Testimony

Economic Consequences of the Federal Fiscal Outlook

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*The views expressed here are my own and do not represent the position of the American Action Forum. I thank Marisol Garibay, Gordon Gray, and Cameron McCosh for their assistance.

Introduction

Chairman Hensarling, Ranking Member Waters, Members of the Committee, it is a privilege to speak to you today on a matter of great importance – the federal fiscal outlook, why accumulating federal debt matters, and the potential for a sovereign debt crisis in the world's most important economy.

I would like to make three basic points in my testimony:

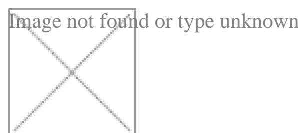
- The federal budget outlook is quite dire, harms economic growth, and ultimately raises the real threat of a sovereign debt crisis;
- The necessary policy response in a debt crisis is in itself deeply damaging; and
- A sovereign debt crisis translates into deep distress for individuals and families.

I will address each in further detail.

The Budget Outlook

On February 4th, the Congressional Budget Office (CBO) released the Budget and Economic Outlook for 2014-2024. The basic picture from CBO is as follows, tax revenues return to pre-recession norms, while spending progressively grows over and above currently elevated numbers. The net effect is an upward debt trajectory on an already large debt portfolio. The CBO succinctly articulates the risk this poses: "Such large and growing federal debt could have serious negative consequences, including restraining economic growth in the long term, giving policymakers less flexibility to respond to unexpected challenges, and eventually increasing the risk of a fiscal crisis (in which investors would demand high interest rates to buy the government's debt)."[1]

Figure 1: The Budget Outlook by the Numbers

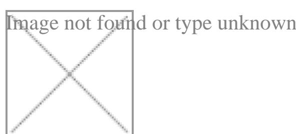


According to the CBO, tax revenue will remain above 18 percent of GDP over the next ten years. This is well above the average since 1974 of 17.7 percent, not including the past six years where revenues have been depressed. The federal government is projected to spend over $48 trillion over ten years, maintaining spending

levels over 1.6 percentage points above historical levels. Mandatory spending, which comprised 41 percent of the federal budget in 1974, will exceed 62 percent in 2024. Interest payments on the debt comprised 8 percent of the budget in 1974 and 6 percent 2013. These payments will more than double, to almost 15 percent. Debt service payments will reach 3.3 percent of GDP by 2024 – the highest level seen in the preceding 50 years.

Projected deficits in the next 10 years will dip below half a trillion only once, and will surpass $1 trillion again by 2022. Importantly, the deficit outlook has worsened since CBO's last estimate, largely driven by a more pessimistic economic outlook. The latest estimates show deficits projected to be a cumulative $1 trillion higher over 2014-2023 than were projected just last May.

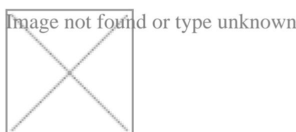
Figure 2: The Deficit Outlook has Worsened



This development also reveals two key concepts relevant to today's hearing: the interaction between a sluggish economy and the budget outlook, and the precarious nature of 10-year budget projections. The former is directly relevant to the mechanics of a debt crisis, while the latter reveals how uncertain debt projections can be. When the existing debt is already so large, the consequences of underestimating future deficits are much greater. Moreover, the nature of conventional, current-law deficit projection, which leaves out certain policies that are likely to continue — e.g., higher Medicare physician payments and certain tax policies — build in a bias to understating future deficits.

The worsened deficit outlook will raise borrowing from the public over the coming decade. Debt held by the public will reach the highest levels since 1950 in FY 2014, reaching 73.6 percent of the economy and despite a temporary and modest improvement, will remain at levels not previously seen in over 60 years.

Figure 3: Debt Ultimately on an Upward Trajectory



The trajectory direction and the magnitude of the current debt outstanding is ultimately the most telling characteristic of the U.S. fiscal path. The widely acknowledged drivers of the long-term debt, health, and retirement programs for aging populations, and borrowing costs, will begin to overtake higher than average tax revenue and steady economic growth by the middle of the decade, and grow ever inexorably upwards until creditors effectively refuse to continue to finance our deficits by charging ever higher interest payments on an increasingly large debt portfolio.

Federal Debt and the Pace of Economic Growth

The projected federal fiscal outlook may have an immediate and increasingly negative impact on the pace of economic growth. The current outlook is unsustainable, which means that in the future one of three things must

happen: spending will be reduced, taxes will be raised, or the U.S. will experience a sovereign debt crisis. Those looking to invest or hire in the United States must assess the likelihood and timing of these policy changes, two of which — taxes and a crisis — are decidedly anti-growth.

The key to their expectations, and thus their willingness to expand the U.S. economy, hinges on controlling spending — especially the large mandatory programs that drive the budget outlook. To date, there has been no serious effort to change their trajectory. If entrepreneurs, small firms, and investors become convinced that their will be *no* change, then radically higher taxes or interest rates are the only options and the current pace of investment, innovation, and employment growth in the U.S. will suffer.

While there has been a significant research controversy over the size of any negative impact on growth presented by a large debt burden, there is no evidence that growth is enhanced. The only issues is how much damage is being done.

The Policy Response to a Debt Crisis

How would a sovereign debt crisis unfold? Reliably predicting when credit markets would refuse to finance our deficits is effectively impossible. Instead, one can only safely say that it is unlikely in the near term but that risks go up dramatically with policy inertia and the passage of time. For the sake of illustration, this testimony contemplates the U.S. confronting the possibility of a sovereign debt crisis in 2024.

Assume that the federal government begins FY2024 with debt at 78 percent of GDP, and assume that credit markets essentially signal — through debt downgrades and other means — to the U.S. that unless the debt is stabilized as a share of the economy, the U.S. would begin to face the crippling interest premiums that characterize a sovereign debt crisis.

The only policy responses readily available to lawmakers in a debt crisis would not target the real source of the problem — the slow-changing health and retirement and entitlement programs. Instead, a fiscal consolidation that was forced by creditors would likely take the form of tax hikes and cuts to discretionary spending.

Assuming GDP levels in CBO's baseline, an immediate leveling of the debt held by the public would require fiscal consolidation of $884 billion.[2] Split evenly between tax increases and spending cuts this would amount to a single year, across the board, tax increase of 9 percent, and a 30 percent discretionary spending cut.[3] In addition, to keep the debt at 78 percent of GDP would require additional savings of roughly $8 trillion over the subsequent decade.

This daunting fiscal math assumes that the U.S. is able to pre-empt a spike in borrowing costs. According to the most recent Treasury projections, about $4 trillion in existing debt would have a maturity of less than one year and would therefore need to be rolled over during 2024. Assuming the $1 trillion in additional borrowing needed to finance the FY2024 borrowing, this amounts to a combined $5 trillion in direct exposure of federal financing to credit markets in 2024.[4]

A stylized example that assumes a 1000 basis point increase in interest rates would see an immediate, and additional interest penalty of $600 billion, which, all else being equal would also have to be borrowed or absorbed through tax increases and spending cuts as in the first example.

The examples do not incorporate the economic impact that such immediate fiscal contractions would have on the economy. From a purely budgetary perspective, large and immediate tax cuts and spending hikes would

reduce growth, and immediately mitigate revenue collected from tax increases. Spending would also increase as certain automatic stabilizers come into force as the economy flags.

Why the Debt Matters to Individuals

As illustrated above, a debt crisis has three key features: abrupt and large fiscal consolidations, high interest rates, and weak economic growth. All three have real implications for individuals and families.

The policy response would certainly be visible to individuals. It is difficult to quantify how the reduced budgetary resources would be experienced individually, but there would be clear erosions in defense readiness, education expenditures, and research initiatives. Other more basic services, many of which were recently experienced during the smaller sequester would be reduced.

With respect to tax policy, a clearer picture can be drawn. According to recent projections, the average federal tax rate, which includes payroll and corporate taxes, in 2024 will be 20.2 percent.[5] A 9 percent hike would take that rate up to about 22.0 percent. However, it would be very unlikely that a policy response would fall evenly across all taxes and all tax brackets. Rates would have to be commensurately higher as fewer and fewer taxpayers and less of the tax base is exposed to higher rates of taxation. One recent estimate suggests that raising rates on just the 28 percent bracket and above would necessitate a rate increase of over 20 percentage points in order to raise the revenue required in the illustrative example above.

The second distinguishing element of a debt crisis is a high interest rate environment. The U.S. Treasury security is the benchmark for the cost of funds, and underpins all manner of consumer financial products. Prime mortgage rates are highly correlated to Treasury notes.[6] Accordingly, one can construct a notional mortgage rate in an extraordinarily high interest rate environment. If 10-year Treasury's jumped 1000 basis points, today's prevailing mortgage rate of 4.32 would jump to 14.32. For the sake of comparison, at today's rates, monthly interest and principal payments on a $250,000 home loan would amount to $1,240. At 14.32 percent, payments would jump to $3,026.[7]

The example holds true in other matters of consumer finance, which rely on Treasury securities as benchmarks. A 5-year car loan can be had at present for 3.06 percent.[8] Under these terms, payments on a $20,000 car loan would amount to $360 per month. At 13.06 percent, payments would jump to $456. That amounts to $5,706 in extra payments just toward interest – and more than a quarter of the car's loan value.

This would also affect college finance. While a great deal of loan volume has fixed interest rates set by statute, private student loans remain an important element of college finance. As an example, some student loans are pegged to the PRIME lending rate, which at present stands at 3.25 percent.[9] With a generous assumption that the rate stays at the current low prime rate, monthly payments would total $351 on a $50,000 loan, with total interest payments amounting to $13,240.[10] Under a high interest rate scenario, this would jump to $641 per month, with total interest payments running to $65,355.60 – more than the underlying loan value.

Lastly, as noted above, high debt hurts economic growth, crowds out private savings, and eventually saps the economy of capital. Moreover, the rapid fiscal consolidation, particularly poorly target policy, harms economic growth particularly in the short run. For example, CBO estimated that a eliminating a scheduled fiscal consolidation of $602 billion would have increased GDP growth by 3.9 percent.[11] Such a rapid policy change would ultimately reinforce certain negative budgetary pressures.

Conclusion

The risk of an eventual fiscal crisis is real, and the United States is not immune from those risks. Rather, at present, the budgetary path of the nation guarantees an eventual confrontation with that threat. A debt crisis would pose real and lasting policy challenges to the United States. Forced fiscal consolidation dictated by creditors offers only poor policy choices that will impose real costs on the economy and families in general. The implications of a debt crisis will be felt throughout the economy. Home loans will be priced out of reach for many, while car payments and student loans will become prohibitively expensive. For those who lose their jobs in the economic turmoil, such expenses become entirely unaffordable. The severity of the consequences of an eventual crisis, rather than the capacity to predict its exact timing, should induce the urgency to address it, and hearings such as this advance that goal.

Thank you for the opportunity to appear today. I look forward to answering your questions.

[1] http://www.cbo.gov/sites/default/files/cbofiles/attachments/45010-Outlook2014_Feb.pdf