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WHAT IS THE REAL DEBT LIMIT?

HEARING

BEFORE THE

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CONGRESS OF THE UNITED STATES

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FIRST SESSION

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WHAT IS THE REAL DEBT LIMIT?

TUESDAY, SEPTEMBER 20, 2011

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:04 a.m., Room 210, Cannon House Office Building, the Honorable Kevin Brady, Vice Chairman, presiding.

Senators present: DeMint.

Representatives present: Brady, Burgess, Campbell, Mulvaney, and Cummings.

Staff present: Connie Foster, Robert O'Quinn, Michael Connolly, Rachel Greszler, Gail Cohen, Will Hansen, Colleen Healy, and Jesse Hervitz.

OPENING STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Vice Chairman Brady. Good morning, everyone. Welcome to the Joint Economic Committee hearing. The topic is, "What is the Real Debt Limit?" We so appreciate the panelists we have here today.

And I want to commend Senator DeMint, who leads Senate Republicans on the Joint Economic Committee, for spearheading this hearing on this very important and timely topic. And I would yield to Senator DeMint for the opening statement.

OPENING STATEMENT OF HON. JIM DEMINT, A U.S. SENATOR FROM SOUTH CAROLINA

Senator DeMint. Thank you, Mr. Chairman. And I appreciate all of your work and your staff's work to put this together.

And I want to thank all of our panelists for taking their time to be here.

A couple of months ago in Washington, everyone was in a panic of what might happen if we couldn't borrow any more money. And the President mentioned we might not be able to pay Social Security. We talked about reneging on payments to contractors. We talked about a pretty dire situation if the United States could not borrow any more money.

But that debt limit was an arbitrary debt limit set by Congress, one that we could change by a simple debt-limit deal. My concern and I think that a number of Americans is, where is the real debt limit? When do we hit the wall where no one will lend us any more money and perhaps the Feds can't even print enough money? At

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what point is there not enough credit in the world to continue to finance not only the United States but all the debtor nations?

You know, under CBO's alternative budget forecast, their model essentially stops working in the early 2040s because of excessive U.S. debt. I just want to look at a couple of charts here of where we see the debt going relative to the GDP. There is no way we are going to get that far. My concern is, can we borrow another 2½ trillion? The Federal Reserve is apparently buying a lot of our debt already. Is there still a market for the kind of debt that the United States needs to sell?

Despite the commitment to reduce our deficit—and, again, "deficit" is a Washington term, the year-to-year shortfall—we have said we would reduce that year-to-year shortfall $2.1 trillion over the next 10 years, giving the impression to Americans that we are actually lowering the debt, when, as I am sure all of our panelists know, we are going to continue to increase the debt. It may be $8 trillion, $10 trillion; we are not sure. But, again, if we look at our charts, I am not sure we can borrow that much money.

But if we look here, at what we are trying to discover today, or determine, or guess at: Where is the tipping point for America beyond which the interest rates will rise sharply, economic growth will decline dramatically? As we look at the potential tipping point for Greece and Ireland and Portugal and U.S. as a percent of GDP, we see the United States is right there where these other nations are. Is the only thing that makes us different that we can print money and that we are the world's reserve currency? These other countries can't print their own. But hopefully our panelists will help us sort this out.

And what does the United States look like once we reach that tipping point, when we hit a very real debt limit? How high will interest rates go? What will be the borrowing cost if we can, in fact, borrow the money? Will the Fed just print money? These are things we are trying to anticipate.

The Fed is clearly engaged in unprecedented action, including the purchase of trillions of dollars of U.S. Treasuries and mortgage-backed securities. You know, since the financial crisis in 2008, the Fed's balance sheet has tripled to $2.9 trillion. We can see here what the Federal Reserve has done, with very little notice by Congress, which effectively means we are printing money and buying debt.

So how could the Fed's policies affect the tipping point? What can we expect? There are a lot of questions. And, certainly, we need to know, how long can the Federal Reserve monetize our debt before the world begins to lose confidence in our currency?

So my challenge to the panelists today is that, all politics aside, all partnership aside, our country is drowning in debt. The plan by this government is to continue borrowing money for the foreseeable future. Any talk of balancing the budget is considered extreme. What does that mean for our country? How much time do we have, and what is going to happen when we can no longer borrow money?

Thank you, Mr. Chairman.

Vice Chairman Brady. Thank you, Senator.

The chair recognizes Representative Cummings for an opening statement.

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OPENING STATEMENT OF HON. ELIJAH E. CUMMINGS, A U.S. REPRESENTATIVE FROM MARYLAND

Representative Cummings. Thank you very much, Mr. Chairman.

I want to thank you, Vice Chairman Brady, for calling today's hearing to examine the effects of the national debt on our broader economy.

I welcome our witnesses and extend, particularly, a warm welcome to Dr. Laurence Ball, professor of economics at Johns Hopkins University. And Johns Hopkins, of course, is located in Baltimore and smack-dab in the middle of my district.

Last week, the Director of the Congressional Budget Office testified before the new Joint Select Committee on Deficit Reduction. He reported that if we proceed under current law—for example, allowing the Bush tax cuts to expire at the end of this year—by 2021 debt held by the public will equal 61 percent of GDP, well above the annual average of 37 percent recorded between 1971 and 2010. Under the CBO's so-called "alternative baseline," in which the Bush tax cuts and the AMT patch are extended and other current policies continue, debt held by the public is expected to balloon to nearly 190 percent of GDP by 2035.

The Director testified that, notwithstanding the latest long-term projections under the so-called Budget Control Act, interest payments on the debt and lost confidence in our ability to manage our budget would create a clearly unsustainable scenario. However, the CBO Director also told the committee that there is no inherent contradiction between using fiscal policy to support the economy today and imposing fiscal restraints several years from now. He instructed, if we want to achieve both a short-term economic boost and longer-term fiscal sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now and reduce it later in the coming decade.

Thus, the CBO Director confirms what countless economists have been warning Congress about. Draconian spending cuts will not generate the economic growth we need now, right now, to put Americans back to work and enable them to compete and succeed. Moreover, such harmful cuts are unnecessary to rein in the debt and will only serve to slow our already tepid growth, ultimately reducing revenues coming in through taxes.

In fact, one of the major causes of our current budget deficits, and, thus, a major cause of the growing debt, is our continued slow economic growth. The recession that started in 2007 is responsible for more than $400 billion of our annual deficits between 2009 and 2011, according to the Center for Budget Policies and Priorities and the CBO. Therefore, one of the most effective steps we could take to tackle the debt right now is to start growing the economy again, which is also what the American people desperately need and desperately want.

According to Laura Tyson, chairwoman of the Council of Economic Advisers and the National Economic Council in the Clinton Administration, which presided over one of the most sustained periods of economic growth and job creation in our Nation's history, investments in infrastructure, job training, and research and development, which would address the immediate jobs gap and foster future growth, would help reduce the deficit. An extra percentage point of growth over the next 5 years would do more to reduce the deficit during that period than any of the spending cuts currently under discussion. And over the next decade, an extra percentage point of growth would add about $2.5 trillion in revenue.

While this hearing is aimed at examining the impact of the Federal debt on our economy, I would submit that, at present, the debt is a nominal factor in our current economic outlook. Rather, slowed hiring, low consumer confidence and demand, skills mismatches between workers and jobs, reduced public investment, and the continuing foreclosure crisis are driving our economic conditions and our rising debt, rather than the other way around.

Finally, until we recognize this reality and move to tackle these challenges, an exclusive focus on the debt crisis will essentially consign our Nation to chasing our economic tail—a wholly unnecessary and unproductive exercise. However, I anxiously look forward to hearing from our witnesses. I thank you all for being here today.

And, with that, Mr. Chairman, I yield back.

Vice Chairman Brady. Thank you.

Two housekeeping notices. One, the clocks are not working, so we will be keeping the time manually. And we will make notice of that as we come up to the 5-minute time limit for both testimony and questions.

Also, I have an opening statement I would like unanimous consent to insert into the record, without objection.

[The prepared statement of Representative Kevin Brady appears in the Submissions for the Record on page 28.]

[Chart titled "Total U.S. Government Spending = 41% of GDP (2011)" appears in the Submissions for the Record on page 30.]

[Chart titled "Rise in Fed's Treasury Holdings Accounts for More Than One-Third the Rise in U.S. Debts Since March 2009" appears in the Submissions for the Record on page 31.]

[Chart titled "What is the Tipping Point?" appears in the Submissions for the Record on page 32.]

[Chart titled "Gross Government Debt as a Percent of GDP" appears in the Submissions for the Record on page 33.]

[Chart titled "Federal Reserve Balance Sheet = $2.9 Trillion" appears in the Submissions for the Record on page 34.]

[Chart titled "Long Term Budget Outlook; Debt to GDP Ratio" appears in the Submissions for the Record on page 35.]

Vice Chairman Brady. And the chair yields to Senator DeMint for introduction of the panelists.

Senator DeMint. Okay. Thank you, Mr. Vice Chairman. It is my privilege to introduce our three distinguished witnesses to provide testimony on this matter of such enormous importance to the American people and to the future health of our economy.

Our first witness, Dr. Allan Meltzer, is currently a professor of political economy and public policy at the Carnegie Mellon University's Tepper School of Business in Pittsburgh, Pennsylvania. He has previously served as a member of the President's Economic Policy Advisory Board, an active member of the President's Council of Economic Advisers, and a consultant to the U.S. Treasury Department and the Board of Governors of the Federal Reserve System.

In 1999 and 2000, he served as the chairman of the International Finance Institution Advisory Commission, which was formed by Congress to review the role of the International Monetary Fund, the World Bank, and other world financial institutions. He is the author of numerous books on economic theory and policy, including a multivolume "History of the Federal Reserve."

Dr. Meltzer received his B.A. from Duke University and an M.A. and Ph.D. in economics from the University of California at Los Angeles.

Next, we will be hearing from Mr. Chris Edwards, who is currently the director of tax policy studies at the Cato Institute and editor of Cato's Web site, DownsizingGovernment.org.

Before he began his work at Cato, he was senior economist for the Joint Economic Committee, as well as an economist for the Tax Foundation from 1992 to 1994. He is also the author of "Downsizing the Federal Government" and co-author of "Global Tax Revolution."

Mr. Edwards holds a B.A. and an M.A. in economics.

Our final witness is Dr. Laurence Ball. Dr. Ball is a professor of economics at Johns Hopkins University. He previously taught at Princeton University and New York University. Dr. Ball has done extensive research and writing on a variety of economic topics, including the foundations of Keynesian economic models. He has done in-depth studies of inflation and monetary policy in both the United States and in high-inflation countries, with a specific focus on how best to reduce inflation and the economic cost of inflation.

Dr. Ball is currently a research associate at the National Bureau of Economic Research. He was previously a lecturer at the IMF Institute, a member of the Federal Reserve Board's Academy Advisory Panel, and a consultant on the International Monetary Fund's World Economic Outlook.

Dr. Ball holds a B.A. in economics from Amherst College and a Ph.D. in economics from Massachusetts Institute of Technology.

It is an honor to have all of you here today and to benefit from your expertise on this subject.

Vice Chairman Brady. The chair recognizes Dr. Meltzer.

STATEMENT OF DR. ALLAN H. MELTZER, THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY, PITTSBURGH, PA

Dr. Meltzer. Thank you, Mr. Chairman. Thank you, Vice Chairman Brady, Senator DeMint, members of the committee. It is a pleasure to appear before the Joint Economic Committee.

My association with this committee goes back to the days of Senator Paul Douglas. It was Senator Douglas who pushed and prodded the Federal Reserve to stop holding interest rates fixed and to permit monetary policy to do much more to prevent inflation. His views eventually prevailed. That should remind the Members of their responsibility.

Today I will answer the questions that the hearing seeks to answer. They are good questions that show the rising concern for the consequences of recent Federal Reserve actions. I will introduce my answers with my explanations of why Federal Reserve policy is misguided and mistaken, inflationary and inappropriate. There are several reasons; I will give three.

First, in writing the three volumes of "A History of the Federal Reserve," I read more minutes and transcripts than any person can endure. With very rare exceptions, notably in the years when Paul Volcker led the disinflation policy, one looks in vain for a statement of the medium-term consequences of the actions taken at the meeting. True, the staff and others provide forecasts of the future, but the FOMC never tries to reach agreement on the consequences of its actions for the public. It publishes forecasts, but there is no clear relation between the forecasts and the actions.

Second, concerns at FOMC meetings are mainly about the near term. The Federal Reserve has little influence over what will happen in the near term but much greater influence on the medium term. The present is characteristic. The Fed Chairman and some of the members seem determined to, quote, "do something," end quote, more about the excessive waste and the harm of high unemployment. They neglect the fact that there is no shortage of money and liquidity and that they have pushed and prodded market interest rates to the lowest levels ever achieved anywhere.

The United States does not have a problem of too little liquidity. There is not much that the Federal Reserve can do by adding reserves or lowering interest rates. The last time they tried it, $600 billion was added; $500 billion ended up in excess reserves. Don't the Chairman and several members understand that there are limits to what the Federal Reserve can do?

Banks hold more than $1.5 trillion of idle reserves. Money growth, M2, for the past 6 months is rising at an almost 15 percent annual rate. I attached a chart to my paper, or asked the staff to do that. Here is the chart, and it shows the enormous increase recently in the rate of increase in M2 growth. Inflation, as a result, has begun to rise. Prices are rising, and the U.S. dollar continues to sink.

The most useful action that the Federal Reserve could take would be announcement of an enforceable inflation target that would give confidence that we will not inflate.

Third, in 1977, Congress gave the Federal Reserve a dual mandate, interpreted as low unemployment and low inflation. It pursues these goals in an inefficient way by pursuing unemployment until inflation rises, shifting to inflation control until unemployment rises, and back and forth. That way, it achieves neither.

The "Great Inflation" of the 1970s is an extreme example. Both unemployment and inflation rose. The current Fed repeats that pattern. In contrast, policy from 1985 to 2003 more or less followed a rule that included both goals. That gave the public one of the very few years of low inflation and stable growth in the Fed's 100-year history.

In Article I, Section 8, our Constitution gives Congress ultimate control of money. It should legislate an enforceable inflation target. I will amplify "enforceable" if you wish.

Now, the three questions that the hearing has asked me to address.

First, given the fiscal policy of the industrial nations, will government debt crowd out private investment? My answer is "yes." Today's deficits and debt raise concerns about future tax rates. The prospect of higher future tax rates raises the rate of return that business investors expect to earn on new investment. And uncertainty about future tax rates and the persistent increase in regulation of health, labor, and energy, and finance has deterred investment and slowed recovery. Faced with heightened current uncertainty, many investors hold cash and wait. Cash is their friend.

Government budget and regulatory policies deter and crowd out investment. One of the most effective things that the Congress could do was to pass a moratorium on new regulation for the next 5 years, excepting national security.

Vice Chairman Brady. Dr. Meltzer, the 5-minute time limit has expired. Would you conclude your testimony? And we will have a chance during questioning to pursue further.

Dr. Meltzer. Yes.

Let me say only this about the tipping point. Why wait for a tipping point and a crisis?

We know that the debt is now a hundred percent, approximately a hundred percent, of GDP. That doesn't include the unfunded liabilities. It doesn't include Fannie Mae and Freddie Mac. It doesn't include a number of other things.

So there isn't a point that we can mark down and say, after this crisis occurs. We don't know when crises will occur. And the experience of Italy and Greece, especially, recently tell us that the market suddenly changes its mind without warning and without prior notification. So we shouldn't wait for that to happen. We should begin.

We have ample warning that we are on an unsustainable path. That unsustainable path—to respond to Congressman Cummings, is to say that we need to announce a plan that will reduce the deficit in a credible way, not beginning by taking everything off the table today, but announcing a plan which will put us on the path that we have to be on if we are going to restore the long-term growth rate of the United States with low inflation.

[The prepared statement of Dr. Allan H. Meltzer appears in the Submissions for the Record on page 36.]

Vice Chairman Brady. Thank you, Doctor.

And I should note that all of the testimony of the three witnesses will be submitted in full in the testimony.

The chair recognizes Mr. Edwards, 5 minutes.

STATEMENT OF MR. CHRIS EDWARDS, DIRECTOR OF TAX POLICY STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. Edwards. Thank you very much, Vice Chairman Brady and members of the committee.

Federal spending, as you know, has soared over the last decade. And looking ahead, the CBO projects that Federal spending will rise from 24 percent this year to 34 percent of the economy by 2035 unless we make some serious reforms. And as your chart showed, the Federal debt, according to the CBO, will explode to almost 200 percent of GDP by 2035 unless we make reforms.

Now, some people and economists think it is okay if America raises taxes and spending in coming years because they think we have a uniquely small government in this country, but that is really no longer the case. If you look at OECD data, total Federal/State/local spending in the United States now is 41 percent of GDP. That is only 4 percent less than the OECD average spending now of 45 percent of GDP. We used to have a 10-percentage-point-of-GDP advantage in terms of a smaller government, so that has shrunk now from 10 down to 4 percent. So, sadly, we are becoming just another sort of an average, bloated welfare state, which I think is really going to damage our economy.

And if you look at debt, I think one of your charts showed United States Federal debt, gross debt, at 101 percent of GDP now, higher than the OECD average of 78 percent of GDP. And if you look at growth and debt over the last 4 years, our debt has grown the sixth fastest out of the 31 OECD countries. So, you know, there are a lot of debt crises going on in Europe, but we are certainly getting up to that level of fiscal irresponsibility.

Without reforms, government spending may represent about half of GDP by 2035, which, in my view, would create a dismal future for young Americans, with fewer opportunities. I think, historically, our high standard of living has been based on a relatively smaller government, and it would be really sad to lose that.

In my view, there are three basic harms of all this—that all this deficit spending creates.

The first basic harm is that additional spending, in my view, sucks resources out of the more productive private-sector economy, puts it in the less productive government sector of the economy. Again, if the government in America is already spending 4 out of every 10 dollars, it seems to me that marginal spending in the government sector is going to have a lower negative return.

In a 2008 book, Texas A&M public finance professor Edgar Browning, he went through the whole Federal budget, looked at Federal spending, and he figures that the extent of Federal spending we do these days in the United States has lowered overall average incomes by about 25 percent. So we are above the tipping point or optimal level for the size of our government in terms of economic growth.

The second basic harm that all this deficit spending is doing, of course, is creating deficits, which are essentially deferred taxes that will pinch the economy down the road. Economists look to the distortions caused by the Tax Code as damaging the economy. This is called deadweight losses. When you raise taxes, you create more distortions in the economy, which reduces GDP.

And the third harm of all the deficit spending is the high debt itself, as we are seeing, is creating financial instability and economic uncertainty. And we can certainly see this in Europe. A number of economists now have written about how 90 percent seems to be sort of a tipping point for debt as a share of the economy, and, above that, economic growth starts to slow.

And here is what I think a lot of people are missing in this debate. When you look at those long-term CBO projections—I think you had some on your charts—that show the rising debt and rising spending, it looks bad enough, but it is actually worse than that, because in CBO's basic alternative fiscal scenario, their basic benchmark projection, they don't take into account the fact that the rising debt and spending suppresses GDP.

In a special analysis, the CBO looks every year at how that rising debt suppresses GDP, and it is pretty scary. It could well be, according to the CBO under some of its scenarios, that real U.S. incomes rise for the next decade or so but then they stagnate and then they start falling. This would be sort of a reversal of American history if American incomes actually started falling over the long term.

Last year, CBO compared Paul Ryan's roadmap, which sort of keeps spending at today's level, versus the sort of do-nothing alternative fiscal scenario. And they found, by the 2050s, U.S. average incomes would be 70 percent higher under the Paul Ryan roadmap plan than under the alternative fiscal scenario because of the build-up of debt.

Some fear, of course, that spending cuts in the short term would hurt the economy. I would only point out that, you know, we have had $5 trillion of deficit spending since 2008, the most enormous sort of Keynesian stimulus you can imagine, and yet we have the slowest recovery since World War II. So I don't think spending helps.

And I think if you look around the world at real-world examples—your staff has put out a useful study looking at Canada and Sweden and other countries that have cut their spending. Canada, for example, dramatically cut their spending in the mid-1990s, and it didn't depress the economy. Quite the reverse: The Canadian economy boomed for 15 years even as spending was cut pretty dramatically.

So, you know, I think Congress should turn its attention to major spending cuts as soon as we can. And, you know, at Cato we have all kinds of ideas for cutting every Federal Government department. I don't look at spending cuts as sort of painful medicine that we should fear; I think it would be a positive boom for economic growth.

Thank you very much.

[The prepared statement of Mr. Chris Edwards appears in the Submissions for the Record on page 39.]

Vice Chairman Brady. Thank you, Mr. Edwards.

The chair recognizes Dr. Ball for 5 minutes.

STATEMENT OF DR. LAURENCE BALL, PROFESSOR OF ECONOMICS, JOHNS HOPKINS UNIVERSITY, BALTIMORE, MD

Dr. Ball. Vice Chairman Brady and members of the committee, thank you for this opportunity to share my views on U.S. fiscal policy.

Other witnesses have emphasized the dangers of rising government debt, and I agree that reforms are needed to put debt on a sustainable path. I will focus, however, on a different side of the issue: the costs of controlling debt by cutting government budget deficits. And here, this will be largely elaborating on a point raised by Congressman Cummings. I will argue that cutting deficits reduces economic growth and raises unemployment in the short and medium run. These costs are especially large if deficit reduction is too hasty and occurs during an economic slump.

Now, opinions about the short-run effects of fiscal policy vary widely, as we all know. Most economics textbooks teach that a fiscal tightening slows the economy by reducing the demand for goods and services. Some economists disagree with this view, suggesting that tightening is expansionary because it boosts confidence in the economy.

Both sides of this debate have reasonable arguments. If we want to know who is right, we have to look at the evidence. And, in my view, the evidence is clear: Cuts in budget deficits have adverse effects that last for 5 years or more. If Congress cuts spending or raises taxes today, its actions will slow economic growth and raise unemployment until at least 2016.

Now, this conclusion is supported by numerous studies—admittedly, not all studies. I will focus on research performed over the past 2 years at the International Monetary Fund, work that many economists view as the best available evidence on the effects of deficit reduction. My written testimony describes this research in detail. In these remarks, I will summarize it briefly.

IMF researchers reviewed the history of 15 countries over the period from 1980 through 2009. They identify a total of 173 years in which governments reduced budget deficits through spending cuts, tax increases, or a combination of the two. The research finds that, on average, a deficit reduction of 1 percent of GDP raises the unemployment rate by four-tenths of percentage point after 2 years, and unemployment is still two-tenths of a point higher after 5 years. An important detail is that higher unemployment results mostly from higher long-term unemployment, meaning workers without jobs for 26 weeks or more.

Making matters worse, these average effects of deficit reduction are likely to understate the effects in today's U.S. economy. In a typical episode studied by the IMF, a country's central bank responds to fiscal tightening by reducing short-term interest rates, and this monetary easing dampens the rise in unemployment. Currently, the Federal Reserve cannot reduce rates because they are already near their lower bound of zero. In this situation, the evidence suggests that the costs of deficit reduction are about twice their normal size.

To better understand these findings, let's consider one hypothetical fiscal policy: a deficit reduction of 3 percent of GDP. I picked this number because the Congressional Budget Office forecasts deficits of about 3 percent of GDP from 2014 through 2020. With a 3 percent cut, deficits would fall to roughly zero.

How would this policy affect unemployment? The evidence says a deficit cut of 1 percent of GDP raises unemployment by about 0.8 percentage points when interest rates are near zero. This means the 3 percent cut in my example would raise unemployment by 2.4 percentage points. With a U.S. labor force of 150 million people, an additional 3.6 million Americans and their families would suffer the consequences of a lost job.

Let me mention another important finding of the IMF study. Recent political debates have focused on the choice between deficit reduction through cuts in government spending and through tax increases. This choice, of course, matters a lot to the beneficiaries of government spending and to people who pay taxes. In one way, however, this choice is not important. The IMF performed separate analyses of spending cuts and tax increases and finds that the adverse short-run effects on economic growth and unemployment are similar in the two cases if interest rates are near zero.

Now, the question, of course, is, can any policy rein in government debt without slowing the economy? And a possible answer is a fiscal consolidation in which spending cuts and tax increases are back-loaded in time. And, again, I think this is related to Congressman Cummings' idea of something which is more stimulative in the short run but gets debt under control in the long run.

Under such a policy, the government would commit to lower deficits in the future without sharply cutting the current deficit. Just as one example of how this might be done, one could imagine cost-saving changes in entitlement programs, such as a higher retirement age, that could be phased in over time.

With any luck, major spending cuts would occur only after the economy has recovered from its current slump. Deficit reduction will be less painful then, in part because interest rates will be above zero and the Federal Reserve could ease monetary policy.

And let me thank you again for your attention.

[The prepared statement of Dr. Laurence Ball appears in the Submissions for the Record on page 48.]

Vice Chairman Brady. Well, thank you all for your testimony today. And we will begin a round of questioning.

The question today, posited by Senator DeMint, is, what is the real debt limit for America? And the answer seems to be, it is dangerously near and not in our control. As Dr. Meltzer said, market perceptions and actions change quickly, and countries that act prudently ahead of the crisis are in a better position.

And my question to Mr. Edwards and Dr. Meltzer is, do you think there are some lawmakers in Washington in denial about the seriousness of our debt crisis? Because, temporarily, the costs of borrowing for this country are low, are being masked by outside—well, both inside and outside, the Fed's quantitative easing, lowering of interest rates, European crises which create a flight to safety, so our borrowing costs are temporarily lower.

Do you think that, once the true costs of America borrowing are revealed, that there could be a more serious action by some in Washington to get this debt crisis under control? Dr. Meltzer? Mr. Edwards?

Dr. Meltzer. I believe that steps that have been taken are preliminary steps—that is, to get $1.5 trillion or $1.2 trillion in reductions is just the beginning.

What we need to do is to give people confidence that their future is going to be bright. We don't do that by throwing a few dollars at them. We do that by giving them care that we are on a stable path, that we are going to go back to the future the way we knew the past.

And that means that when, unlike Mr. Ball, models like the IMF model leave out is the fact that if you move resources from low-productivity goods—you know, it may be very desirable for people to receive transfers from the government. I don't dispute that. But those have very low productivity use. If we transfer resources to higher-productivity use, we raise the future and their optimism. If we cut the deficit, we convince people that their tax rates are not going to be higher in the future.

The IMF model doesn't allow for that. It doesn't take into account the productivity change, and it doesn't take into account the beneficial effects of expected lower tax rates. Those are important conditions.

Let me close by comment by saying two things. If we look at the history of the postwar period, we find that there were three fiscal changes that really did enormous good. One was the Kennedy-Johnson tax cuts. Arthur Okun, who was the Chairman of the Council of Economic Advisers, said the most effective part of those tax cuts were the business tax cuts. They got the biggest bang for the buck.

The second big fiscal change that worked well were the Reagan tax cuts of the early 1980s and again in 1986. And the third policy that gave people confidence were the Clinton tax increases, which assured people that their future tax rates were not going to go up, that they had seen what they were going to have to pay and there wouldn't be any more.

That is important. Give people confidence. That is what the public desperately needs at the moment, confidence that the policies that the government puts out are going to be sustainable and productive.

Vice Chairman Brady. Thank you, Doctor.

Mr. Edwards.

Mr. Edwards. Yeah, I think your question goes to the right point, that because the United States is special, because we are a haven for international capital in a dangerous world, American policymakers have been able to get away with running giant deficits for far too long. I think if we were a smaller country like Australia, the crisis from our debt would have already happened.

I noticed in a story yesterday on Bloomberg, Italy has just been downgraded. And one of the things that I think it was S&P noted is that they have been downgraded partly because they have a dysfunctional political system. And that seems to be sort of what is going on in the United States.

Canada, again, to go back to the 1990s, hit the wall with their debt at 80 percent of GDP. Ours is up to 100 percent of GDP. So we have been skating along for so long, I think, partly because we are in this special situation. And Japan shows that you can run along sort of as a zombie economy for a decade or two with debt at 200 percent of GDP.

So, you know, the real damage, though, I think, you know, is ultimately the spending. We have to get the spending under control. And that has been the key to success in places like Canada and Sweden that have cut their deficits.

Vice Chairman Brady. Thank you. The point, I think, from both being: The key is to restore consumer and business confidence by getting our financial house in order with a credible way to shrink the size of government to restore that balance.

Mr. Cummings.

Representative Cummings. Thank you very much, Mr. Chairman.

Just adding on to what was just said by Mr. Brady, Dr. Meltzer, did I understand you correctly to say—when you talked about when President Clinton raised the taxes, you said—you didn't see that as a negative thing. You saw it, in a way, I think—now, correct me if I am wrong—as something that created a level of certainty. And you are saying that the certainty is more important than some other factors? Is that accurate?

Dr. Meltzer. Well, let me say, he also had the benefit of the end of the cold war.

Representative Cummings. We really want to hear this. Is your microphone on?

Dr. Meltzer. Sorry.

Representative Cummings. Yes, don't go silent on me.

Dr. Meltzer. He really had the benefit of the end of the cold war. So he was able to cut spending. And he was able to cut—he had Mr. Rubin there. Mr. Rubin, being a finance person from Wall Street, told him, don't run deficits. And he didn't run deficits, and he gave people confidence.

Now, does that mean that a tax increase now would do what a tax increase then did? I don't believe so.

Representative Cummings. Okay.

Well, let's pick up on that, Dr. Ball. In 1999, postwar, middle-class incomes peaked. And, by the way, during that Clinton era, we produced some 22 million jobs. Since 2000 they have steadily declined, notably notwithstanding the implementation of historically low tax rates due to the passage of the 2001 and 2003 Bush tax cuts. This reversal of growth has led some economists to describe the time period between 2000 through 2010 as "the lost decade" for America's middle class.

Therefore, I find particularly troubling your findings that the government-imposed austerity measures during economic downturns have lasting negative impacts on economic and employment levels and that the bulk of these negative effects falls on middle-class and working people. Specifically, I am concerned that, if the Select Committee on Deficit Reduction achieves the required $1.2 trillion in savings only through spending cuts, rather than through a balance of revenue and cuts, this could result in a lost lifetime for millions of Americans—for example, those who are 5 or 10 years away from retirement.

Dr. Ball, if throughout the last decade working Americans have watched their incomes stagnate or spiral downward and 25 million more Americans are unemployed or underemployed, are you concerned about the detrimental impact that the $1.2 trillion in cuts could have on America's workers and middle class? Particularly in the context of the recent report that in America we have now 46.2 million people living under the poverty level, meaning $22,000 for a family of four?

Dr. Ball. Absolutely, I am very concerned about that. There has been this stagnation of middle-class living standards that has a variety of causes. But there is no question that a harsh fiscal contraction right now would exacerbate that.

One thing I didn't have time to mention in my testimony was another research finding, is that if you look at how total income of the economy goes down when there is a cut in government spending, it is disproportionately labor income or wages as opposed to capital income. So there is every reason to think that there would be a shift in the income distribution away from workers, as well as a fall in total income.

And, as far as unemployment I don't think anybody really needs a lecture on how terrible a problem unemployment is. And there is a lot of research, but, again, it is also pretty obvious that losing your job is especially difficult, especially terrible during an economic downturn because then it takes a long time to find a new job. We have almost half the unemployed who are unemployed for 6 months or more. And I could go in to some of the social science research about the damage that does to families, health, divorce, children's performance in schools, but I am sure all of you understand that.

Representative Cummings. Let me ask you this. You know, we constantly hear, get rid of this regulation, get rid of that regulation. You know, I wonder, when we get rid of all these regulations, does that guarantee that jobs are going to be added? In other words, you make it easier for the employer—you take away safety measures, in many instances, from the public—easier to make more money, but is that a guarantee that we will then see jobs expand?

Dr. Ball. No, absolutely not. I mean, again, on any given regulation, there are a lot of pros and cons about the costs and benefits, but as a way of dealing with the current slump and 9 percent unemployment, that is really, honestly, a non-factor, because what we have is a classic shortfall of demand.

Normally when that happens, historically, the Federal Reserve has dealt with that by cutting interest rates and, if the economy doesn't recover, cutting interest rates some more. What is uniquely problematic about the current situation is that interest rates have hit zero, so the Fed has run out of ammunition, at least its usual kind of ammunition. And we need to somehow be creative and think about some other way to get firm spending on investment and to get consumers spending.

Representative Cummings. Thank you, Mr. Chairman.

Dr. Meltzer. Congressman Cummings, may I add to that? May I add to that?

Vice Chairman Brady. Briefly, Dr. Meltzer, yes.

Dr. Meltzer. Yes, briefly.

Cutting regulation and giving people assurance about future taxes does a great deal. What it does is, if you are a businessman and you want to invest, the first thing you do, you learn in business school, is go out and figure out what the expected rate of return is going to be. You can't do that, because every day or every week there are new regulations—for health care, for finance, for labor, also for environment—and the President is out campaigning for higher tax rates. So you don't know what you are going to face, and so you sit on a bundle of cash and wait.

We have never seen so much cash in the hands of banks and businesses as we do now. So we have to ask ourselves, why is that? And the answer is, because they are dreadfully uncertain and lack confidence about what the future is going to be. They don't know what that future is, and they can't estimate what the expected rate of return is.

If they invest, they create jobs. Most of the jobs that are created are created by firms that start up and in the first few years hire and expand.

Vice Chairman Brady. Thank you, Dr. Meltzer.

Senator DeMint.

Senator DeMint. Thank you, Mr. Chairman.

Dr. Ball, you have referenced an IMF study a number of times. Is it fair to assume that the study includes many nations with government workforces that are a larger percent than the U.S.?

Dr. Ball. Yes.

Senator DeMint. So, then, is a determination of when you are cutting government spending, that those nations would likely have a higher unemployment because of that, because that spending directly affects the government workforce?

Dr. Ball. I don't quite think that follows. The study is very careful in trying to measure, if we have a spending cut of a certain percentage of GDP, what are the average effects on output and unemployment.

Senator DeMint. What we have seen with our deficit spending over the last few years, generally it is maintaining government employees at the State levels—teachers, others. But it would just seem to me, if your hypothesis that deficit spending is good for the economy and cutting that spending would cause higher unemployment, that using a study where most of the nations have a greater percent of government workers as part of the workforce, it may not necessarily be accurate.

And do you not see the American economy, our free-market, capitalist system, as somewhat different than most of the other nations in the world?

Dr. Ball. Well, I mean, this study includes Canada. It includes a variety of most of the world's advanced countries.

Senator DeMint. Right.

Dr. Ball. And I think—I mean, that is an interesting thing—that they could follow up, looking at different types of economies. But I think we are talking here about fairly general principles of economics that I would think apply to Europe, to Australia, to the U.S.

Senator DeMint. Well, one of the challenges we have here is I think there are a lot of folks that want us to be more like European economies that are centrally planned. That is part of our different world views that we are dealing with right here.

But let me just—maybe a question to the whole group. And, Mr. Edwards and Dr. Meltzer, maybe I will go to you first on this. But we are clearly in uncharted territory right now.

Dr. Meltzer. Yes.

Senator DeMint. We can have different opinions about that. But the Federal Reserve interventions are unprecedented. Stimulus spending is at unprecedented levels. The bleak and unsustainable fiscal outlook that we are dealing with is unprecedented. The weak and almost nonexistent recovery, despite the incredible levels of stimulus spending, is unprecedented.

So how do these factors affect the nearness to the tipping point? And I know we can't determine exactly where that is. But I am wondering, where are we going to borrow the money from? We are projecting a trillion dollars a year, about, that we have to borrow or print. Where is that going to come from? And aren't we in such uncharted territories now that we need to do more than just sound an alarm, or am I just unnecessarily seeing a bleak situation?

And, Mr. Edwards, I will start with you.

And, Dr. Meltzer, I would like to get your opinion very quickly, too, if I could.

Mr. Edwards. Yeah, I mean, we don't know where the tipping point is, where the next financial crisis is. I mean, recent academic research by Rogoff, Reinhart, and others points out that different countries are hitting that sort of wall in different sorts of places.

As I mentioned, I mean, Japan's debt is 200 percent of GDP and has been for a couple decades. They are in a unique situation because most of their savings to finance that debt comes domestically. So we are not in that, you know, lucky camp. Half of our borrowing now comes from abroad. That is a real problem, as the CBO points out in their long-range projections. That means that, in the future, if we keep this up, we will be producing GDP but a bigger and bigger chunk of that GDP won't be going to Americans; it will be going to foreign creditors. So that is why our standard of living will be suppressed by this buildup of debt.

I must say that, you know, hitting the tipping point isn't—I mean, that is not the end of the story. Ireland hit the tipping point, but recent news reports are indicating that they have taken some very good policy actions, cutting spending, and they are on the brink of recovery. They are in a much different situation than Greece, even though both of those countries had these massive spikes in debt. Ireland has taken the right policy courses, and they are headed now in the right direction.

So, again, I don't think the biggest issue facing you is where the tipping point is. I think it is just, you know, stopping the bleeding as soon as we can.

Senator DeMint. Dr. Meltzer, quickly—I am almost out of time—just a comment?

Dr. Meltzer. Let me just say that Ireland did not have a large debt. It got a large debt because it assumed the debt of the banking system. It was a private debt. It assumed it as a public debt. That was a huge mistake that got Ireland into a problem.

Take the case of Italy, which is a good case for us to study because it went along for decades with low growth and high deficits over 100 percent. When it jointed the ECB, it hid some of its debt, but it was basically over 100 percent, instead of the 60 percent that was required. Suddenly, that same situation gave rise to a loss of confidence. That was the tipping point. Why didn't it occur 2 years, 5 years, 10 years earlier? I don't think anyone can answer that.

Senator DeMint. Thank you.

I yield back.

Vice Chairman Brady. Thank you, Senator.

Representative Mulvaney of South Carolina is recognized.

Representative Mulvaney. Thank you, Mr. Chairman.

Dr. Ball, I am going to take the unusual step of asking you some questions. I have learned not to get into a battle of wits when I am woefully underarmed. It has been a long time since I have taken economics, so I am going to ask a couple questions and try not to make too big of a fool of myself.

But let me ask you this question to start off. Do you believe that there is such a thing as a tipping point in the size of this debt?

Dr. Ball. Oh, absolutely. And I think probably all three of us agree there is a tipping point and we don't know where it is and it would be prudent not to find out. So by no means do I want to say that we shouldn't be very concerned about long-run sustainability.

Representative Mulvaney. And that is sort of where I was hoping we could get. I think one of the things that all three of you could agree on is that, if we get past that point, it would be actually much worse than the situation we find ourselves in today. Is that a fair statement?

Dr. Ball. Probably. I think, again, because the U.S. is special and this is unprecedented, when it would happen or how bad it would be—again, it is the kind of thing we don't want to learn about.

Representative Mulvaney. And that is one of my frustrations with the classical Keynesians is that they seem to lack, in my opinion, a long-term outlook. We are always looking quarter to quarter, we are looking year to year; there is no long term. And you remember what Dr. Keynes' comment was regarding the long term that we are all dead.

We have sat in this room this year with a board of experts regarding entitlements. And I am talking; there were two Republican witnesses, an independent witness, and a Democrat witness. And the window of opportunity that that broad group gave us to fix entitlements was someplace between 2 years for the most conservative and 5 years for the most progressive or liberal witnesses that we had.

And one of my concerns is that when I read your analysis, when I read your testimony, is that we lack any type of mid- to long-term outlook; that we are simply looking at the next quarter in an effort to try and boost the GDP.

You go to the end of your testimony, for example, you talk about why printing money, why expansionary policies might not have the same type of inflationary outcomes that we have seen or that many of us, including many of the members of this board, and I know Mr. Edwards and Dr. Meltzer fear, because you say that businesses generally do not monitor the Fed's balance sheet and they do not base their pricing decisions on changes in the monetary base.

I used to run a business. I can assure you that I didn't watch the Fed Reserve and I didn't watch expansionary policies. But what I did watch was my costs. And when my costs went up, I had to raise my prices. And I can assure you, while I wasn't watching the Fed, the brokers in food and fuel certainly were. And as my costs went up because of expansionary policies, I had no choice but to raise my prices or to go out of business.

You go back to the Weimar Republic. You saw a tremendous inflation—in fact, hyperinflation—without an overheated economy. It was driven entirely by the printing of money. There was high unemployment at that time. There was fairly low productivity. And what we had was—well, we had middling productivity but you had tremendous inflation.

One of the things that I fear when I look at your proposals is that we are underestimating the risk of inflation and hyperinflation. Take a minute and tell me why I can sleep at night and I shouldn't be too worried about that.

Dr. Ball. Well, first of all, on the fiscal issues, you talked about the long run and the short run. I think the quote about, "In the long run, we are all dead," is something that people are a little bit embarrassed about now, because the long run is important.

Again, I think there is a lot of agreement about the long-run dangers of the debt. It is just, we need to be realistic about if we are very aggressive right now at cutting the debt, there will be major costs in the——

Representative Mulvaney. If we believed that we were closer to the tipping point rather than further, if we believed that we were closer than you think that we may be—let's say that we are the 2 years, you are the 5 years—isn't it entirely rational for us to be taking the steps that we are proposing?

Dr. Ball. Well, I think at some level the right steps are obvious, and maybe everybody could even agree. It is addressing the looming—I mean, there is the CBO chart of the debt going off. That is because of primarily entitlement programs. So, in a perfect world, Congress would get together and have a friendly discussion and figure out some nice moderate compromise on how to fix entitlement programs, and that would solve the long-term problem without giving a big negative jolt to the economy today.

I mean, if we address the deficit just by willy-nilly spending cuts over the next decade, I mean, maybe—I am not going to say whether that is, overall, good or bad, but there are going to be—there is going to be higher unemployment. There are going to be costs. So we should be realistic about that.

Representative Mulvaney. You mentioned—very quickly, I have just a few seconds—you mentioned willy-nilly cuts. I agree with you that simply going in and cutting randomly might have a different output than coming in and cutting specifically. The Canada example is one that several of you have mentioned. And there, if you go back and you look at the history, it appears as if their cuts focused primarily on wealth-transfer programs and not on infrastructure.

Would you agree, sir, with the premise that cuts in wealth-transfer programs might have less of an impact on employment than cuts to infrastructure spending?

Dr. Ball. I think that is plausible because infrastructure spending has a substantial effect on employment.

Let me say very briefly on the inflation issue, that is something where maybe I do differ from others. I think the fears of inflation really are quite unwarranted, and that is a bogeyman that doesn't really—again, without a long economic debate, I think historically in the U.S. inflation pressures have taken off when the economy is overheated. Unemployment has been low, so workers push for higher wage increases. Firms are straining their capacities, so they have more of an incentive to raise their prices. An overheated economy is obviously the last thing we need to worry about right now.

Representative Mulvaney. Thank you, Doctor.

Thank you, Mr. Chairman. Sorry to go over my time.

Vice Chairman Brady. No. Thank you.

Mr. Campbell of California is recognized.

Representative Campbell. Thank you, Mr. Chairman.

The subject of this hearing is something I have been talking about for some years: the real debt limit; and I have been saying that, although we have had a lot of debates and disputes here in Congress over the statutory debt limit, that the statutory debt limit is an arbitrary number, and the real debt limit is when we reach what we are all today calling as the tipping point. But the pushback I get on that from some people—and I would like to ask Dr. Meltzer and Mr. Edwards to respond to this—is that people say, well, we are really a long ways from that.

Look at what is happening with Treasury debt today. Look at the 10-year Treasury dropping—I don't know where it is right now—right around 2—but dropping at some point below 1.9 or so forth. The auctions are going out. There is a tremendous appetite for Treasury debt. The interest rates on Treasury debt are dropping dramatically. And this is an indication that we are a long, long ways from that tipping point.

Would either or both of you like to respond to that?

Dr. Meltzer. First, I would say the size of the unfunded mandate, which is not included in most of the numbers we talk about—not in the 90 percent, not in the 100 percent—is six to seven times the size of the deficit, depending upon what interest rate you use to discount it back for the future. So that puts us at an enormous amount. It is just as the chart shows. Mr. Ball and I agree. It is the Medicare and Medicaid expenditure that is going to cause us the problems we have. Social Security is a minor but important part of the problem, but it pales in significance compared to Medicare and Medicaid.

So there are lots of things we can do, and there are a lot of things we can do to Medicare and Medicaid that don't require taking away promised benefits to people but changing them. For example—and just one of many examples—we have to ask: Why do we spend about 50 percent of the Medicare money on people who are within 6 months of dying? Now, they don't all die. So, for some, there is a benefit. But there is no copay attached to that. If we attached a copay and graduate it according to income, we would reduce a lot of——

Representative Campbell. Dr. Meltzer, just because of the time, how do you respond to those people that say, in spite of all this, that we have considerably more debt that we can run up and that the evidence of that is the appetite for and the low interest rate on Treasury bills?

Dr. Meltzer. The reason we have the low interest rate is because the Fed enforces it. If you want to look at where the pressure is coming from, look at the fact that the dollar has depreciated by about 15 percent against a weak currency like the Euro and by an even larger percent against a weak currency like the Japanese Yen, that the most recent inflation number was 3.8 percent—well above the Fed's target.

So I don't buy the argument that in a weak economy you don't get inflation. You gave the example of Germany. Spain at the moment has 20 percent unemployment. Prices are rising. Britain has a high unemployment rate. Prices are rising. So there are other sources other than the labor market to give you inflation. And we are going to get them.

Representative Campbell. Mr. Edwards.

Mr. Edwards. There are these gigantic negative risks out there that something big and bad is going to happen to the American economy. We don't know what it is. If you go back and look at the January, 2008, CBO projection, they didn't project a recession. They said, well, maybe a recession would happen. But they actually projected growth would be strengthening in coming years. So we are going to be surprised by the next big recession or negative factor.

If you look at CBO projections, I mean, there are no recessions in their 10-year outlook. But what if we have a gigantic recession a few years from now, another major recession? Tax revenues would plunge again, unemployment comp costs would soar, a lot of policymakers would want to do another giant stimulus, and we would be in this spiral downward of debt and poor economic growth.

So we have got to start planning now. The risk factors are all on the negative side. European countries have this horrible demographic problem—worse than ours. Their debt loads are going up. So the higher their debt loads become and the higher ours become, the more risk of an international sort of a contagion, the more we are all at sort of a tipping point. If Europe can go into another deep recession, it would cause a deep recession here. The risks are all on the ugly side.

Representative Campbell. In my last 15 seconds, do any of you want to comment on the thing the Fed is discussing to change the maturities of the debt that they hold?

Dr. Meltzer. It won't do much. They tried it back in the 1960s. They had a big experiment. It didn't work. That is, their own research at the Fed said it didn't work. Why? Well, think about it. If you suppress long-term rates and raise short-term rates, what do you think the market people are going to do? They are going to go the other way.

Representative Campbell. All right. My time is expired.

Vice Chairman Brady. Thank you.

The chair recognizes Dr. Burgess of Texas.

Representative Burgess. Dr. Meltzer, you referenced just a moment ago about the costs of Medicare for patients in the last months, even weeks, of life. I will just tell you, as somebody who practiced medicine for a number of years, the principal problem we have there is the lack of transparency on the part of the patient. They don't tell us when that last 2 weeks begins. So it makes it very, very difficult for us to balance our decisions.

Dr. Meltzer. Of course.

Representative Burgess. But along that line, you talk about the cost drivers contained within Medicare and Medicaid and you talked about perhaps changing things so that they don't take away future benefits. I will submit within the health care realm there is probably $1.3 trillion in immediate savings that will not take away future benefits, and that would be to delay the implementation of the Affordable Care Act, which nobody seems to seriously consider when they have deficit commissions or talk to the President. Is that something that this Congress should take under serious consideration?

Dr. Meltzer. Yes.

Representative Burgess. Thank you.

We also talked—and this is for any one of you—we talked a great deal about cash on the sidelines. I have talked to a number of my community bankers, not just in the August recess but going back this past year and a little bit longer. The community bankers tell me that they are hampered by the fact that they must keep their loan-to-deposit ratio under 80 percent or they will invite a visit from some type of bank examiner, and that visit may not be pleasant. So they take pains to not go that last—to not touch that last 20 percent as a consequence. They are not making money on that 20 percent of deposits. The community is deprived of the loans that those 20 percent of deposits could create.

Do any one of you have a sense that that is a bigger problem than what has been talked about before?

Dr. Ball. If I may comment, I think that is a problem. I think probably depressed lending by community banks is one factor holding back the recovery. And perhaps regulators could change their attitude a little bit or think of creative ways to encourage lending and perhaps help recapitalize community banks.

Representative Burgess. But we have kind of gone the other way in the past 18 to 24 months; and rather than making the regulations, perhaps clarifying them even, we have made them more obscure, as has been previously mentioned. We frighten people with what is the future regulatory environment that they are going to encounter.

Dr. Meltzer, is that one of the reasons this cash is staying on the sidelines?

Dr. Meltzer. That is one of the reasons. That is generally regulation. As Speaker Boehner said so well in his speech the other day, you can move your plant to China, but you can't move it to South Carolina. That sounds funny, but at the same time it really tells us a serious thing about what regulation does to the attitudes of businessmen.

Representative Burgess. And we are talking right now and the President is talking about raising taxes to create jobs, and yet this is the same White House that just this weekend said that Lockheed in Fort Worth can't sell F–16s to Taiwan.

Their National Labor Relations Board said you can't build Boeing aircraft in South Carolina, and American Airlines biggest jet purchase in the history of the country, probably, is buying non-Boeing products for perhaps the first time in their company's history.

American Airlines is buying non-American-produced jets.

Eight to 18 power plants are going to close in Texas on January 1 because the Cross-State Air Pollution Rule is going to be a significant detriment on jobs.

The Keystone Pipeline, argue the environmental effects one way or the other, but the White House simply will not make a decision, whether they say yes or no.

Drilling in the Arctic for Shell Oil, they just will not make a decision.

The problem, as I see it, is not that taxes are not high enough. It is that the White House is so risk averse, it is afraid to act.

Do any of you have an opinion about that?

Dr. Meltzer. I agree with that completely. You don't know what the future is going to be. Cash is your friend.

Mr. Edwards. Just a general sort of a comment. There has been so much focus in the last few years by policymakers in Washington on macroeconomics—a misguided focus in certain ways, in my view. Microeconomics is extremely important. If you go back, for example, and look at what Margaret Thatcher did after a decade of stagnation in the 1970s in Britain, sure she got the macroeconomics in order, but she did a heck of a lot of on the microeconomic side. Tax reform, deregulation, privatization, all those things, it is hard to quantify the impact on the economy. But there is no doubt that fast-growth economies, they are getting both the macro and microeconomics right.

Dr. Meltzer. I would like to second that. I worked with Mrs. Thatcher some of the time. She was a real leader. She was willing to make tough decisions.

Representative Burgess. Thank you, Mr. Chairman.

Vice Chairman Brady. Thank you.

We are going to undergo a second round of questioning by Mr. Cummings and Senator DeMint.

Mr. Cummings is recognized.

Representative Cummings. Dr. Ball, to what extent are our current deficits being driven by slow economic growth and what impact would more robust economic growth have on our ability to reduce the deficits and rein in the debt? And the proposals—the most recent jobs proposals that were presented by the President, I just wanted to know what your opinion of those might be and do you feel that they would be helpful, as many economists have projected?

Dr. Ball. I think there is absolutely no question that the main driving force behind the big run-up in the budget deficit is the economic slump. Somebody else referred to lower tax revenues, higher unemployment insurance. It is a very strong economic regularity that deficits go up in recession. So we have had a big recession. And that is the main thing.

The stimulus program added to the debt, but it was secondary just compared to the recession. And, absolutely, if we can find a way to restore robust growth, that is the best possible deficit reduction plan. Anything which retards growth is going to be somewhat self-defeating as far as the fiscal situation because of the effects of growth on the deficit.

As far as the President's jobs plan, I haven't studied it in detail. It seems like a step in the right direction.

It stills seems, frankly, we face a huge problem. Actually, whether it is the President's jobs plan or various deregulation or things the Fed can do, it is not clear that any of the measures we have are really sufficient, that we may have to either really try something more radical or accept that we are going to live with high unemployment for quite a while.

Dr. Meltzer. Mr. Cummings, that jobs plan costs $200,000 per job. My wife, who is not an economist, listened to that and said, why don't we pick the same people, give them $150,000, and we will be ahead of the game? We are not going to get out of this problem by spending $200,000 per job.

Representative Cummings. So, Dr. Meltzer, you are saying that you can't—one of the things that has always bothered me about all of this is you look at something like infrastructure, and in Maryland they say we have got a sinkhole developing every 8 minutes.

Let me finish, Dr. Meltzer. I see you shaking your head.

Dr. Meltzer. I agree with that.

Representative Cummings. Every 8 minutes. We have got bridges falling apart. I told some people the other day, you can erode from the inside. You can die from the inside. If you are not educating your people, if you are not innovative, you can't be competitive. So at what point—I mean, seems to me, you have got to spend carefully to get the economy going and get people moving—carefully—but at the same time you can't die in the process. Because by the time you get out of the mess, you don't have a country.

Dr. Meltzer. I agree, Mr. Cummings.

Representative Cummings. You agree with me?

Dr. Meltzer. I agree the infrastructure in the United States is bad. I live in Pittsburgh. I will match you bridge for bridge, and I will have a whole bunch left over. So, absolutely. But if you think that you are going to take carpenters and bricklayers and convert them into road builders and bridge builders overnight, you are kidding yourself. Building a bridge is a big job, and it requires people who are trained in steel.

The President says, well, just let's take some of the unemployed construction workers and make them road builders. Have you watched them build roads? They use heavy equipment. You have to learn how to drive that. That is not going to be a solution.

I agree. We have a long-term problem of infrastructure, and we are to do what we can about infrastructure. That is a constructive thing. We have waited way too long to do something about it.

Education. We really have tried with education. It is terribly important. The gap in incomes between the poor and the rich is driven mainly by the fact that technology has changed.

I was a corporate officer or director. If you didn't have an education, you couldn't read the computer that was beside your work station, you swept the floor. That is a loss of people. We need to do something about that. I wish I thought I knew what we needed to do.

Representative Cummings. Thank you very much.

Vice Chairman Brady. Thank you.

Senator DeMint is recognized.

Senator DeMint. Thank you, Mr. Chairman.

I want to thank Congressman Cummings and Dr. Ball for kind of presenting the alternative view today. Obviously, we have a big difference of opinion in Washington about what we need to do to fix the problem.

I, frankly, don't think I am looking at this through a political prism. I am thinking of it as a guy who was in business for many years. I consulted with a number of other businesses. So my political perspective is really not a political perspective. And what I am looking at today, by any measure from a business perspective, our Nation is bankrupt, if you look at the balance sheet. We have got a negative cash flow projected continuously, indefinitely. Most of our operating capital is borrowed money. Every new program we suggest has to be borrowed or printed.

So our fate is in the hands of our creditors. That is a worrisome situation. I don't know how we can get around that.

And the solution, if you use a business parallel, the 3 percent of Americans who make over $200,000 also happen to create most of our jobs and give the most to charity, provide 60 percent of all investment capital. They happen to be the ones making things happen. Taking more money from them and giving it to the people who are creating the debt does not seem to be making a lot of common sense.

So just like a business whose revenue is down and they decide the best way to get out of that is to raise their prices, that is what we are talking about doing here. Our business is down. Our revenue is down. So we want to raise the prices on who are effectively our customers, those who are creating the revenue for us. And that is a difficult thing to swallow when we know in economy—it may not be true in IMF economies, but we have got a economy where 3 percent of Americans are already paying over half of the taxes. They are the ones creating the jobs, providing the investment capital. Frankly, that is not going to solve our problem.

If you look at the data for the last 10 years, the increase in our deficit is mostly attributable to an increase in spending, and that includes a lot of discretionary spending.

Social Security has not contributed to our debt at all. In fact, if we hadn't borrowed $3.6 trillion from Social Security, we would be a whole lot more in debt than we are today.

So this is not all on the entitlements. This is on a belief of government that we need to direct the economy. And I think the difference of opinion here is that the government is the primary stimulator of the economy versus those of us who think the reason America was so exceptional and prosperous was that we were a bottom-up economy with millions of people starting businesses, innovating, being entrepreneurs. Those are the people we seem to want to attack right now. Of those who have income over $200,000, 40 percent of their income is small business income.

So I understand the need to balance revenue as well as spending cuts, but we can get new revenue by making the economy grow. Frankly, if you look at 20-year data, you can raise the taxes as much as you want, but the revenue is going to be about 20 percent of our GDP—excuse me—18 to 19 percent of our GDP over time.

So I appreciate all of our panelists helping us to talk through this. To me, this is a situation where, like all of you have said, let's not wait to find out. Because all this is going to take is China to say they are not going to lend us more money, to dump our debt at 80 cents on the dollar. And the faith that keeps us up—and that is what we do have to admit, that the only thing keeping our dollar up, keeping what economy we have going is faith and the fact that other economies are worse off than we are right now.

But thank you for helping us talk through this. Mr. Chairman, to you and your committee staff, I appreciate all the work you have done. I appreciate all the folks who have answered questions, and I hope we will follow up with some decisive action that will solve our problem.

Vice Chairman Brady. First, let me thank Senator DeMint for leading this hearing today and the members of the Joint Economic Committee, both parties, for engaging. I so much appreciate the insight and thoughts provided by our panelists as well.

To borrow from the President's current speech, it is clear the real debt limit is upon us now. We have to act credibly to reduce that debt—and now—and we need to get Washington out of the way of our recovery now.

With that, the meeting is adjourned.

[Whereupon, at 11:21 a.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

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PREPARED STATEMENT OF REPRESENTATIVE KEVIN BRADY, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

When the Joint Economic Committee must hold a hearing on what the real debt limit is, the American people know instinctively that their federal government is borrowing too much. One does not really want to contemplate the grave consequences if creditors were to lose faith in the federal government to repay its debts.

The United States supplies the world's primary reserve currency; has the world's largest economy; and is source of much of the world's technological progress and economic development. The federal government should never violate its real debt limit because the consequences of exceeding it would be calamitous not just for the United States but indeed the entire world.

Nevertheless, the JEC must hold this hearing because the question now is asked: What is the real debt limit? Amazingly there are some that do not believe the U.S. has a serious debt problem. Given the anemic recovery, these individuals argue that President Obama's deficit spending splurge should continue. "Don't worry because interest rates on Treasuries remain low, and the federal government can print more money to pay all its debts," they say.

I hope that today's hearing sheds light on the fallacy of this mindset and puts an end to it.

Keynesian theory tells us to ignore the level of federal debt and continue deficit spending until full employment has been achieved. Well, we simply cannot ignore the debt anymore.

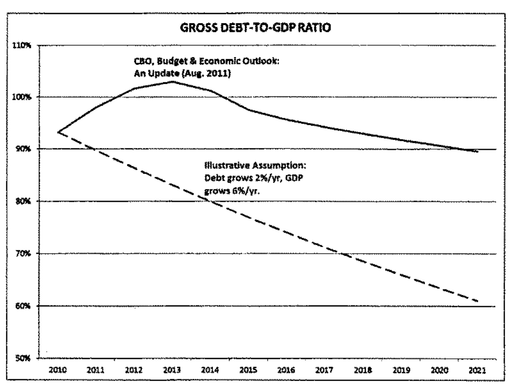
According to recent economic studies, when gross government debt relative to size of the economy exceeds a certain threshold, the economic growth and job creation slow dramatically. Economists Carmen Reinhart and Kenneth Rogoff put the threshold at 90%, while another study by economists at the Bank of International Settlements put it at 85%. The page in the Keynesian playbook on what policymakers should do when gross government debt exceeds this threshold and high unemployment persists is—blank.

Gross federal debt already exceeds 98% of GDP and is on course to exceed 100% next year according to the Congressional Budget Office (CBO). Now that we are staring at that empty page in the Keynesian playbook, we have to forge a new path.

The dynamics of rising federal debt relative to our economy are dangerous. The federal government must stay clear of the undertow of deteriorating economic performance, rising interest rates, and higher tax rates.

To begin, we must discard fiscal policies that have not been working. Economists John Taylor and Michael Boskin have detailed how the Obama "stimulus" and other federal spending were wasted on transfers that produced no lasting growth. We cannot afford another round of "stimulus" disguised as a "jobs" bill.

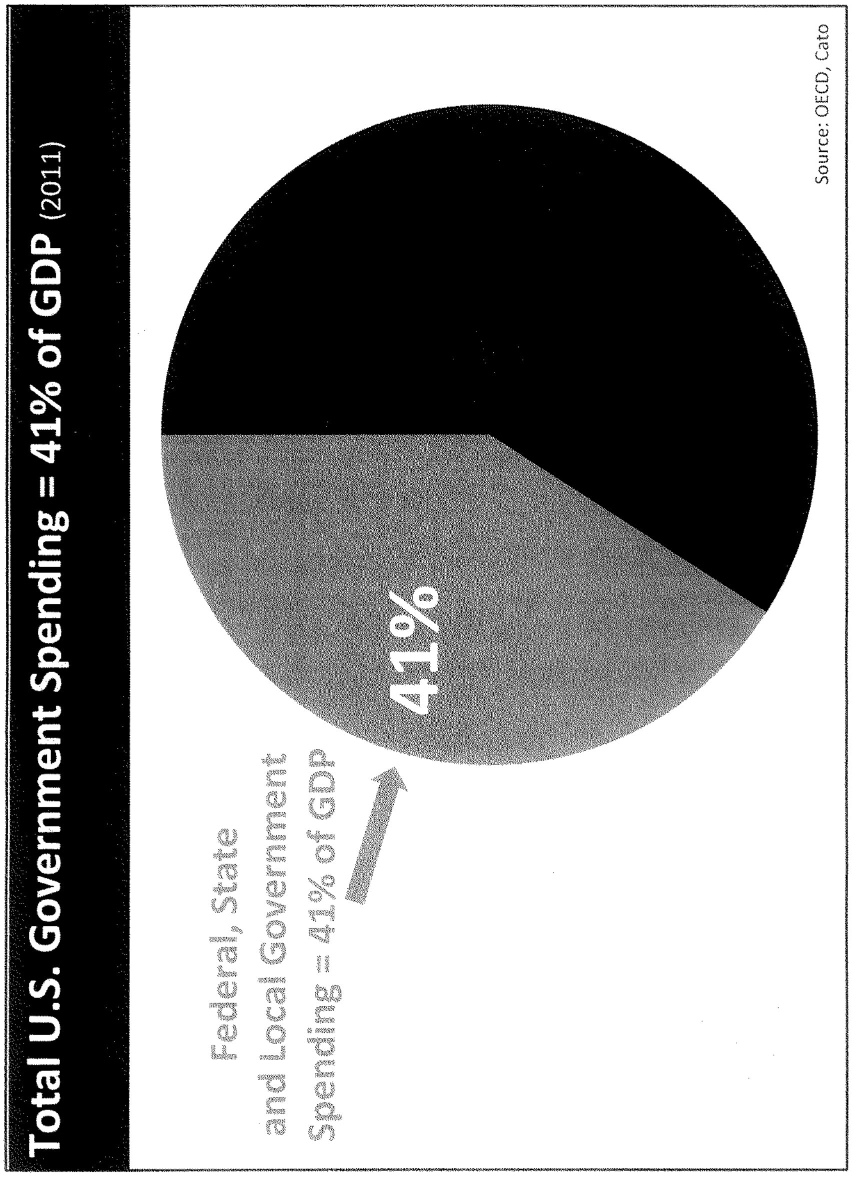
Growth is what we need. In the following chart, the top line shows the gross debt-to-GDP ratios for the next ten years, as implied by CBO's projections since the Budget Control Act was adopted. The average annual growth rate during the forecast period is 4.2% for gross debt and 4.6% for nominal gross domestic product (GDP)—just slightly higher. This is why the ratio of the two ends close to where it starts. The blue line shows the ratio if the debt grew only 2% while nominal GDP grew 6% per year.

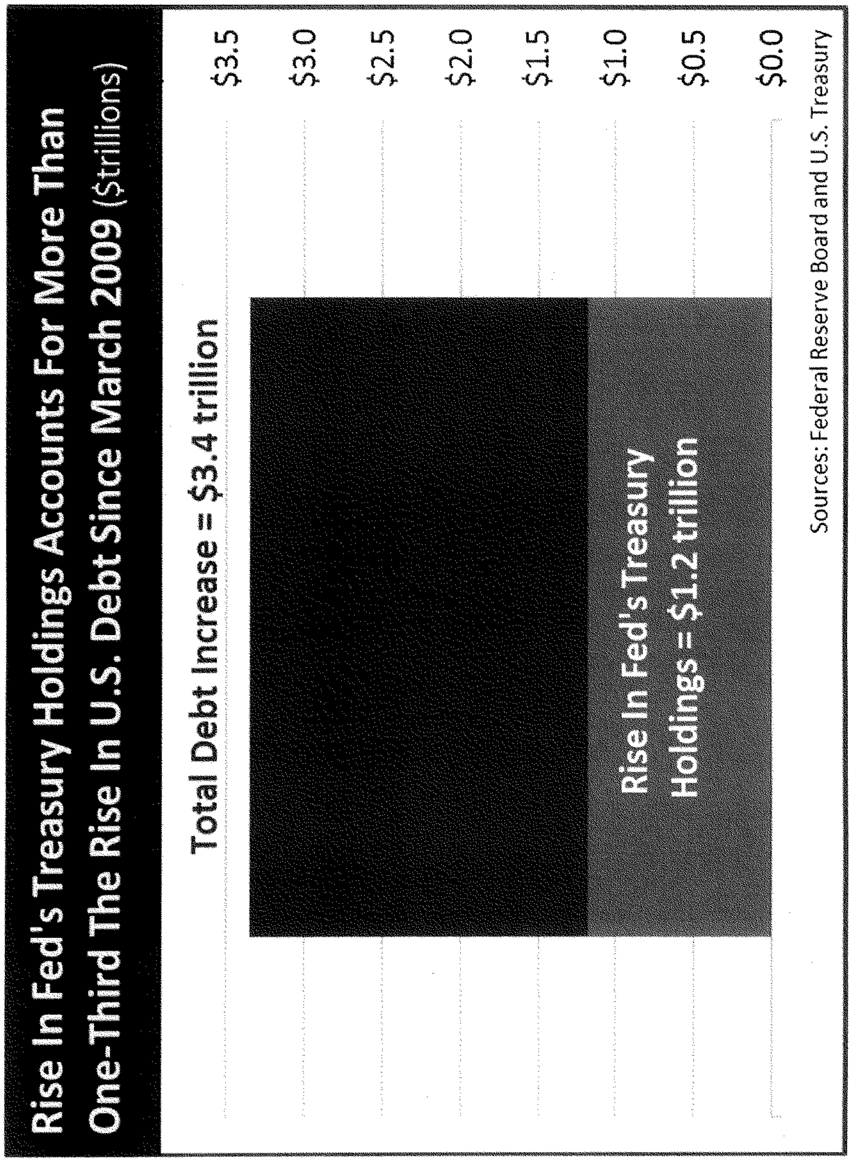


The U.S. economy must grow significantly faster than federal debt to move the ratio down from the dangerous levels around 90%. In the CBO's outlook for the Administration's budget, that fails to happen; the spread in trajectories of debt and economic growth is too small.

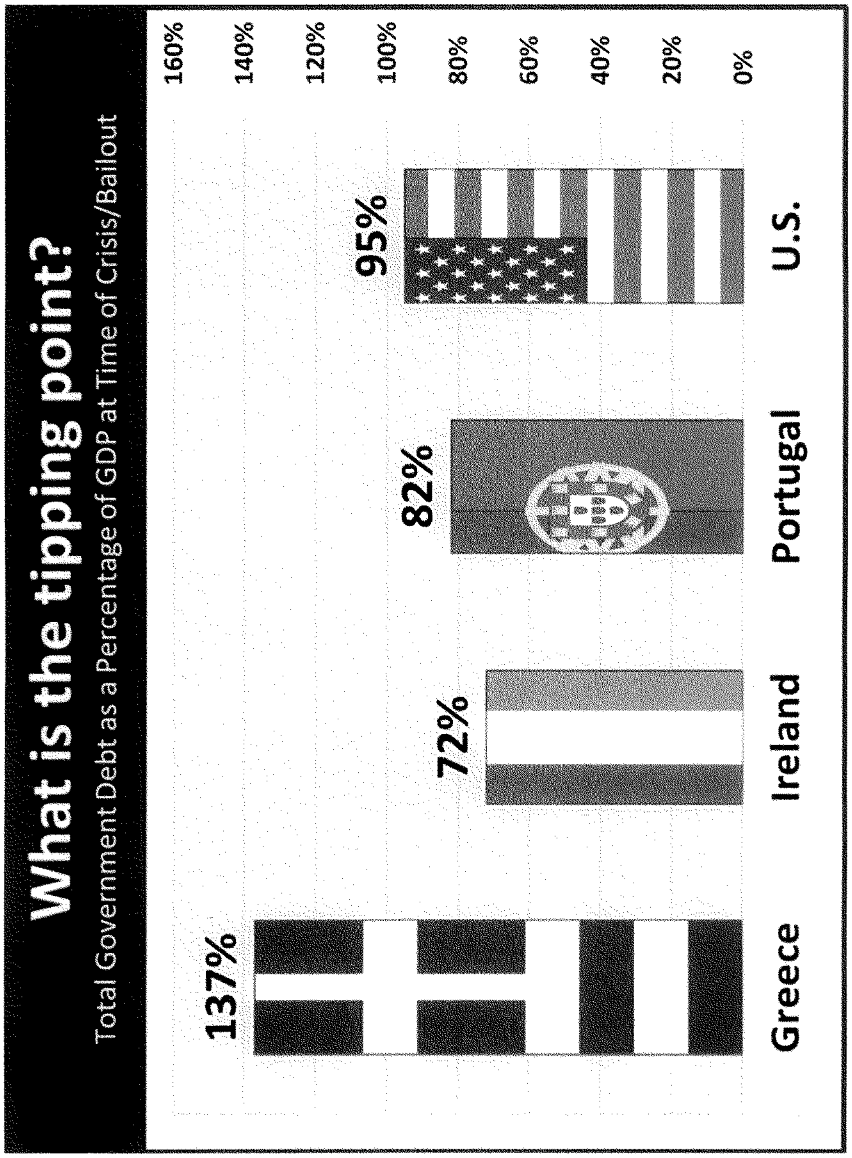
Viewed this way, it is obvious that the country's economic policies must change, and not only with regard to federal spending and borrowing. Myriad regulations that hamstring economic activity and discourage private investment must be reversed, and the anti-employer attitude must go.

We know that entrepreneurs, investors, and consumers on Main Street fear the consequences of the rising federal debt. The real debt limit is upon us. We must act credibly to contain federal debt and release the private economy so that it can grow as it has in the past and how it must grow again.


Total U.S. Government Spending = 41% of GDP (2011)
Federal, State and Local Government Spending = 41% of GDP
41%
Source: OECD, Cato



Rise In Fed's Treasury Holdings Accounts For More Than One-Third The Rise In U.S. Debt Since March 2009 ($trillions)
Total Debt Increase = $3.4 trillion
Rise In Fed's Treasury Holdings = $1.2 trillion
$3.5
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$0.0
Sources: Federal Reserve Board and U.S. Treasury



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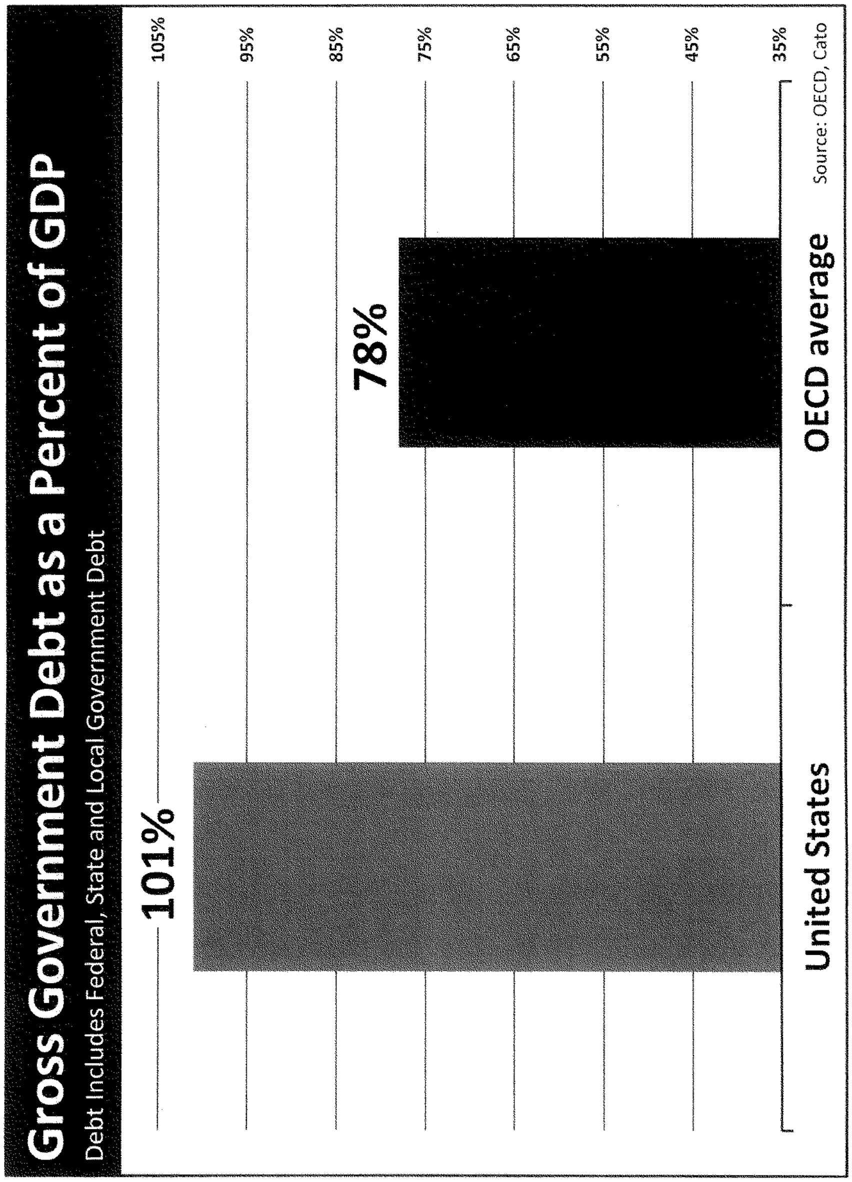

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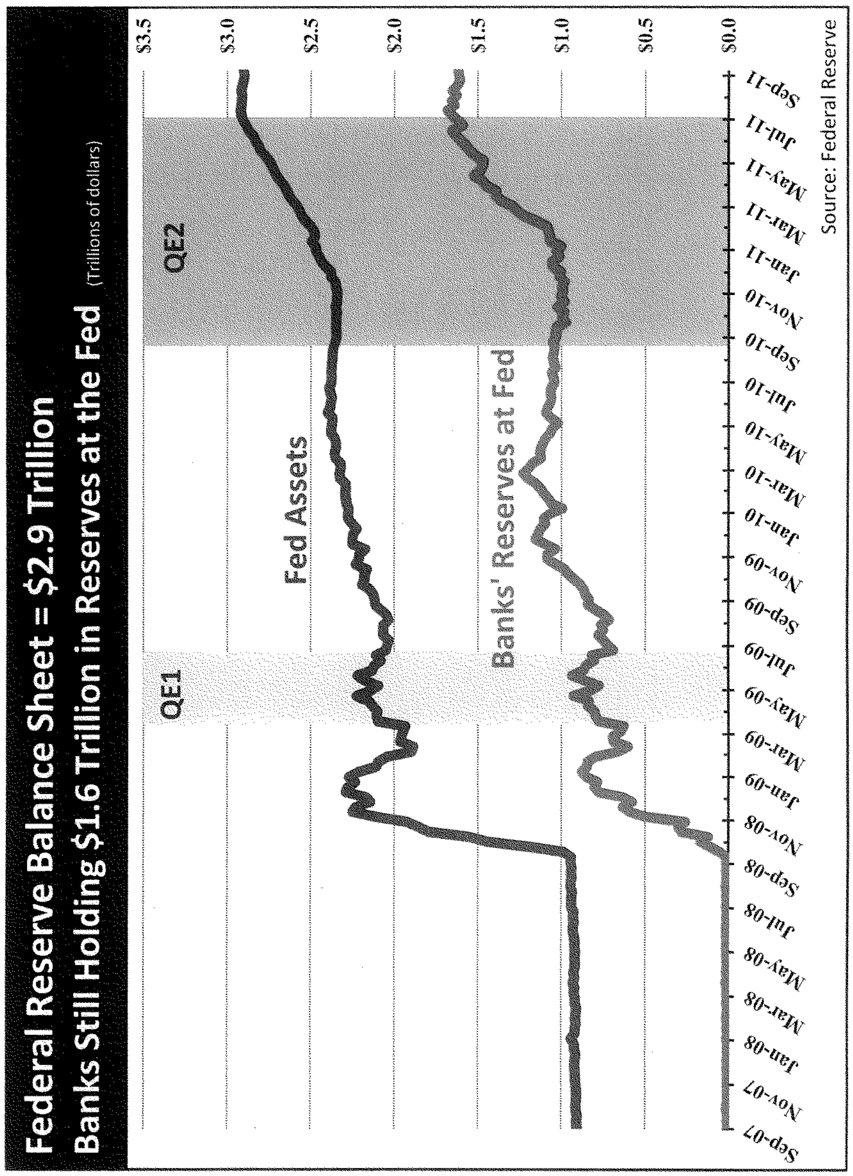
Federal Reserve Balance Sheet = $2.9 Trillion
Banks Still Holding $1.6 Trillion in Reserves at the Fed (Trillions of dollars)
QE1
QE2
Fed Assets
Banks' Reserves at Fed
$3.5
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$0.0
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Jan-10
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Sep-10
Nov-10
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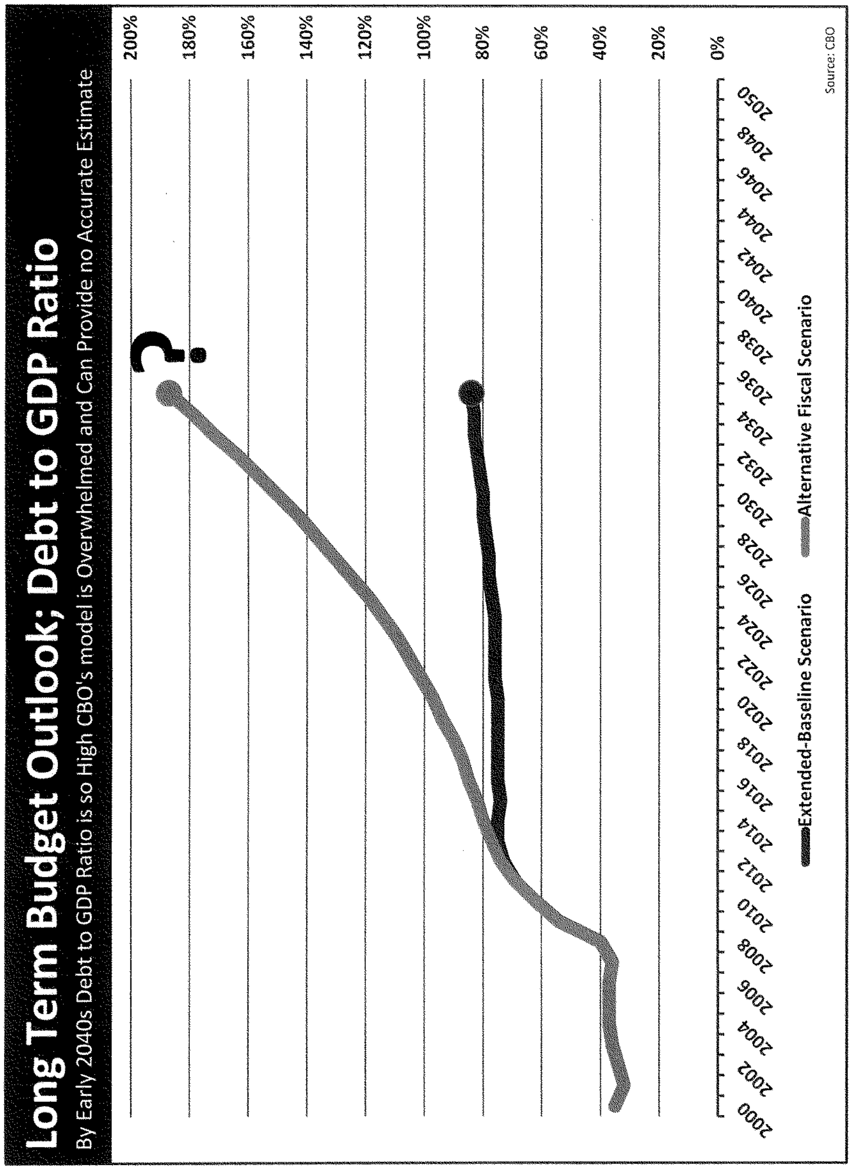
Mar-11
May-11
Jul-11
Sep-11
Source: Federal Reserve



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PREPARED STATEMENT OF DR. ALLAN H. MELTZER

Vice Chairman Brady, Senator DeMint, Members of the Committee.

It is a pleasure to appear again before the Joint Economic Committee. My association with this committee goes back to the days of Senator Paul Douglas. It was Sen. Douglas who pushed and prodded the Federal Reserve to stop holding interest rates fixed and permit monetary policy to do much more to prevent inflation. His views eventually prevailed. That should remind the members of their responsibility.

Today, I will answer the questions that this hearing topic seeks to address. The question of "what is the real debt limit" includes some good questions that show rising concern for the consequences of recent Federal Reserve actions. I will introduce my answers with my explanations of why Federal Reserve policy is misguided and mistaken, inflationary and inappropriate. There are several reasons. I will give three.

First, in writing the three volumes of "A History of the Federal Reserve," I read more minutes and transcripts than any person can endure. With very rare exceptions, notably in the years when Paul Volcker led the disinflation policy, one looks in vain for a statement of the medium-term consequences of the actions taken at the meeting. True, the staff and others provide forecasts of the future, but the FOMC never tries to reach agreement on the consequences of its actions for the public. It publishes forecasts but there is no clear relation between forecasts and actions.

Second, concerns at FOMC meetings are mainly about the near-term. The Federal Reserve has little influence over what will happen in the near-term but much greater influence on the medium-term. The present is characteristic. The Fed Chairman and some of the members seem determined to "do something" more about the excessive waste and harm of high unemployment. They neglect the fact that there is no shortage of money and liquidity and that they have pushed and prodded market interest rates to the lowest levels ever achieved. THE UNITED STATES DOES NOT HAVE A PROBLEM OF TOO LITTLE LIQUIDITY. THERE IS NOT MUCH THAT THE FEDERAL RESERVE CAN DO BY ADDING RESERVES OR LOWERING INTEREST RATES. Doesn't the Chairman and several members understand that there are limits to what the Federal Reserve can do? Banks hold more than $1.5 trillion of idle reserves. Money growth (M2) for the past 6 months is rising at almost 15 percent annual rate. (See chart.) Prices are rising and the U.S. dollar continues to sink. THE MOST USEFUL ACTION WOULD BE ANNOUNCEMENT OF AN ENFORCEABLE INFLATION TARGET TO GIVE CONFIDENCE THAT WE WILL NOT INFLATE.

Third, in 1977 Congress gave the Federal Reserve a dual mandate, interpreted as low unemployment and low inflation. It pursues those goals in an inefficient way by pursuing unemployment until inflation rises, shifting to inflation control until unemployment rises, and back and forth. That way, it achieves neither. The Great Inflation of the 1970s is an example. Both unemployment and inflation rose. The current Fed repeats that pattern. In contrast, policy from 1985 to 2003 more or less followed a rule that included both goals. That gave the public one of the very few years of low inflation and stable growth in the Fed's 100 year history. In Article 1, Section 8, our constitution gives Congress ultimate control of money. It should legislate an enforceable inflation target. I will amplify "enforceable" if you wish.

Now to the more specific questions of the real debt limit.

First, given the fiscal policy of the industrialized nations, will government debt crowd out private investment spending? My answer is yes. Today's deficits and debt raise concerns about future tax rates. The prospect of higher future tax rates raises the rate of return that business investors want to earn on new investment. And uncertainty about future tax rates and the persistent increase in regulation of health, labor, energy, and finance has deterred investment and slowed recovery. Faced with heightened, current uncertainty, many investors hold cash and wait. Cash is their friend. Government budget and regulatory policies deter, crowd out, investment.

Second, the original Federal Reserve Act prohibited loans to the Treasury. Early in its history the Federal Reserve circumvented the prohibition by buying Treasury bonds from the market after the Treasury sells them. This monetizes debt. With the exception of wartime, the Federal Reserve bought mainly very short-term Treasury bills. In the 1950s, it ran a "bills only" policy. Recently it has done what no central bank should do: It has implemented the government's fiscal policy by buying long-term Treasury bonds and $1 trillion worth of mortgage-backed securities. Ask them how they plan to sell mortgages in this mortgage market. The screams from home-builders would be heard all across the country. A straightforward way of saying the same thing is that THE FEDERAL RESERVE DOES NOT HAVE A CREDIBLE PROGRAM FOR SHRINKING ITS BALANCE SHEET.

If Treasury rates rise, the Federal Reserve portfolio will lose value. Until Dodd-Frank, 90 percent of the Fed's earnings became Treasury receipts, so the Treasury and the taxpayers bear the cost of the recent change. Dodd-Frank authorizes the new consumer agency to sequester Federal Reserve earnings without approval by the Congress or the Fed. I have been told that this off-budget finance is not unconstitutional. I continue to believe that the Congress should prohibit ALL off-budget finance. The constitutional provision that makes Congress responsible for spending should be strengthened.

The question regarding the implications of our enormous debt has several parts. Some ask for more precise answers than anyone can give correctly.

The "tipping point": Some authors say a ratio of 90 to 100 for government debt to gross domestic product (GDP) is a ceiling. Beyond the ceiling, interest rates rise suddenly because bond investors fear inflation, default, or sharply rising interest rates and losses in the value of bond holdings. We are there. Public debt is $14.7 trillion, and second quarter nominal GDP is $15 trillion. If we add, as we should, to the current U.S. government debt, the promises to pay obligations of Fannie Mae, Freddie Mac, the Federal financing bank and the unfunded liability for Medicare, Medicaid, and Social Security, the debt of the United States government passed the 90 percent ratio years ago. Currently, unfunded debt in the medical programs reaches $70 to $100 trillion, as much as 6 or 7 times the reported debt, depending on the rates used to discount future promises. The "full faith and credit of the United States" is stretched far above the ability to pay. Yet interest rates on government bonds are lower than they have ever been. There is no sign in current interest rates of the looming debt problem. Exchange rates tell a different story.

Why wait for a "tipping point" and a crisis? We have ample warning that we are on an unsustainable path. We don't know when a crisis will occur, and we should not wait to learn whether it does. PRUDENT POLICY ANTICIPATES CALAMATIES BEFORE THEY OCCUR. RESPONSIBLE POLICY MAKERS DON'T WAIT FOR CRISES.

Japan's outstanding public debt is at least double its GDP. Government debt for Italy and Belgium has long been above 100 percent of GDP. I do not know what unfunded liabilities may add to these sums. They suggest that we will not find a precise number like 90 percent of GDP to warn us of impending interest rate increases. But we also know from the recent experience of Greece and Italy that sudden changes in market perceptions occur. What was acceptable suddenly becomes unacceptable. This is a warning that prudent folks will heed.

Perhaps we should see a warning in the fact that our debt and deficits are unsustainable. Every knowledgeable observer recognizes that. Why wait for a market crisis to tell us what we already know?

At a time of considerable uncertainty about the future of currencies and economies, the large, open market for U.S. debt is a refuge for frightened investors. The Federal Reserve does not let interest rates increase, so holders think they are protected from losses caused by rising interest rates. Some hope for additional gains if the Fed lowers rates by making additional large-scale purchases. The result is that for the present holders are willing to accept negative real returns on their bonds. Negative real returns subtract the current inflation rate from the current market interest rate.

Japan's relatively large debt is almost entirely owned by Japanese citizens. Unlike our current citizens, Japanese save and put much of their saving into Japanese institutions that buy government debt. The nominal interest rate on long-term Japanese debt has remained between 1 and 2 percent for many years. Investors expect that pattern to continue, so there is no sign of an impending debt crisis. Japanese experience should not make us sanguine. We depend on the rest of the world to finance at least half our annual budget deficit. That's a risk for us but not for Japan.

Italy is instructive. The debt-to-GDP ratio remained above 100 percent for years. Italian savers bought a large part of the debt. As concerns about the future of the euro rose, Italian debt suddenly and unexpectedly rose in yield and fell in price. The European Central Bank made large purchases to reassure investors that there was a residual buyer. Uncertainty about what will happen in the future, not the distant future, remains.

German and French banks hold large amounts of Italian debt. They would like a government bailout, so they pressure governments. Meanwhile, they sell as much of the Greek, Italian, and Spanish debt as they can.

The sudden crisis affecting Greece and Italy teaches two things of value to us. One is market perceptions and actions can change quickly. The other is that prudent policy does not wait for the crisis. It acts before when many more options are available. It would be better to adopt Congressman Ryan's budget plan that leaves current and near-term health care beneficiaries unharmed than to wait for a crisis that forces much more immediate, drastic action and harms current recipients.

If rates spike up, without warning, we will be forced to make sharp, sudden changes in spending and tax rates. The alternatives are default and inflation. Default would harm the credit of the United States for years, even decades. It should be unthinkable.

Many now propose to ease the debt burden by raising the inflation rate to 5 or 6 percent. That would reduce the burden of long-term debt and mortgages, but it would raise interest rates for new debt issues and refunding. The average maturity of outstanding debt is between 3 and 4 years, so we would face higher interest rate expense very soon. I would like the proponents of a higher inflation target to tell us how they propose to bring the inflation rate down in the future. It is unlikely that we can reduce inflation without causing a new recession. People invest expecting inflation to continue. Farmers borrow to buy land. Home builders suffer a collapse when disinflation raises interest rates. Moreover inflation will not put much of a dent in the enormous unfunded liability for health care. And it cheats the principal holders of U.S. debt, especially China and Japan, with unforeseen consequences.

Recent unprecedented actions by the Federal Reserve solicit questions about limits to Federal Reserve monetary expansion. There are no legal restrictions. The only limit I know comes from the public. At some inflation rate, the public will demand less inflation. In 1979, inflation reached double digits. The public declared inflation to be the major economic problem. President Carter responded by appointing a known anti-inflationist, Paul Volcker. In his interview, Volcker told the president that he would reduce inflation. President Carter responded that was what he wanted. He had not taken effective action before, but he faced an election in which the public wanted lower inflation.

Increasing inflation until the public responds is not the right answer. One part of the right answer is to reach a long-term budget agreement that brings government spending below sustained GDP growth. That will be difficult but there is much waste in health care and other spending. I will expand a bit if you wish. The other part of the right answer is to rein in the unrestricted power of the Federal Reserve by imposing an inflation target.

And finally, what might be the consequences of adopting stabilizing policies? Ten years from now, we will export more and import relatively less. We will grow family incomes at about our long-term trend. Consumption will grow more slowly than in recent years because we must export more and import less to service the nearly $ 5 trillion of debt owed to foreigners. Foreigners will have to find a substitute for export-led growth because we can no longer be the importer of last resort. Of major importance for the future is the smaller role we will play in maintaining world peace. The United States cannot be the world's policeman. But political stability is vital. That's a big, separate set of issues that take us far afield.

The Damaging Rise in Federal Spending and Debt

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute,

before the Joint Economic Committee

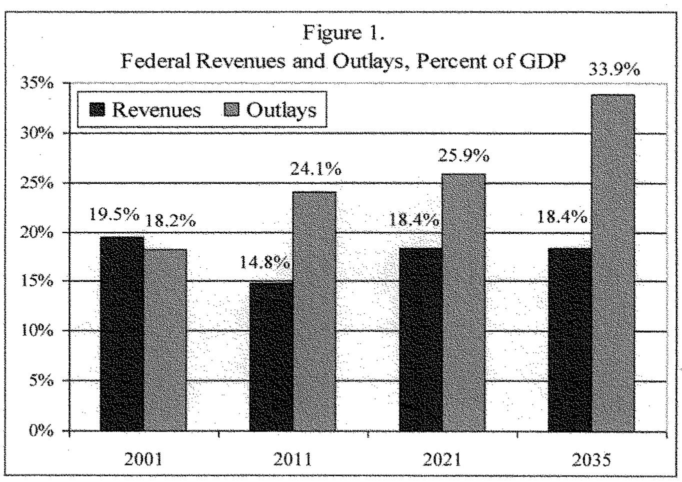
September 20, 2011

Mr. Chairman and members of the committee, thank you for inviting me to testify today. My comments will examine the likely damage to the economy if federal spending and debt keep spiraling upward.

Rising Spending and Debt

Federal spending and debt have soared over the past decade. As a share of gross domestic product, spending grew from 18 percent in 2001 to 24 percent in 2011, while federal debt held by the public jumped from 33 percent to 67 percent. The causes of this expansion include the costs of wars, growing entitlement programs, rising spending on discretionary programs, and the 2009 economic stimulus bill.

Projections from the Congressional Budget Office show that without reforms spending and debt will keep on rising for decades to come.[1] Under the CBO's "alternative fiscal scenario," spending will grow to about 34 percent of GDP by 2035, as shown in Figure 1, and federal debt held by the public will increase to at least 187 percent of GDP.



Hopefully, we will never reach anywhere near those levels of spending and debt. Going down that path would surely trigger major financial crises, as the ongoing debt problems in Europe illustrate. It is also very unlikely that Americans would support such a huge

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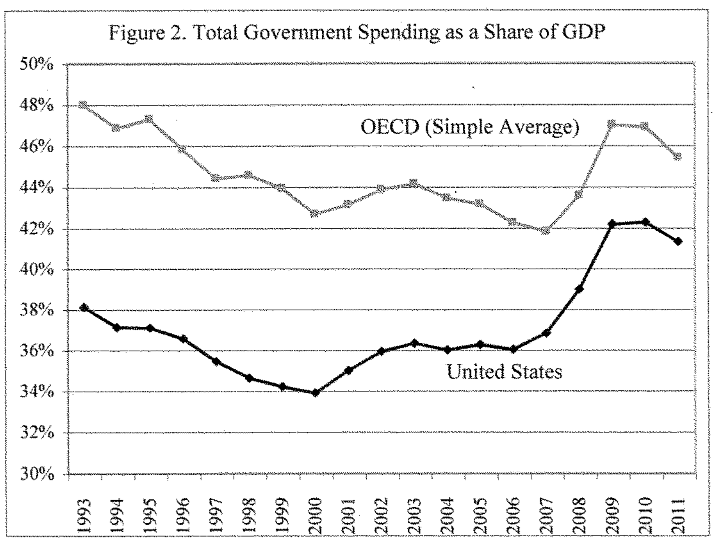
expansion of the government. The results of the 2010 elections suggest that the public has already started to revolt against excessive federal spending and debt.

Some policymakers are calling for a "balanced" package of spending cuts and tax increases to reduce federal deficits. But CBO projections show that the long-term debt problem is not a balanced one—it is caused by historic increases in spending, not shortages of revenues. Revenues have fallen in recent years due to the poor economy, but when growth returns, revenues are expected to rise to the normal level of about 18 percent of GDP—even with all current tax cuts in place. It is spending that is expected to far exceed normal levels in the future, and thus spending is behind the huge increases in debt that are projected.

America Has a High-Spending and High-Debt Government

Some analysts say that America can afford to increase taxes and spending because it is a uniquely small-government country. Alas, that is no longer the case. Data from the Organization for Economic Cooperation and Development (OECD) show that federal, state, and local government spending in the United States this year is a huge 41 percent of GDP.[2]

Figure 2 shows that government in the United States used to be about 10 percentage points of GDP smaller than the average government in the OECD. But that size advantage has fallen to just 4 percentage points. A few high-income nations—such as Australia—now have smaller governments and much lower government debt than the United States.



Source: OECD Economic Outlook Database, September 2011, Annex Table 25.

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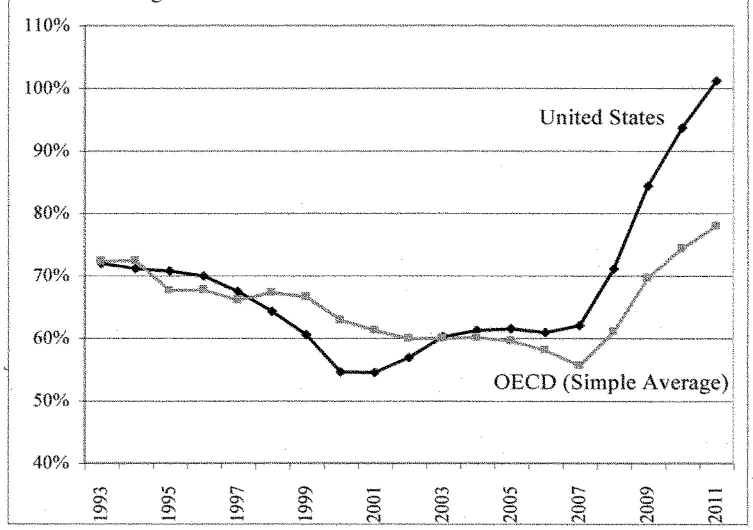
Historically, America's strong growth and high living standards were built on our relatively smaller government. The ongoing surge in federal spending is undoing this competitive advantage we had enjoyed in the world economy. CBO projections show that without reforms federal spending will rise by about 10 percentage points of GDP by 2035. If that happens, spending by American governments will be more than half of GDP by that year. That would doom young people to unbearable levels of taxation and a stagnant economy with fewer opportunities.

American government debt has also soared to abnormally high levels. Figure 3 shows OECD data for gross government debt as a share of GDP.[3] (The data include debt for federal, state, and local governments). In 2011, gross government debt is 101 percent of GDP in the United States, substantially above the OECD average of 78 percent.[4]

Figure 3. Gross Government Debt as a Share of GDP



Source: OECD Economic Outlook Database, September 2011, Annex Table 32.

Harmful Effects of Deficit Spending

Federal deficit spending has exploded. Even with the recent passage of the Budget Control Act, the deficit is still expected to about $1 trillion next year. The damage caused by this spending includes:

1. Transferring resources from higher-valued private activities to lower-valued government activities. With government spending already at 41 percent of GDP, new spending will likely have a negative return, which will reduce output.

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2. Creating pressure to increase taxes in the future, which would reduce growth. Higher taxes impose "deadweight losses" on the economy of at least $1 for every $2 of added revenues, as discussed below.
3. Increasing federal debt, which creates economic uncertainty and a higher risk of financial crises, as Europe's woes illustrate. Research indicates that economic growth tends to fall as debt rises above about 90 percent of GDP, as discussed below.

Economists in the Keynesian tradition dispute the first point. They believe that the demand-side "stimulus" benefits of spending are so important that they outweigh the problems of microeconomic distortions and misallocations caused by federal programs. However, it is very difficult to see any economic boost from the huge deficit spending of recent years.

The total Keynesian stimulus in recent years includes not only the 2009 stimulus package of more than $800 billion, but the total amount of federal deficit spending. We've had deficit spending of $459 billion in fiscal 2008, $1.4 trillion in fiscal 2009, $1.3 trillion in fiscal 2010, and $1.3 trillion in fiscal 2011. Despite that huge supposed stimulus, U.S. unemployment remains at high levels and the current recovery has been the slowest since World War II.[5]

The Obama administration claimed that there are large "multiplier" benefits of federal spending, but the recent spending spree seems to have mainly just suppressed private-sector activities.[6] Stanford University's John Taylor took a detailed look at GDP data over recent years, and he found little evidence of any benefits from the 2009 stimulus bill.[7] Any "sugar high" to the economy from spending increases was apparently small and short-lived. Harvard University's Robert Barro estimates that any small multiplier benefits that the stimulus bill may have had is greatly outweighed by the future damage caused by higher taxes and debt.[8]

John Taylor recently testified that deficit-spending stimulus actions "have not only been ineffective, they have lowered investment and consumption demand by increasing concerns about the federal debt, another financial crisis, threats of inflation or deflation, higher taxes, or simply more interventions. Most businesses have plenty of cash to invest and create jobs. They're sitting on it because of these concerns."[9]

As federal debt grows larger, the problems caused by fiscal uncertainty will get magnified. The CBO notes that "growing federal debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would . . . probably have a very significant negative impact on the country."[10]

Research by economists Kenneth Rogoff and Carmen Reinhart found that government debt burdens above 90 percent of GDP are associated with lower economic growth.[11] After examining data on dozens of countries, they concluded that "high debt is associated with slower growth; a relationship which is robust across advanced and emerging markets."[12] High debt can also be associated with inflation crises, "financial repression," and other problems. Furthermore, high public and private debt acts as a "contagion amplifier" in the globalized economy.

A new paper by economists at the Bank for International Settlements (BIS) similarly found that when government debt in OECD countries rises above a threshold of about 85 percent of GDP, economic growth is slower.[13] As debt rises, borrowers become increasingly sensitive to changes in interest rates and other shocks. "Higher nominal debt raises real volatility, increases financial fragility, and reduces average growth," the authors note.[14]

The BIS economists conclude that countries should build a "fiscal buffer" by keeping its debt well below the danger threshold. They note that without major reforms, debt-to-GDP levels will soar in coming decades in most advanced economies due to population aging. Thus, one more reason for the United States to cut its spending and debt is to help it weather future financial crises spilling over from countries that are in even worse shape than we are.

Baseline Projections Are Optimistic

In support of building a large "fiscal buffer," policymakers should recognize that both short-term and long-term CBO projections are optimistic in various ways. Perhaps the future will include some positive budget surprises, but the big risk factors seem to be on the negative side.

In CBO's baseline, federal deficits fall substantially over the coming decade, partly due to changes under the recent Budget Control Act. However, spending will be higher than projected if:

- Policymakers lift caps in the Budget Control Act.
- Policymakers launch new spending programs or respond to unforeseen crises or wars.
- Higher interest rates push up interest costs, which is a risk that gets magnified as federal debt grows larger.
- A major recession causes large cost increases in programs sensitive to economic cycles, such as unemployment insurance.
- Policymakers respond to another recession with costly new "stimulus" plans. The persistence of Keynesian policy ideas in Washington is an important risk to the outlook for federal debt.

There are likely to be negative shocks in coming years that we don't foresee. Consider that in its January 2008 budget outlook, CBO projected that U.S. economic growth would slow in 2008 but then rebound fairly strongly in subsequent years.[15] CBO discussed the risk of a recession, but didn't foresee the calamity that was already starting. The upshot is that policymakers should take a conservative approach and build a "fiscal buffer" with large spending cuts now before another recession causes the deficit to soar again.

CBO's long-range projections—such as the "alternative fiscal scenario" (AFS) shown in Figure 1—are also optimistic. In its basic projections, CBO does not factor in the negative effects of rising spending, debt, or taxes on GDP after 2021, but it does do that in a separate analysis.[16] If spending actually followed the course shown in Figure 1, CBO estimates that GDP in 2035 would be up to 10 percent less than shown in the AFS, and

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GNP would be up to 18 percent less. In turn, spending-to-GDP and debt-to-GDP ratios would be worse than usually shown in long-range budget charts.

Under the AFS, rising deficit spending could reduce American incomes. The CBO finds that real GNP per capita could stop growing in the late 2020s, and then start falling after that. In a historic reversal, future generations of Americans would become successively poorer.

The way to ensure our continued prosperity is to cut federal spending and reduce debt. In a 2010 analysis, the CBO compared the high-spending AFS with Rep. Paul Ryan's "Roadmap" plan.[17] The Ryan plan would restrain federal spending to roughly current levels for the next few decades, and then start reducing it. By the late 2020s, GNP per capita under the Ryan plan would begin rising above the flat and then falling levels under the AFS. By the late 2050s, GNP per capita would be 70 percent higher under the Ryan plan than under the AFS.[18]

Rising Spending Reduces Growth

Let's take a look at how federal spending damages the economy over the long-run. Federal spending is financed by extracting resources from current and future taxpayers. The resources consumed by the government cannot be used to produce goods in the private marketplace. For example, the engineers needed to build a $10 billion government high-speed rail project are taken away from building other products in the economy. The $10 billion rail project creates government-connected jobs, but it also kills $10 billion worth of private activities.

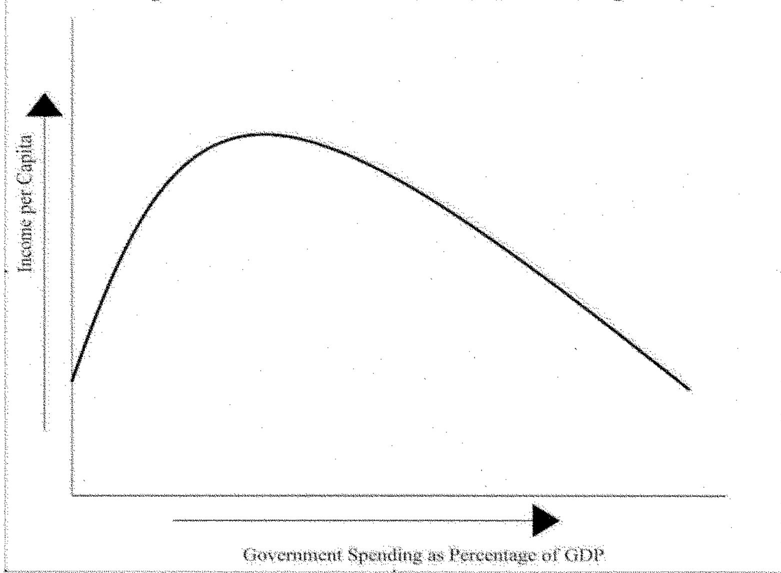
Indeed, the private sector would actually lose more than $10 billion in this example. That is because government spending and taxing creates "deadweight losses," which result from distortions to working, investment, and other activities. The CBO says that deadweight loss estimates "range from 20 cents to 60 cents over and above the revenue raised."[19] Harvard University's Martin Feldstein thinks that deadweight losses "may exceed one dollar per dollar of revenue raised, making the cost of incremental governmental spending more than two dollars for each dollar of government spending."[20] Thus, a $10 billion high-speed rail line would cost the private economy $20 billion or more.

The government uses a "leaky bucket" when it tries to help the economy. Stanford University's Michael Boskin, explains: "The cost to the economy of each additional tax dollar is about $1.40 to $1.50. Now that tax dollar ... is put into a bucket. Some of it leaks out in overhead, waste, and so on. In a well-managed program, the government may spend 80 or 90 cents of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar."[21] Texas A&M University's Edgar Browning comes to similar conclusions about the magnitude of the government's leaky bucket: "It costs taxpayers $3 to provide a benefit worth $1 to recipients."[22]

The larger the government grows, the leakier the bucket becomes. On the revenue side, tax distortions rise rapidly as marginal tax rates rise.[23] On the spending side, funding is allocated to activities with ever lower returns as the government expands. Figure 4 illustrates the consequences of the leaky bucket. On the left-hand side, tax rates are low and the government delivers useful public goods such as crime reduction. Those activities create high returns, so per-capita income initially rises as the government grows.

As the government expands further, it engages in less productive activities. The marginal return from government spending falls and then turns negative. On the right-hand side of the figure, average income falls as the government expands. Government in the United States—at 41 percent of GDP—is almost certainly on the right-hand side of this figure. In a 2008 book on federal fiscal policy, Professor Browning concludes that today's welfare state reduces GDP—or average U.S. incomes—by about 25 percent.[24] That would place us substantially to the right in Figure 4, and it suggests that major federal spending cuts would boost incomes over time.

Figure 4. The Size of the Government and Average Incomes



Conclusions

Federal spending is soaring, and government debt is piling up at more than a trillion dollars a year. Official projections show rivers of red ink for years to come unless policymakers enact major budget reforms. Unless spending and deficits are cut, the United States is headed for economic ruin as growth falls and rising debt threatens further financial crises.

Policymakers should turn their full attention to long-run spending reforms. They should begin terminating the many unneeded and damaging federal programs that draw resources out of the private sector and sap the economy's strength. The essays on Cato's website www.DownsizingGovernment.org describe many federal programs that produce low or

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negative returns. Programs often create economic distortions, damage the environment, restrict individual freedom, or have high levels of fraud and abuse.

I've proposed a plan to cut spending on entitlements, defense, and discretionary spending over 10 years to balance the budget.[25] Spending reforms should aim to revive constitutional federalism and reverse the expansion of the federal government into areas better left to state and local governments, businesses, charities, and individuals.

Some analysts worry that spending cuts would hurt the economy, but other high-income nations have cut spending with very positive results. In the mid-1990s, for example, Canada faced a debt crisis caused by runaway spending—similar to our current situation. But the Canadian government changed course and slashed total spending 10 percent in just two years—which would be like us chopping annual spending by $360 billion in two years.[26] Total government spending in Canada was cut by more than 10 percentage points of GDP over a decade. The Canadian economy did not sink into a recession as Keynesian economists might fear, but instead was launched on a 15-year economic boom.

A recent Joint Economic Committee report summarizes other international examples of spending cuts coinciding with strong economic growth.[27] Thus, spending cuts should not be viewed as bad tasting medicine needed only to cure our debt disease, but as an opportunity to create positive and lasting benefits to the economy and society.

Thank you for holding these important hearings.

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[1] Congressional Budget Office, "Long-Term Budget Outlook," June 2011.
[2] Organization for Economic Cooperation and Development, "Economic Outlook Database," September 2011, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls.
[3] Organization for Economic Cooperation and Development, "Economic Outlook Database," September 2011, Annex Table 32.
[4] This is a simple average of OECD countries. The OECD publishes a weighted average, but that figure is, of course, heavily influenced by the United States.
[5] See Joint Economic Committee, "Uncharted Depths: Welcome to Barack Obama's 'Recover Bummer,'" Republican Staff, June 23, 2011. And see the comments of economists Robert Gordon and Robert Hall at www.cato-at-liberty.org/biggest-keynesian-stimulus-slowest-recovery.
[6] See Robert J. Barro, "Government Spending Is No Free Lunch," *Wall Street Journal*, January 22, 2009; John F. Cogan and John B. Taylor, "The Obama Stimulus Impact? Zero," *Wall Street Journal*, December 9, 2010; John H. Cochrane, "Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies," University of Chicago Booth School of Business, February 27, 2009.

[7] John Taylor, Testimony to the House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, February 16, 2011.
[8] Robert J. Barro, "The Stimulus Evidence One Year Later," *Wall Street Journal*, February 23, 2010.
[9] John Taylor, Testimony to the Senate Finance Committee, Subcommittee on Fiscal Responsibility and Economic Growth, September 13, 2011.
[10] Congressional Budget Office, "Long-Term Budget Outlook," June 2011, p. 22.
[11] The authors summarize their findings in Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt," National Bureau of Economic Research, Working Paper 16827, February 2011.
[12] Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt," National Bureau of Economic Research, Working Paper 16827, February 2011, p. 5.
[13] Stephen Cecchetti, M.S. Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bureau for International Settlements, September 2011.
[14] Stephen Cecchetti, M.S. Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bureau for International Settlements, September 2011, p. 4.
[15] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," January 2008, Chapter 2.
[16] See Chapter 2 in Congressional Budget Office, "Long-Term Budget Outlook," June 2011.
[17] Congressional Budget Office, Douglas Elmendorf letter to Paul Ryan, January 27, 2010, www.cbo.gov/ftpdocs/108xx/doc10851/01-27-Ryan-Roadmap-Letter.pdf.
[18] Congressional Budget Office, Douglas Elmendorf letter to Paul Ryan, January 27, 2010, p. 16.
[19] Congressional Budget Office, "Budget Options," February 2001, p. 381.
[20] Martin Feldstein, "How Big Should Government Be?" *National Tax Journal*, vol. 50, no. 2, June 1997, pp. 197-213.
[21] Michael Boskin, "A Framework for the Tax Reform Debate," in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.
[22] Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 179.
[23] Deadweight losses rise more than proportionally as tax rates rise.
[24] See Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 188.
[25] www.DownsizingGovernment.org/balanced-budget-plan.
[26] See www.cato-at-liberty.org/cutting-government-the-canadian-way and see www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
[27] Joint Economic Committee, "Spend Less, Owe Less, Grow the Economy," Republican Staff, March 15, 2011.

PREPARED STATEMENT OF DR. LAURENCE BALL

Chairman Casey, Vice Chairman Brady, and members of the Committee,

I am grateful for the opportunity to discuss the challenges to the U.S. economy posed by the combination of rising government debt and high unemployment. I will also comment briefly on current Federal Reserve policy, which your committee is also considering.

THE COSTS OF FISCAL CONSOLIDATION

Indisputably, Congress must address the problem of rising debt to prevent a fiscal crisis that could gravely damage the economy. How to solve this problem is a complex issue. We need policies that will keep debt on a sustainable path while providing essential government services and minimizing the economic distortions caused by taxation. I will not analyze all these issues or presume to say what fiscal policies Congress should adopt. Instead, I will focus on a more narrow question: What are the short- and medium-run impacts of fiscal consolidation—of cuts in government spending or tax increases—on economic growth and unemployment? Congress must understand these effects to choose the best response to rising government debt.

Opinions about the effects of fiscal policy vary widely. Most economics textbooks teach that a fiscal consolidation slows the economy in the short run. Higher taxes or lower government spending reduce the demand for goods and services, reducing growth and increasing unemployment. Yet some economists and policymakers disagree with this view, suggesting that fiscal consolidations are expansionary. One view is that lower budget deficits strengthen confidence in the economy, leading to higher consumption spending and more investment by firms.

Both sides of this debate present logical and plausible arguments. If we want to know who is right, we have to look at the evidence. Fortunately, history provides numerous examples of fiscal consolidations that we can study. And in my reading of the evidence, the verdict of history is clear: fiscal consolidations slow the economy, with adverse effects that last for five years or more. That is, if Congress cuts spending or raises taxes today, the consequences will include slower economic growth and higher unemployment than we would otherwise expect until at least 2016.

Numerous studies (admittedly, not all studies) support the conclusion that fiscal consolidations are contractionary. I will focus, however, on several studies performed over the past two years in the Research Department of the International Monetary Fund. In my view, this work provides the best available evidence on the effects of fiscal consolidation, because of the wealth of data that it examines and its straightforward and compelling methodology. In addition, the expertise of the IMF's staff and its history of promoting responsible fiscal policy lend credibility to its analysis. (I should note that I am a part-time visiting scholar at the IMF, but not a lead researcher in its work on fiscal policy.)

The basis of the IMF research is a painstaking review of history in 15 countries over the period from 1980 through 2009. Based on records of fiscal policy decisions, the researchers have identified a total of 173 years in which governments adopted policies to reduce budget deficits—either spending cuts, tax increases, or a combination of the two.

Having identified fiscal consolidations, the IMF researchers measure the effects with very simple statistical techniques. They ask whether economic growth and unemployment were higher or lower after consolidations than one would expect based on their normal behavior. The central conclusions concern the average effects of consolidation across the 173 episodes. It is essential to average over many episodes to eliminate the influences of factors besides fiscal policy that may affect the economy in any one case.

How does a fiscal consolidation affect growth and unemployment? The IMF research finds that a consolidation that reduces the budget deficit by one percent of GDP reduces future GDP by 0.6 percent after two years. The effect then diminishes, but GDP is still 0.4 percent lower after five years. The consolidation raises the unemployment rate by 0.4 percentage points after two years and 0.2 points after five years.

The research also finds that the effects of fiscal consolidations vary with economic circumstances. In particular, the average effects I have just cited are likely to understate the contractionary effects of consolidation in today's U.S. economy. In a typical episode in the IMF data set, a country's central bank responds to fiscal consolidation by reducing short-term interest rates, and this monetary easing dampens the effects of the consolidation. In the United States today, the Federal Reserve cannot reduce interest rates because short-term rates are already near their lower bound of zero. According to the IMF study, the effects of fiscal consolidation are about twice their normal sizes if interest rates are near the zero bound. This doubling means that a consolidation of one percent of GDP reduces GDP by 1.2 percent after two years and raises unemployment by 0.8 percentage points.

What do these numbers mean? To understand them better, let's focus on unemployment effects and consider one hypothetical fiscal consolidation. The Congressional Budget Office forecasts that the budget deficit will be about 3% of GDP in 2014 and stay near that level through 2020. Suppose that Congress chooses to eliminate this 3% deficit: it cuts spending and/or raises taxes by a total of 3% of GDP, so the deficit settles near zero. What will happen to unemployment?

As I have discussed, the IMF research suggests that a consolidation of one percent of GDP under current circumstances raises unemployment by 0.8 percentage points after two years. This implies that the 3% consolidation in our example would raise unemployment by 2.4 percentage points. With a U.S. labor force of 150 million people, an additional 3.6 million Americans and their families would suffer the consequences of a lost job.

Let me mention another important finding of the IMF study. Recent debates about U.S. fiscal policy have focused on the choice between deficit reduction through cuts in government spending and through tax increases. This choice matters greatly to the beneficiaries of government spending and to taxpayers. In one way, however, the choice is not important. The IMF researchers perform separate analyses of spending cuts and tax increases and find that the adverse effects on economic growth and unemployment are similar (at least in the case when interest rates are near zero).

Is there any way to control government debt without harming the economy in the short run? The IMF's findings suggest a type of policy that could achieve this goal: a fiscal consolidation in which spending cuts and tax increases are backloaded in time. Under such a policy, the government commits to lower deficits in the future without sharply cutting the current deficit. An example is a cost-saving change in entitlement programs, such as an increase in the retirement age, that is phased in over time. Such a policy could put government debt on a sustainable path without raising unemployment sharply. By the time major spending cuts occur, we can hope the economy has recovered from its current slump and unemployment is lower. Spending cuts would be less painful at that point than they would be now. One reason is that interest rates would be above zero, allowing a monetary easing.

WILL INFLATION RISE?

I have mentioned the fact that the Federal Reserve is holding short-term interest rates near zero—a highly unusual policy by historical standards. The Fed has also purchased large quantities of Treasury bonds and mortgage-backed securities, causing the monetary base to triple. Further asset purchases appear to be under consideration. Some economists and policymakers have expressed concern that these policies will cause inflation to rise to undesirable levels. Let me comment on this issue briefly, explaining why I believe that fears of inflation are unwarranted.

At first blush, the Fed's near-zero interest rate target and its expansion of the monetary base are highly expansionary policies. In normal times, such policies would indeed cause inflation to rise. But these are not normal times.

We need to remember why expansionary monetary policy normally causes inflation. Inflation occurs when businesses around the country raise their prices. These businesses generally do not monitor the Fed's balance sheet, and they do not base their pricing decisions on changes in the monetary base. Instead, monetary policy affects inflation indirectly, through its effects on aggregate spending. If policy is too expansionary, the economy overheats. Firms see their sales rise and their productive capacity is strained, and workers find that jobs are plentiful. Under these conditions, firms are likely to raise prices rapidly and workers push for large wage increases.

Given this mechanism, inflation is a danger only if the economy is overheated—regardless of what the Fed is doing to its balance sheet. In today's environment, with unemployment above 9% and likely to stay high for years, an overheated economy is the last thing we should worry about. Some day the economy will recover and the Fed will need to exit from its current expansionary policy. But today's challenge is the terrible problem of 9% unemployment. Rather than scale back its policies, the Fed should redouble its efforts to stimulate the economy and push unemployment down.

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