



American Enterprise Institute for Public Policy Research

Testimony before the Joint Economic Committee

**The Way Forward from Government Shutdown and Debt Ceiling Confrontation
toward Long-Term Fiscal Sustainability and Economic Growth**

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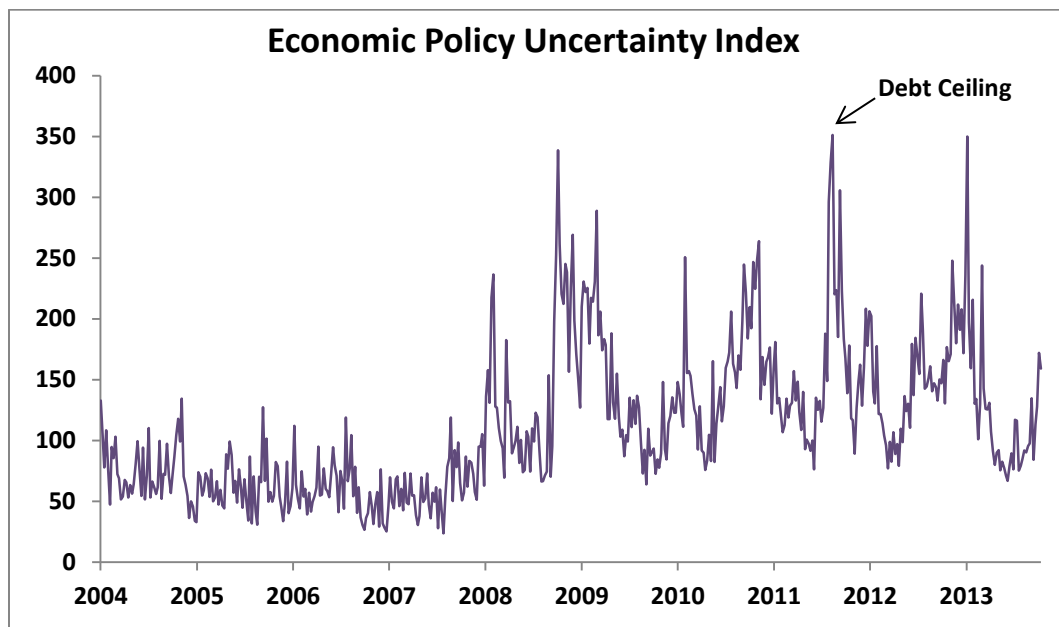
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Chairman Brady, Vice Chair Klobuchar, and Members of the Committee, thank you for inviting me here today to discuss possible solutions to the government shutdown and debt ceiling debate and ways to move our country forward in a fiscally-sustainable way.

We meet today in the midst of a historic government shutdown, with the government's debt limit rapidly approaching. In a recent article, my colleague Abby McCloskey and I reviewed the history of debt limit increases and concluded that debt limit struggles have been quite common in recent U.S. history, and have lead more often than not to legislation that ties increases in the debt limit to specific factors. While a full accounting of the costs and benefits of these prior actions would require estimates of the long run impact of the policies that were enabled by debt limit actions, there is little dispute in the economics literature that struggles like that of 2011 increase economic policy uncertainty, and this heightened uncertainty has negative economic consequences. A recent path-breaking paper by Baker, Bloom, and Davis¹, shows these effects clearly. The authors compile a unique index of policy uncertainty, which draws on news coverage of uncertainty in policy decisions, the number of federal-tax-code provisions set to expire, and the disagreement among forecasters about economic variables one year in the future. They use this index to estimate the impact of policy uncertainty on the economy, finding massive negative effects; their results imply that a 112-point rise in their policy-uncertainty index - which occurred between 2006 and 2011 - would reduce real GDP by 3.2 percent and employment by 2.3 million jobs. The chart below shows the large spike in uncertainty that occurred during the debt-ceiling debate in 2011. It should not be in dispute that we can do better.



Source: FRED; Baker, Bloom, and Davis

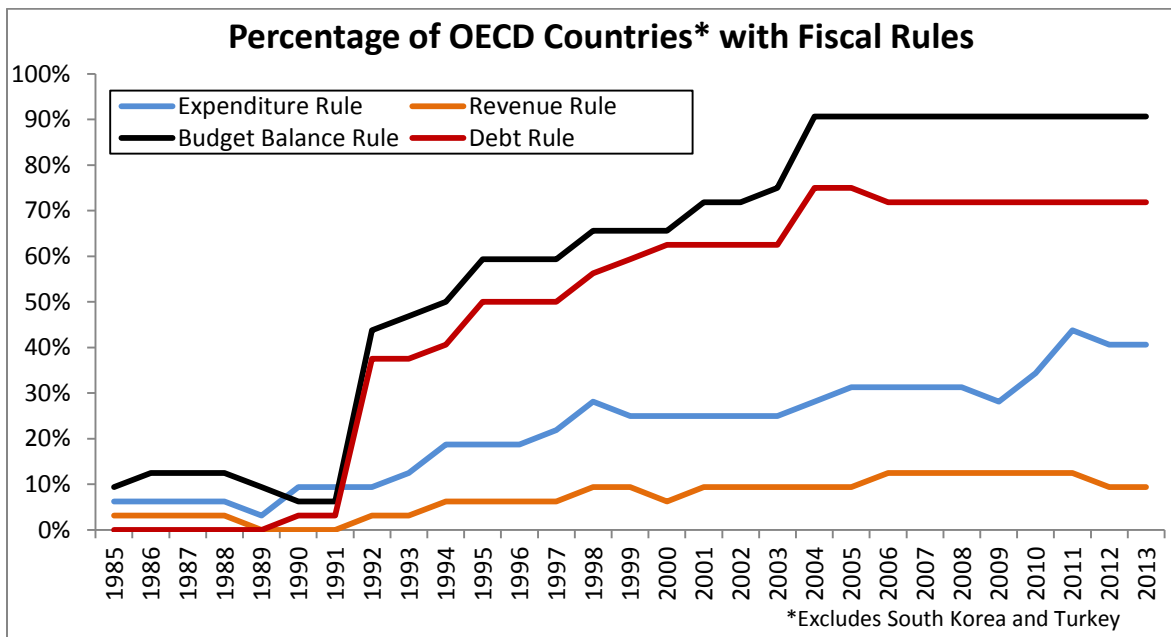
¹ Baker, Scott R., Nicholas Bloom, and Steven J. Davis. "Measuring Policy Uncertainty." Working Paper. May 19, 2013.

The purpose of my testimony is to review the budgetary practices of other countries, and draw lessons for U.S. policy, with the objective of helping lawmakers assure that this be the last time that our nation endures anything like our current mess.

My first observation is that most developed countries around the world have significantly more advanced budgetary rules than we do in the U.S., often encoding specific targets that constrain the actions of policymakers.

Budgetary Rules in Other Countries

The IMF recently compiled a database of 87 countries² and the fiscal rules that they use in their budgetary processes. The analysis broke the fiscal rules into four categories – expenditure rules, which set limits on total spending or on certain types or spending; revenue rules, which set floors or ceiling for revenues; budget balance rules, which constrain deficits that contribute to central government debt (either by limiting the amount that a deficit can be in an individual year, or by specifying that there should be a balance over a certain cycle); and finally, debt rules, which set an explicit limit or target for public debt. The U.S. currently has one fiscal rule in place, according to the IMF – the sequester agreed upon in 2011 which acts as an expenditure rule.



Source: IMF

OECD countries have clearly moved towards having a greater number of fiscal rules over time. As the authors of one IMF study³ state:

“Over the past two decades, fiscal rules have spread worldwide. In 1990, only five countries—Germany, Indonesia, Japan, Luxembourg, and the United States—had fiscal rules in place that

² The Fiscal Rules dataset can be accessed at <http://www.imf.org/external/datamapper/FiscalRules/map/map.htm>

³ Schaechter, Andrea, Tidiane Kinda, Nina Budina, and Anke Weber. “Fiscal Rules in Response to the Crisis – Toward the “Next Generation” Rules. A New Dataset.” IMF Working Paper WP/12/187. July 2012.

covered at least the central government level. In Japan and Germany, fiscal rules have a long tradition dating back to as early as 1947 and 1969, respectively, though adherence to the rule was weak for most years. Over the next two decades, the number of countries with national and/or supranational fiscal rules surged to 76 by end-March 2012 ... This includes, most recently, responses to the crisis with a view to provide credible commitment to long-term fiscal discipline.”

In addition to countries adopting their own fiscal rules, there are some supra-national rules (by the EU, along with a few other currency unions in the Caribbean and Africa) that band countries together. In the EU, the Maastricht Treaty, signed in 1992, set a limit of three percent of GDP for deficits and 60 percent of GDP debt for EU member states. Following the financial crisis and recession from 2007-2009, in which many EU member states experienced large deficits and growing debt, a new Fiscal Compact was agreed to. Twenty five member states signed an agreement in 2012 requiring countries to adopt national legislation limiting annual structural deficits to 0.5 percent of GDP and implementing new rules on debt reduction to achieve the eventual goal of 60 percent debt to GDP ratios.

Although many EU countries have relied upon budget rules to push deficits back to lower levels following the Great Recession, there are certainly exceptions, and one could not possibly assert that they have been a ringing success. In a recent study, Frankel and Schreger (2012)⁴ show that one of the reasons that Eurozone countries have frequently exceeded the 3 percent deficit rules is overly optimistic growth forecasts that allow central governments to project meeting deficit targets that they in fact end up missing. This is especially true of countries that have previously violated their 3 percent deficit cap. However, countries that have an independent fiscal institution that produces budget forecasts tended to have less overly-optimistic forecasts than countries that did not.

The evidence from Europe shows that in many cases, limits to budget deficits can be ineffective because it is easy to tinker with projections to appear to come into balance, when a deficit limit is in fact going to be breached. Limits to budget deficits also have the disadvantage that they require agreement on both spending and revenue, without providing a guide to the proper level of either. This creates a situation where one side favors lower taxes and lower spending, for example, while the other side favors a higher tax and higher spending level – and each can point to their own plan as meeting the deficit ceiling.

Perhaps because of these problems, countries have increasingly begun to rely on specific expenditure targets, either top line numbers, or as a percentage of GDP. The adoption of such targets makes a great deal of sense. Some policymakers may like the government to be larger, some might like it to be smaller, but everyone should agree that bills eventually have to be paid. By focusing budget rules on the key variable in dispute, countries around the world are beginning to assure that the focus of policy debate is on the actual substance of the debate.

The data suggest, then, that we might well seek to adopt a new set of budget rules that set a limit on spending, and then agree to automatically pass continuing resolutions and debt limit increases, provided

⁴ Frankel, Jeffrey A. and Jesse Schreger. 2012. Over-optimistic Official Forecasts in the Eurozone and Fiscal rules. NBER Working Paper 18283.

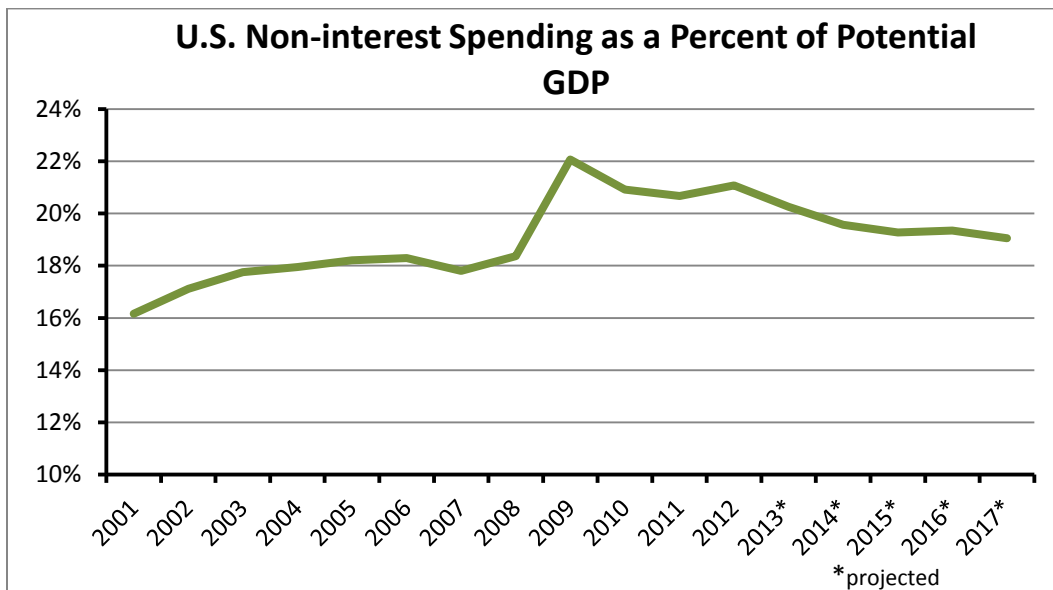
that the government is spending at or below the target. While establishing that target would certainly be difficult, existing proposals, such as one put forward several years ago by Chairman Brady, provide a useful guide to the possible concerns.

Limiting Spending

A hard limit on spending is impractical, because the cost of providing government would necessarily increase as the economy and wages grow. As such, I encourage you to consider a policy that limits spending as a share of GDP. A direct limit on such spending would also be poor long run policy, since a contraction in GDP might lead spending, which includes built in stabilizers, to increase as a share of GDP in a desirable fashion. There are several possible methods to adjust for this. One is to cyclically adjust the variables, another is to rely on spending as a share of potential GDP. Potential GDP is a measure calculated by the Congressional Budget Office that estimates the level that GDP in the U.S. economy would be if the economy were operating at a high level of resource use (including full employment). It is meant to be a measure of a sustainable output. In a recession, GDP generally falls below potential GDP as resources remain unused. Potential GDP then allows the estimate of GDP to be smoothed over peaks and troughs in the business cycle.

Marking spending to potential GDP would be an effective way to enact budget legislation that is transparent and difficult to game. The CBO's methods for calculating it are well established, and it would be easy to agree to consequences that would reduce spending in real time in response to a surge in spending that pushed the government past the agree upon caps.

The target percent of potential GDP that lawmakers might prefer would, of course, be in the eye of the beholder. As can be seen in the next chart, in recent years government's share of potential GDP has varied from about 16 percent to as bit more than 22 percent. That would seem to be a reasonable range to begin the discussion in.



Source: Congressional Budget Office; Office of Management and Budget

As each lawmaker forms his or her own opinion about the appropriate number, it will clearly depend on their own assessment of the possible benefits of government spending programs, such as infrastructure spending, or clean energy subsidies. But as those benefits are considered, I would also urge you to keep in mind the benefits of budgetary restraint. While there is a good deal of uncertainty concerning the size of the government multiplier effect in the short run, the long run impact of government spending on growth has a fairly robust underpinning in the empirical growth literature. Barro (1989⁵, 1991⁶) examines the impact of government consumption and investment spending on economic growth in a series of cross-country growth regressions. He concludes that public consumption spending has a robust negative relationship with growth and investment while public investment spending has an insignificant effect on economic growth. Grier and Tullock (1989)⁷ find that an increase of one percent in government growth reduces average GDP growth by 0.32 percentage points. In other words, there is a strong negative effect of the growth of government consumption as a fraction of GDP. Alesina, et al. (1999)⁸ find similar negative results of government spending on economic performance, as measured by business investment, in an analysis of OECD countries. Fölster and Henrekson (2001)⁹ find a negative growth effect of large public expenditures in cross-country analysis.

Conclusion

Countries around the world have increasingly relied upon budgetary rules to help constrain the growth of government. I encourage Congress to consider adopting a budget rule that caps spending in the U.S. (other than interest payments) at some agreed upon fraction of GDP. If spending is below that cap, than government debt limits should be automatically lifted, and the government should stay open. The economic benefits from the reduced uncertainty that would follow could well be significant.

⁵ Barro, Robert J. 1989. "A Cross-Country Study of Growth, Saving and Government." NBER Working Paper No. 2855. January.

⁶ Barro, Robert J. 1991. "Economic Growth in a Cross-Section of Countries." *Quarterly Journal of Economics* 106 (2): 407-43.

⁷ Grier, Kevin. B, and Gordon Tullock. "An Empirical Analysis of Cross-National Economic Growth, 1951–80." *Journal of Monetary Economics* 24 (2): 259–276.

⁸ Alesina, Alberto, et. al. 1999. "Fiscal Policy, Profits, and Investment." NBER Working Paper 7207. July.

⁹ Fölster, Stefan, and Magnus Henrekson. 2001. "Growth Effects of Government Expenditure and Taxation in Rich Countries." *European Economic Review* 45 (8): 1501–1520.=