Creating a Fiscal Turnaround in the United States

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The Unsustainable Debt Trajectory

For decades now, we have known that the United States faced serious long-term fiscal challenges. The aging of society and growing health care costs have led to projected unfunded liabilities in the double-digit trillions of dollars that were clearly unsustainable. Year after year, the long-term fiscal challenges were discussed, but the political hurdles needed to take action were just too high, and changes were delayed.

Because of the policy choices made in the past decade, the situation deteriorated. Multiple rounds of tax cuts; uncharacteristically high levels of increases in discretionary spending; not one, but two, wars that were entered into without any attempt to offset the costs; and an expensive new prescription drug entitlement program all dug the fiscal hole deeper.

Then the major global economic downturn hit. The policy responses will be debated for decades, but the risks clearly were massive, and trillions of dollars were spent to try to keep the financial market fiasco from spreading and the recession from turning into a depression. My belief is that while the dollars were certainly not spent perfectly, it is good that they were spent given the large downside risks. Additionally, the recession itself led to a major deterioration in the United States financial position as the revenues dried up and the automatic stabilizers such as unemployment insurance kicked in.

Suddenly the long-term fiscal problem was at the U.S.' doorstep.

The results have been a massive fiscal slide. In 2009 the budget deficit was $1.4 trillion or 9.9 percent of GDP. In 2010 it was $1.3 trillion, or 8.9 percent of GDP. And this fiscal year, it is expected to be $1.1 trillion, or 7 percent of GDP. While these numbers were bad, they were probably necessary. Sometimes deficits are absolutely appropriate and the past few years was one of those instances.

But the troubling part is not so much where the country has been, but where it is headed. The debt held by the public has averaged less than 40 percent of GDP over the past 50 years in the United States. It now stands at 62 percent, and is projected to reach close to 90 percent by the end of the decade, 100 percent by fiscal 2024, and 200 percent by the mid-2040s. While we don't know at what point these debt levels become unaccabtable to global credit markets, we know that they will.

A fiscal crisis—something heretofore unimaginable in the Untied States—could take a number of forms. It could be less transparent with the massive debt load standing in the way of a real economic recovery, with general uncertainty causing consumers and businesses to hold back from spending and investing. Or it could be more abrupt with creditors losing faith and pulling their money from the United States. Interest rates would

spike, causing interest payments to grow, forcing the government to borrow more, pushing rates up even higher. The result would be a vicious debt spiral, another deep recession, and ultimately, a lower standard of living in the U.S. and presumably around the world.

The Committee for a Responsible Federal Budget recently held a conference with some of the world's top financial and economic experts on the topic of what would cause a fiscal crisis and what exactly it would look like. There was nothing close to a consensus about what would kick off a crisis—only that we may well be dangerously close to finding out. Possible triggering events were seen to be: sovereign debt contagion with market fears spreading from Europe to the U.S.; some of the contingent liabilities of the government such as the Pension Benefit Guarantee Corp. or Fannie Mae and Freddie Mac encountering larger-than-expected losses; or a crisis set off from a state not being able to meet its own debt obligations.

Even short of a fiscal crisis, excessive debt levels create numerous problems in the economy. Once the economy returns to full capacity, the large levels of borrowing absorb private capital and squeeze out private investment levels. If we don't make changes to our debt trajectory, we will pay a heavy price through a weaker economy, a lower standard of living, less growth potential, a less flexible budget, and a loss of leadership in the world.

Turning the Fiscal Situation Around

A starting point will be for leaders to agree on a single budget objective or fiscal target. Several groups, including the Peterson-Pew Commission on Budget Reform have adopted a threshold of a debt of 60 percent of GDP. That standard has the needed credibility and it has become an international standard. In the European Union, under the requirements of the Maastricht Treaty and the Growth and Stability act, EU countries must satisfy a benchmark target of 60 percent of GDP for debt and 3 percent for annual deficits. In addition, the International Monetary Fund has singled out the 60 percent target as a reasonable benchmark. Recently, the International Monetary Fund has pointed out that the goal cannot just include stabilizing the debt at post-crisis levels, but rather, must involve bringing it down to pre-crisis levels.

The Peterson-Pew Commission on Budget Reform recommended a six step framework for getting the U.S. to reasonable budget targets:

1. Commit immediately to stabilize the debt
2. Develop a specific and credible debt stabilization package as quickly as possible
3. Begin to phase in policy changes gradually in 2012;
4. Review progress annually and implement an enforcement regime to stay on track;
5. Stabilize the debt by end of the decade;
6. Continue to reduce the debt as a share of the economy over the longer-term.

The starting point must be adoption of a medium-term budget goal, or debt target. In terms of a fiscal goal, it is actually quite remarkable how regularly US policymakers craft budgets without a specific goal in mind. It is like flying blind, yet the budget process does not require a goal or target to be the starting point of the process. A fiscal goal has the advantage of helping policymakers say no, and it also allows for comparisons between different budget options.

There are legitimate concerns that enacting a fiscal consolidation plan prematurely could derail the economic recovery. Additional immediate and well-crafted stimulus measures are probably in order if paired with a credible debt reduction plan. However, we are now also experiencing the loss of fiscal flexibility that comes with high debt levels. Instead of just borrowing for stimulus, we should add stimulus measures as necessary and offset the costs of the measures over a longer period of time, so that the funds—whether for unemployment insurance, state and local governments, or business tax incentives—do not lead to more debt over the longer-term.

Importantly, the recovery can be helped by simply committing to a credible fiscal consolidation plan right now, even if the policies are not phased in for a few more years. The so-called "Announcement Effect" can reassure investors and help keep interest rates from rising as they might otherwise do as a result of the debt, as the economy starts to recover. We have seen this in the past in other countries around the world.

For a plan to be credible, and for our creditors to accept it, it will have to be statutory, specific, bipartisan, and transparent to the public. It should be put in law immediately with the policies slated to phase in as gradually as necessary. The specific policies in the plan must be developed now, not just filled with magic asterisks. Importantly, the plan must have bipartisan support. The necessary policy changes will be too difficult if either party tries to do this alone. Moreover, if something is pushed through by one party alone, and is met with calls to repeal it, it will undermine confidence that the plan will stay in place. Finally, the public has to understand the plan, be on board, and hold politicians accountable for staying on track. This kind of public commitment has been very helpful in other countries.

Getting Specific

The surprising success of the White House's National Commission on Fiscal Responsibility and Reform led by Erskine Bowles and Alan Simpson has created the starting point for discussions here in the Untied States. The plan received bipartisan support not just from the politically appointed members, but from sitting members of Congress.

In brief, the plan would achieve almost $4 trillion in deficit reduction through 2020. The plan includes cuts in both defense and non-security spending, discretionary spending caps, comprehensive tax reform, health care cost containment, changes in other entitlement programs and major Social Security reform. It would reduce the debt to 60 percent of GDP by 2023. As an indication of how seriously Americans appear to be

taking the debt problem, a variety of other plans have emerged as well. They include proposals from:

- Rep. Paul Ryan (R-Wis.)—The likely new chairman of the House Budget Committee was the first to offer comprehensive plan, which focuses on longer-term entitlement reform.
- Bill Galston of the Brookings Institution and I suggested a budget plan that focuses on the medium- and long-term.
- A group of former lawmakers created by Esquire Magazine to develop a comprehensive plan.
- The Debt Reduction Task Force of the Bipartisan Policy Center—a bipartisan group of analysts and former lawmakers, who developed a comprehensive budget plan.

Aside from the comprehensive debt reductions plans now being offered, the Peterson-Pew Commission has proposed a new budget framework to enforce a long-term debt reduction plan. The Peterson-Pew Commission of bipartisan budget experts has recommended adoption of medium- and long-term debt targets, with enforcement mechanisms to ensure that the targets are met. Under the Peterson-Pew plan, if Congress and the President failed to enact policies to reach those targets, automatic spending cuts and tax increases would go into effect.

The sheer number of groups that have developed their own plans may be considered as a sign of how serious the public is now taking the problem. A number of similarities can be drawn from the plans:

- Defense cuts are on the table. But there is now a newfound commitment by many on the political left and right to find savings within the defense budget. Nearly all of the proposed fiscal plans specifically target the defense budget as a source of potential savings. In addition, a growing amount of work has been done by experts to suggest areas of the defense budget—from weapon systems, to procurement and R&D, to compensation—which could be reduced without compromising security interests.

- Health care needs a budget. In the long-term, growing health care costs still remain the single largest problem in the budget. The federal commitment to health spending cannot remain open-ended. Addressing this growth in health care spending must be a part of any budget plan, and there are a number of different approaches to doing so including a public option and voucher. Greater cost sharing by consumers is also likely.

- Domestic discretionary cuts are likely. Since entitlement reforms (the most important aspect of controlling government spending) are generally phased in more slowly, discretionary spending controls will be critical in the medium-term. Spending caps have been successful in the U.S. in the past and are likely to be reinstated. Looking at what the British and other European governments recently

have proposed suggests that the U.S. should consider going beyond freezes to significant nominal dollar cuts in some areas.

- Social Security needs a lasting fix. Some combination of benefit reductions, retirement age increases, and new revenues—either from the payroll tax or other revenues—will be needed. The sooner changes are made, the more time participants will have to adjust and the more people over which the changes can be spread. There is no reason to delay. Additionally, there appears to be a growing consensus that those who depend on the program for a large part of their retirement income should be protected from excessive benefit reductions, and in many cases, reform plans would increase their benefits.

- Time for fundamental tax reform. The U.S. government loses more than a trillion dollars a year in revenue because of tax expenditures—the multitude of exclusions, exemptions, deductions, and credits that run through the tax code. These programs are more similar to spending than tax cuts, and often are inefficient and regressive. Cleaning up the tax base will certainly be the first step in fundamental tax reform along with a likely reduction in corporate tax rates to help make the U.S. more competitive.

Politics: The Wild Card

The question remains whether any agreement is possible, given divided government and the political partisanship that pervades Washington. So far, many conservatives remain firm in their opposition to any tax increases. On the left, there is the fear that any proposal that attacks the federal debt will dramatically scale back the safety net for the neediest.

The main goal for anyone actually wanting to enact a debt control plan will be to convince policymakers that the tax increases and spending cuts they pass now will be much less draconian than the ones they would have to swallow if the financial markets turn against the U.S. We have seen how quickly the markets can turn against a nation heavily in debt.

The ultimate question for policymakers is whether they are willing to make the changes necessary while they still control their own destiny or will they wait until they are forced to take even more draconian measures.

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