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CONGRESSIONAL TESTIMONY

The Debt Limit: A Key Action-Forcing Tool to Control Spending and the Debt

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Chairman Sean P. Duffy, Ranking Member Alan Green, Members of the House Financial Services Subcommittee on Oversight and Investigations, thank you for the opportunity to testify today. My name is Romina Boccia. I am the Grover M. Hermann Research Fellow in Federal Budgetary Affairs and Deputy Director in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The nation is on a fiscal collision course. Absent presidential and congressional leadership through the regular budget process, the debt limit is a key action-forcing tool that drives attention toward the nation's precarious fiscal state, and enables lawmakers to leverage a crisis scenario for necessary and urgent policy reforms that might not otherwise come about.

Though the debt limit is a blunt tool to motivate fiscal discipline, a brief self-imposed fiscal crisis to enact structural policy reforms that rein in growing spending and debt may very well be the lesser evil. This is especially true in comparison with an unexpected, sudden, and drastic fiscal crisis that leaves policymakers with few tools to respond in a predictable and gradual manner. Desperate times require desperate measures.

Our Nation's Fiscal Condition

The latest fiscal and economic projections by the Congressional Budget Office (CBO), published in its January 2015 *Budget and Economic Outlook,*[1] paint a clear picture. Spending and debt are growing at an unsustainable pace; greatly increasing the risks of a sudden fiscal crisis during which investors would demand much higher interest rates to continue lending to the U.S. government.

The CBO projects that outlays will grow from $3.7 trillion in 2015 to $6.4 trillion in 2026, in nominal dollar terms. Moreover, spending growth is projected to outpace economic growth, as outlays are expected to grow from 20.7 percent of gross domestic product (GDP) in 2015 to 23.1 percent of GDP in 2026. Meanwhile, tax revenues are projected to remain relatively stable at around 18 percent of GDP. Growing spending is clearly the culprit responsible for growing deficits and debt.

The annual deficit is growing again, after a short respite brought about by an economy recovering from the Great Recession, rising tax revenues, lower spending on automatic stabilizers, and the spending caps imposed by the Budget Control Act of 2011. The CBO now projects that deficits will reach annual trillion dollar levels as soon as 2022, growing to nearly $1.4 trillion by 2026. Cumulative deficits are now projected at $9.4 trillion just over the next decade.

[1]Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*, January 25, 2015, https://www.cbo.gov/publication/51129 (accessed January 28, 2016).

Growing spending is driving debt to economically harmful levels. Projected deficits would push debt held by the public to 86 percent of GDP by the end of the decade, or nearly twice the historical average level.

Debt Drags Down Growth

Several economists, employing different methods, have arrived at the same conclusion: high levels of public debt are correlated with lower levels of economic growth. While there is no definite threshold, public debt levels at, or nearing, the size of an industrialized country's economy are more robustly correlated with lower levels of growth. A 2013 literature review by my Heritage colleague, Dr. Salim Furth, covered research by three different teams of economists, all of which separately showed that high government debt has a negative effect on long-term economic growth. "When government debt grows, private investment shrinks, lowering future growth and future wages," concludes Furth.[2]

Since then, even more research has surfaced drawing a close link between depressed economic growth in the face of high public debt levels.

Afonso and Alves, in a 2014 paper titled "The Role of Government Debt in Economic Growth," reviewed data for 14 European countries from 1970 to 2012. The authors identify a clear negative link between high public debt and economic growth. Servicing the interest on the public debt has the most harmful effects. According to the authors, "we can conclude that, as is usually affirmed, debt is negative for growth, both in the short and long-term…. When we analyse both debt-to-GDP ratio and debt service variables, the latter has a much more negative effect on economic performance when compared with debt." [3]

A 2015 International Monetary Fund (IMF) working paper by Alexander Chudik, Kamiar Mohaddes, M. Hashem Pesaran, and Mehdi Raissi studies whether there is a definitive threshold at which debt begins to hurt growth and whether there is a causal link between high debt and slow economic growth. While the authors reject the hypothesis that high public debt levels always slow growth, they find a statistically significant threshold effect for countries whose debt levels are not only high, but growing. The authors stress the importance of which direction the debt is heading.

Because debt perceptions are dependent on expectations by investors and the public, debt growth or shrinkage sends powerful signals beyond what is conveyed by threshold levels. Debt trajectory matters. According to the authors, "regardless of the threshold, however, we find significant negative long-run effects of public debt build-up on output growth."[4]

[2]Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.
[3]Antonio Afonso and Jose Alves, "The Role of Government Debt in Economic Growth," working paper, Social Science Research Network, 2014.
[4]Alexaner Chudik, Kamiar Mohaddes, M. Hashem Pesaran, and Mehdi Raissi, "Is There a Debt-threshold Effect on Output Growth?" 2015, https://www.imf.org/external/pubs/cat/longres.aspx?sk=43260.0 (accessed January 28, 2016).

Even those analysts who sought to intentionally reject the thesis, that high debt causes growth to slow, were unable to rule out economic drag from high levels of public debt. Ugo Panizza and Andrea F Presbitero set out to do just that in a 2012 paper. The authors concluded that the "fact that we do not find a negative effect of debt on growth does not mean that countries can sustain any level of debt. There is clearly a level of debt beyond which debt becomes unsustainable, and a debt-to-GDP ratio at which debt overhang, with all its distortionary effects, kicks in."[5]

How does high public debt negatively impact long-term growth prospects? Through which mechanisms do high public debt levels exert downward pressure on the economy?

Deficit-spending allows government to consume resources today at a cost to future generations. This enables greater government spending than would be the case if the government had to raise all of the revenue to finance its spending in the current period. Raising taxes is more politically difficult than is increasing deficits. By shifting some of the burden of today's government spending to younger generations, government is able to consume more of the economy's resources than it otherwise could.

Without a tight budget constraint to impose spending discipline, government spending is also less likely to go toward financing the highest priority projects. More of the spending will go to frivolous projects that benefit well-connected interested groups, instead of the public interest, and federal agencies are better able to sustain mismanagement and waste. This wastes economic resources that could have been put to better use in the private sector.

High public debt levels demand high debt service costs. Federal spending on interest payments draws on dollars that could have otherwise been spent on current national priorities, instead of servicing the sins of the past. Every dollar that goes toward interest spending is a dollar that is no longer available for national defense, infrastructure, and other public services.

Investor concerns about the sustainability of large and growing public debt may demand higher interest rates to continue lending to the government. Spending pressures could put pressure on tax revenues, motivating lawmakers to raise taxes, which harms private spending and investment. In the absence of greater revenue, government may resort to devaluation of the dollar to lower the public debt burden.

The CBO in its most recent *Long-Term Outlook* also emphasized reduced flexibility to respond to challenges in the event of an economic or fiscal crisis. According to the CBO:

> The large amount of debt would restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns or financial crises. As a result, those challenges would tend to have

[5]Uga Panizza and Andrea F. Presbitero, "Is High Public Debt Harmful for Economic Growth?" Vox, April 22, 2012, http://www.voxeu.org/article/high-public-debt-harmful-economic-growth-new-evidence (accessed January 28, 2016).

> larger negative effects on the economy and on people's well-being than they would otherwise. The large amount of debt could also compromise national security by constraining defense spending in times of international crisis or by limiting the country's ability to prepare for such a crisis.[6]

Why the Debt Limit Matters

Congress has several legislative tools to address the drivers of growing spending and debt. Importantly, Congress's budget resolution affords lawmakers not only a forum to lay out its action plan to return the budget to balance; it also provides a fast-track legislative process to implement reforms that control government spending programs. However, this process, called reconciliation, requires active engagement by Congress. If Congress fails to make use of reconciliation, lawmakers face no immediate consequences as debt and spending continue spiraling out of control.

The debt limit, on the other hand, does provide an urgent and important deadline, enforced by painful fiscal measures, to motivate Congress to take action. At the same time, the debt limit provides the political cover necessary to make unpopular, but necessary, legislative decisions. Reducing entitlement benefits is a prime example.

The debt limit is a separate check on borrowing. It limits the amount of money or the dates during which the Treasury is authorized to borrow to finance federal deficit spending. At the debt limit, Treasury finds itself unable to meet all federal payment obligations as they come due. Absent specific guidance by Congress, Treasury and the President are confronted with a difficult decision: prioritize spending in accordance with the national interest (making judgments that will be closely scrutinized in courts and by the public), or delay payments across the board, paying bills in the order in which they come due when sufficient revenues are available, regardless of the nature of those bills.

Several analysts and pundits argue that the debt limit is an archaic construct that serves no useful purpose. They argue that because Congress authorizes all spending, it does not make sense to have a separate limit on borrowing. As one proponent of repealing the debt limit put it: "members are only covering their tracks for supporting more spending and big tax giveaways.… Very simply, they have voted to spend the money, but they don't want to pay the bill."[7]

Ideally, congressional decisions to spend and borrow would be aligned. However, there are at least three reasons why the debt limit serves a useful purpose: (1) the programs driving the majority of the growth in federal spending were authorized decades ago and are allowed to grow on autopilot with few congressional action-forcing deadlines to change those programs' trajectories; (2) the public does not recognize that it is their most cherished entitlement programs that are driving the growth in spending and the debt and

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[6] Congressional Budget Office, *The 2015 Long-Term Budget Outlook*, 2015, https://www.cbo.gov/publication/50250 (accessed January 18, 2016).
[7] Scott Lilly, "Congress Shouldn't Raise the 'Debt Limit'—It Should Repeal It," Center For American Progress, October 15, 2013.

the debt limit debate can help to elevate public understanding while at the same time providing political cover for lawmakers who seek to reduce spending on those programs; and (3) lawmakers only control some of the factors that drive the growth in the debt, and economic downturns or unanticipated increases in interest costs may mean that previously authorized spending should be reconsidered in light of factors outside Congress's control.

Autopilot Spending

The federal budget is separated into three major categories: discretionary spending, mandatory spending, and net interest. The key difference between mandatory and discretionary spending is that discretionary spending receives its source of funding from annual appropriations (some programs less frequently), while mandatory spending is governed by laws that contain the source of funding. The vast majority of mandatory spending occurs in two programs: Social Security and Medicare.

Overall, mandatory spending made up 62 percent of the budget in fiscal year 2015, and consumed nearly 13 percent of GDP.[8] Congress only appropriates about one-third of federal spending in any given year. The vast majority of federal spending grows on autopilot based on conditions put into law many Congresses ago.

In an interview on his recent book, *Dead Men Ruling*, Eugene Steuerle explained this predicament as follows:

> Today's government is constructed and constricted by programs and policies that were designed by men (women, too, but they were largely excluded) decades ago, many of whom are not with us today. Many of these programs were well designed to improve the economic and social welfare of Americans at the time they were created and some years into the future. But the world has moved on, and these programs have not.… My intention with the book was to convince the reader that this is a very different problem from a more traditional "deficit" problem that would arise when government becomes profligate through new legislation year after year. The profligacy is now built in. The former problem could often be solved by temporary legislative inaction; the new problem requires legislative action to remove it.[9]

The debt limit provides an action-forcing deadline to pursue the legislative steps necessary to rein in out-of-control autopilot spending. The debt limit can draw attention to the key drivers of spending and debt and highlight the budget reforms necessary to control the growth in debt. It can also provide political leverage to pursue those changes in laws that are necessary to change the debt trajectory.

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[8]Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*.

[9]Rebecca Rolfes, "Debts of the Past Limit the Future: An Interview with Eugene Steuerle," The Gail Fosler Group, March 11, 2014, http://www.gailfosler.com/debts-past-limit-future-interview-eugene-steuerle (accessed January 28, 2016).

Political Cover

The very programs that are most responsible for the growth in spending and debt are also the most popular with voters. A Roper Center analysis at Cornell University concerning public opinion polling on questions of government spending, deficits, and debt concluded that "questions about cutting spending on government programs in the abstract tend to overstate the public's willingness to see particular programs cut."[10]

Different opinion polls tend to arrive at the same result. Americans are much more willing to support spending cuts in the abstract than they are to support spending cuts in particular programs. The only exception appears to be foreign aid.[11] The public is particularly unwilling to support cuts in Social Security and Medicare to reduce the deficit.[12] To the contrary, there is widespread support for cutting fraud, waste, and abuse. Basically anything that appears as though cutting it would have no impact on recipients of public services in the U.S. is ripe for the cutting board. If there was a painless way to balance the budget, Americans would be all for it.[13]

The false perception by the public that reductions to fraud, waste, abuse and foreign aid are sufficient to reduce government spending and control the debt creates political difficulties for lawmakers who seek to represent their constituents' wishes even if they create vast challenges for public finances and the economy. When more than half of the projected growth in federal spending over the next decade is driven by Social Security and federal health care programs—in particular Medicare, Medicaid (especially its expansion under Obamacare), and Obamacare's premium subsidies—it becomes nearly impossible to balance the budget without entitlement reform. According to the CBO, "almost half of the projected $2.5 trillion increase in total outlays from 2016 to 2026 is for Social Security and Medicare." CBO also projects that Social Security and Medicare will grow in real terms by 0.9 percentage points of GDP and 0.8 percentage points of GDP, respectively, just over the next decade.[14]

A debt limit that binds creates consequences sufficiently severe to provide political cover for lawmakers who will lead on making the important reforms that are in the long-term interest of their constituents and the nation writ large, even if their constituents do not see it that way. Presidential leadership is one key ingredient. In the same way in which

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[10] Roper Center, "In the Balance: The Public, the Budget and the Deficit," Cornell.edu, January 29, 2015, http://ropercenter.cornell.edu/in-the-balance-the-public-the-budget-and-the-deficit/ (accessed January 28, 2016).
[11] Pew Research Center, "As Sequester Deadline Looms, Little Support for Cutting Most Programs," February 22, 2013, http://www.people-press.org/2013/02/22/as-sequester-deadline-looms-little-support-for-cutting-most-programs/ (accessed January 28, 2016).
[12] Pew Research Center, "Public Still Unwilling to Cut Entitlement Benefits to Reduce Deficit," April 10, 2013, http://www.pewresearch.org/daily-number/public-still-unwilling-to-cut-entitlement-benefits-to-reduce-deficit/ (accessed January 28, 2016).
[13] Michael Tanner, "This Is Going to Hurt: There Is No Painless Way to Balance the Budget," *National Review*, April 6, 2011, http://www.nationalreview.com/article/263972/going-hurt-michael-tanner (accessed January 28, 2016).
[14] Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*.

Congress and President Obama explained to their constituents why the Budget Control Act's spending reductions were necessary following the debt limit standoff in 2011,[15] lawmakers and the executive can justify reductions in entitlement benefits to serve the broader public interest of controlling the growth in spending and the debt, leveraging the debt limit for political cover. "Our hands were tied!"

Factors Outside Congress's Control

There are several factors that influence the size and direction of public debt. These include congressional budget decisions, the state of the economy, and interest rates. Spending and revenue decisions are factors within Congress's control. Yet, actual revenue levels are highly dependent on the state of the economy. During an economic downturn, revenue tends to fall steeply as businesses sell fewer goods and services, workers lose employment, and entities go out of business. Interest costs, likewise, represent a factor mostly outside Congress's control. If investors demanded higher interest rates as a risk premium when government borrowing seems to spiral out of control, this can suddenly raise the cost of federal borrowing.

After congressional budget decisions are made, the debt limit confronts Congress with the state of the debt. If factors outside Congress's control significantly affected the trajectory of the debt, it may be prudent to reconsider prior spending decisions to improve the fiscal situation. This does not mean that Congress should renege on obligations that are due; rather, Congress should adjust commitments going forward and the debt limit provides a legislative opportunity to make adjustments as necessary.

Prioritization

As the federal government approaches the debt limit and absent congressional action to increase the limit, Treasury does not necessarily default on debt obligations. Even while cash-strapped, the Treasury can reasonably be expected to prioritize principal and interest payments on the national debt, protecting the full faith and credit of the United States above all other spending. It is almost impossible to conceive that the Treasury and the President would choose to default on debt obligations. Doing so would have damaging economic consequences.

Treasury did employ the threat of default numerous times. Treasury argued publicly that it lacked the logistical means and the statutory authority to prioritize payments—including debt obligations—in the event of a debt limit impasse. In response to an inquiry by Senator Orrin Hatch (R–UT) in 2011 as to contingency plans Treasury may have made for a possible debt limit impasse, Treasury stated that "organizationally they viewed the option of delaying payments as the least harmful among the options under review." This interpretation of executive authority directly contradicts a previous statement by the Government Accountability Office, which asserted that Treasury has the discretion to

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[15] Barack Obama, "Statement by the President," The White House, August 2, 2011, https://www.whitehouse.gov/the-press-office/2011/08/02/statement-president (accessed January 28, 2016).

prioritize payments:

> We are aware of no statute or any other basis for concluding that Treasury is required to pay outstanding obligations in the order in which they are presented for payment unless it chooses to do so. Treasury is free to liquidate obligations in any order it finds will best serve the interests of the United States.[16]

Treasury's assertion was likely employed to apply pressure to congressional Republicans to raise the debt limit. An Administration official, speaking on the basis of anonymity, confirmed as much, stating in 2011 that Treasury intended to prioritize meeting its debt obligations to avoid default.[17] Credit rating agencies have also voiced confidence that Treasury would not risk a sovereign debt default, including Moody's and Fitch.[18]

Moreover, sovereign debt default should never be a primary concern during a temporary debt limit impasse. Congress has voted in support of several bills that would allow the Treasury to continue borrowing at the debt limit to meet debt service needs.[19] In the event that insufficient cash levels became a concern to meet federal debt obligations, Congress and the Administration could cooperate to remove at least this critical risk.

This has not happened likely because debt limit standoffs represent a game of chicken. Borrowing authority for debt limit service would defuse much of the tension inherent in current debt limit standoffs. Importantly, such authority would reduce executive leverage at the debt limit. The President's strongest hand in debt limit standoffs is to threaten default. Similar to the fable in which a child finally reveals to all that the emperor has no clothes, forcing the Administration to show its cards during a debt limit impasse may serve to focus on the real issue lawmakers should be debating: What reforms will we put in place to control spending and debt?

Another useful exercise would ask the congressional budget committees and the executive to present a prioritized annual cash budget. Assuming no borrowing, how would Congress and the executive prioritize among competing federal programs? This

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[16]Government Accountability Office, "Letter to Senator Bob Packwood (R-OR)," October 9, 1985, http://www.gao.gov/products/449522#mt=e-report (accessed September 6, 2013).
[17]Peter Cook and Cheyenne Hopkins, "U.S. Contingency Plan Said to Give Priority to Bondholders," Bloomberg, July 28, 2011, http://www.bloomberg.com/news/2011-07-28/u-s-contingency-plan-gives-bondholders-priority.html (accessed September 6, 2013)
[18]Romina Boccia, "Moody's: Further Deficit Reduction Needed to Maintain Stable Outlook," The Foundry, July 23, 2013, http://blog.heritage.org/2013/07/23/moodys-further-deficit-reduction-needed-to-maintain-stable-outlook/, and Fitch Ratings, "Fitch Affirms United States at 'AAA'; Outlook Remains Negative," U.S. Medium-Term Fiscal Projections—An Update, June 28, 2013, http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=711441 (accessed September 11, 2013; subscription required).
[19]Representative Tom McClintock (R–CA), "HR 807-Full Faith and Credit Act," February 25, 2013, https://www.congress.gov/bill/113th-congress/house-bill/807 (accessed January 28, 2016); Senator Pat Toomey (R–PA). "S.163 - Full Faith and Credit Act," January 26, 2011, https://www.congress.gov/bill/112th-congress/senate-bill/163 (accessed January 28, 2016); and Representative Tom McClintock (R–CA), "H.R. 692- Default Prevention Act," February 3, 2015, https://www.congress.gov/bill/114th-congress/house-bill/692 (accessed January 28, 2016).

would be a prudent exercise to reveal to the public what Congress and the executive considered to be the most important programs. It would also confront lawmakers and the public more directly with the important question of whether the things the federal government is borrowing for are truly necessary. Americans might ask twice whether a certain activity should take place when considering the impact on younger generations from borrowing for this or that purpose more specifically. In the event of a debt limit impasse, this cash budget could serve as guidance for prioritization of payments at the debt limit.

Desperate Times Call for Desperate Measures

The debt limit allows Congress to exercise its power of the purse in making vital course corrections when confronted with the results of unsustainable spending decisions. As such, the debt limit presents a decisive, action-forcing moment for Congress to take charge of the automatic spending increases that are driving the U.S. spending and debt crisis.

The fact that Congress has not been willing to force spending reforms does not lessen the importance of the debt limit as an action-forcing mechanism to prevent a future fiscal crisis. Congress should cut spending and reform the entitlement programs to put the budget on a path to balance before increasing the debt limit again.

Congress could avoid repeated debt limit panics by acting prudently and with enough foresight to address the federal government's spending and debt problems before the debt limit seemingly forces lawmakers to adopt bad policy. It is not the debt limit that is the problem. The problem is a lack of congressional and presidential leadership to address the root source of growing spending and debt: unsustainable spending growth in federal health care programs and Social Security.

Congress should modernize Medicare, Medicaid, and Social Security and empower people to exercise more choice in spending their health care and retirement dollars.

Congress's budget resolution included some important reforms in this direction. However, without additional legislation to implement the reforms in the congressional blueprint, spending will continue to grow out of control. Lawmakers should address the key drivers of spending growth and put the budget on a path to balance—before raising the debt limit. My colleagues and I at the Heritage Foundation laid out that path in detail in a recent report, which I submit for the congressional record.[20]

Thank you.

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[20]Romina Boccia, Paul Winfree, Curtis Dubay, and Michael Sargent, "Blueprint for Congressional Fiscal Action in the Remainder of 2015," Heritage Foundation *Backgrounder* No. 3052, September 2, 2015, http://www.heritage.org/research/reports/2015/09/blueprint-for-congressional-fiscal-action-in-the-remainder-of-2015.

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