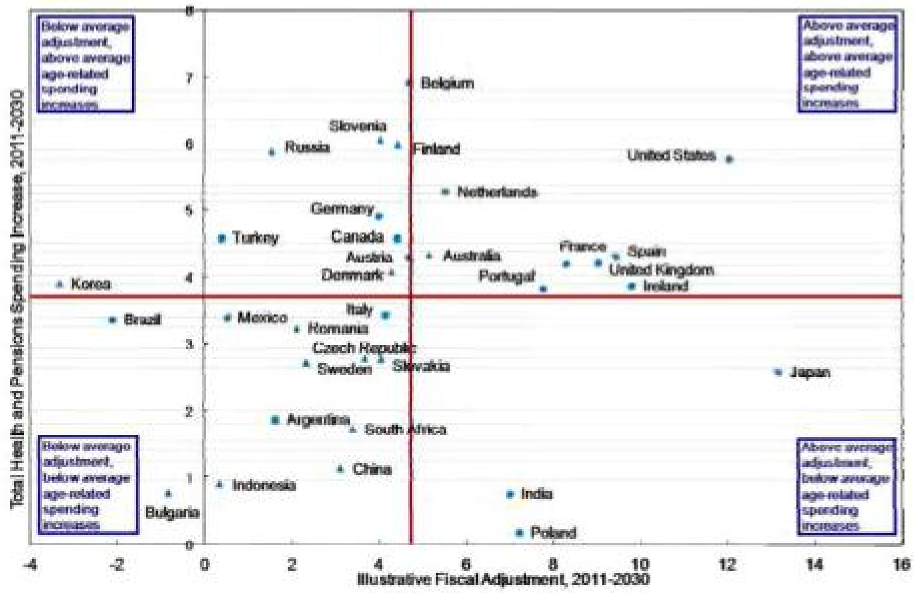


The numbers tell a very clear story. Taxes will slowly but surely claim a larger share of our output over time, but government debt levels are projected to increase because the burden of government spending will grow even faster, consuming an ever-larger portion of the economy's output. As noted above, this is primarily the result of entitlement programs that resemble Ponzi schemes, combined with demographic change, specifically an aging population and falling birthrate that will cause a population pyramid to become a population cylinder.

In some sense, we're on a path to becoming a failed European-style welfare state. But the numbers may tell an even more depressing story. Various international bureaucracies put together apples-to-apples projections of long-run fiscal status.

This chart is from a study by the International Monetary Fund looking at fiscal challenges in varying nations. The vertical axis captures the degree to which age-related outlays will increase by 2030 and the horizontal axis is an estimate of the amount of fiscal consolidation (as a share of GDP) that will be necessary to stabilize government debt burdens. It's not good to be in the upper-right quadrant and the United States arguably is in a worse position than any other nation.

Figure 14. Illustrative Fiscal Adjustment and Projected Age-Related Spending Increases in 2011–2030 (In percent of GDP)



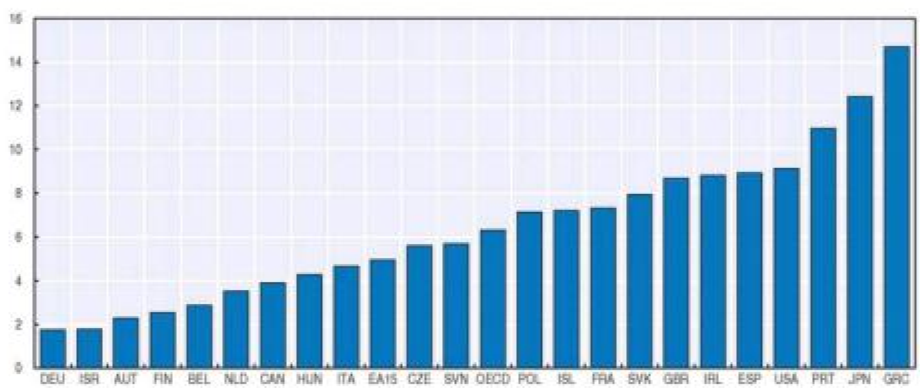
Source: IMF staff estimates and projections; IMF (2010c).

Note: Fiscal adjustment refers to improvement in the cyclically adjusted primary balance needed to achieve the illustrative gross government debt target. Circles indicate debt ratios above 60 percent for advanced economies and 40 percent for emerging economies, projected at end-2012 (higher debt); triangles indicate debt ratios below 60 percent for advanced economies and 40 percent for emerging economies, projected for the same period (lower debt). See note in Figure 11 for further details. The vertical and horizontal lines represent unweighted averages.
For Australia, the figures do not take into account the federal government budget, released on May 11, which envisages a return to federal government surpluses by 2012/13. For Greece (not shown), the illustrative 2011–30 adjustment need is 9.2 percent of GDP, after measures of 7.6 percent of GDP undertaken in 2010. The increase in health and pension spending is projected at 7.6 percent of GDP.

Here are the [latest estimates](#) from the Organization for Economic Cooperation and Development, which show the amount of annual fiscal consolidation that would be necessary to stabilize debt levels by 2030. In the developed world, only three nations have a bigger long-run problem than the United States.

Figure 1.12. **Budgetary consolidation requirements to reduce government debt to 60% of GDP**

Average change in the underlying primary balance (2010-2030), percentage points of GDP

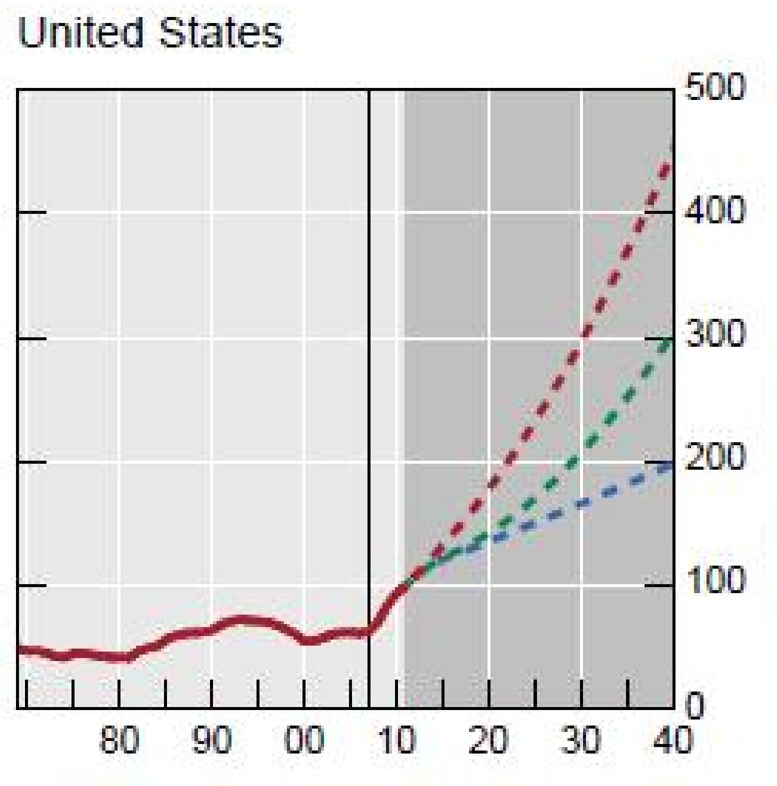


Note: The average measure of consolidation is the difference between the underlying primary balance in 2010 and the average underlying primary balance between 2015 and 2030, except for those countries for which the debt target is only achieved after 2030, in which case the average is calculated up until the year that the debt target is achieved.

Source: OECD (2013), *OECD Economic Outlook 93 Long-Term Database.*

StatLink http://dx.doi.org/10.1787/888932983870

Last but not least, here is an estimate of future government debt from the Bank for International Settlements. The red line is the baseline forecast and the blue and green lines show debt levels based on assumptions of varying degrees of fiscal reform. Of the major economies reviewed in the study, only Japan had worse numbers than the United States.



For what it's worth, I think these forecasts from the IMF, OECD, and BIS are actually too pessimistic, at least in that I would not want to trade places with countries like France or Italy. The long-run numbers for the United States are bad because of the assumption that spending will climb dramatically and revenues will stay constant, and this leads to compounding levels of government debt. But that problem is actually simple to solve with some sort of spending cap.

But for many of Europe's welfare states, the burden of government spending already exceeds 50 percent of economic output and tax burdens have been pushed close to – or even beyond – revenue-maximizing levels. That problem is much harder to solve.

2. **The debt limit is an appropriate vehicle for legislation**

While there is presumably near-universal recognition that the United States has major long-run challenges, there is not agreement on how to solve the problem. And there may be even less consensus on whether the debt limit should be used as an action-forcing vehicle for fiscal reform.

In part, this is partisan posturing and conventional executive-vs-legislature game playing. All Administrations, regardless of party, dislike fights over debt limits and prefer "clean" legislation. And both parties in Congress, when the White House is controlled by the other side, like to attach conditions and create obstacles.

Setting aside these political aspects, there is a strong case for using must-pass pieces of legislation as a means to an end. Simply stated, it beats the alternative of doing nothing.

Consider this example. Greece is now suffering through a very deep recession, with record unemployment and harsh economic conditions. Wouldn't it have been preferable if there was some sort of mechanism, say, 15 or 25 years ago that would have enabled some lawmakers to throw sand in the gears so that the government couldn't issue any more debt? Yes, there would have been some budgetary turmoil at the time, but it would have been trivial compared to the misery the Greek people currently are enduring.

Let's now apply this reasoning to the United States. We know we're on an unsustainable path. Do we want to wait until we hit a crisis before we address the over-spending crisis? Or do we want to take prudent and modest steps today – such as reasonable entitlement reform and spending caps – to ensure prosperity and long-run growth?

The second option is much better. Yet since those steps won't be popular with interest groups, it's quite possible that they can only be imposed in the unusual circumstances that surround debt-limit legislation.

With this in mind, it would be useful to offer [a response to the July 2015 GAO report] on the debt limit and proposed alternatives. GAO basically concluded that that it would be best to have automatic or near-automatic increases in the debt limit, mostly because of a finding that uncertainty in financial markets can cause small increases in interest rates for government debt. And since there's a lot of government debt, even a small increase can add tens of millions of dollars to the fiscal burden.

All that may be true, but GAO was looking at a tree and ignoring the forest. The issue is not whether fights over the debt limit may cause hiccups in the short run. What matters is whether fights over debt limits may produce reforms that avert catastrophic consequences in the long run.

3. A debt limit fight would only lead to default if an Administration wanted default

The more common argument against using the debt limit to force reform is that it is akin to playing with fire and may lead to default. And that would be potentially catastrophic to financial markets rather than a mere hiccup.

Predictions of doom almost certainly are overheated, but it doesn't matter because there is more than enough tax revenue to ensure that the federal government can honor its contractual obligation to bondholders. If we assume the next debt limit is reached in 2017, it's very difficult to see how a default may occur since projected revenues that year will be more than $3.5 trillion, more than 11 times greater than the projected interest payments for 2017, which CBO says will total $308 billion.

Some argue that prioritizing interest payments would be impossible or impractical for a couple of reasons. First, they say Treasury doesn't have the legal power to prioritize payments, so if the debt limit wasn't increased (which would be akin to an immediate balanced-budget requirement), the department would face chaos and a default would be an inevitable consequence. But this is nonsense because the law does not micromanage Treasury operations, and it certainly does not prohibit "prioritization."

The second – and more common – argument is that Treasury has the power to prioritize in a spend-only-what-you-collect world, but that it lacks the competence. This is a specious argument since many state and local governments routinely delay payments to vendors and other beneficiaries when money is tight. Suffice to say that if notoriously mismanaged states such as California and Illinois can figure it out, then there's no reason not to expect a similar level of performance from Treasury officials.

Indeed, one must assume that Treasury already has contingency plans for such a possibility, and this Committee's work seems to have confirmed this suspicion.

Finally, I will close by noting that utterly disingenuous Administration tactic of trying to blur the difference between contractual obligations to bondholders and promises to give money to various interest groups. Treasury officials and others use deceptive and misleading language about defaulting on commitments/promises/etc to make it seem as if delaying payments of things like crop subsidies and Medicaid reimbursements is somehow equivalent to default on interest payments.

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