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of the Committee on Homeland Security and Governmental Affairs

*"The Effect of Borrowing on Federal Spending"*

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Federal policymakers face a daunting number of significant pressing fiscal challenges. Most immediately, Congress has an April 28 deadline to renew expiring government spending authority through the end of the current fiscal year. Failure to do so could result in a government shutdown.

Then there is the budget for fiscal 2018, which is sure to be a matter of significant debate given President Trump's recent call for big increases in spending on the military and veterans' benefits, and commensurate cuts to nondefense discretionary programs.

The Treasury debt limit was also reinstated on March 16, although the Treasury probably has until at least August and perhaps as long as early October before it runs out of cash to pay bills coming due.

Policymakers appear likely to take up comprehensive tax reform this year. This will involve lowering marginal tax rates for businesses and individuals, and scaling back or eliminating preferences in the tax code to help pay for the lower rates. To pay for significant tax cuts, policymakers will need to find other sources of revenue or additional cuts in government spending, both of which will be extraordinarily difficult to do.

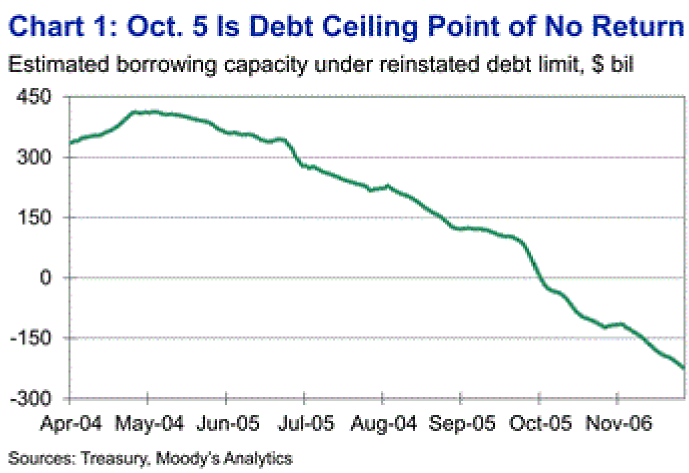
And then there is the nation's longer-run fiscal problems. The federal budget deficit is currently running at nearly $600 billion annually, equal to just over 3% of GDP. Publicly traded federal debt is equal to more than 75% of GDP, more than double what it was a decade ago, prior to the Great Recession. But more disconcerting, without significant changes to federal tax and spending policies, the federal government's deficits and debt load will steadily increase. The Congressional Budget Office estimates that by 2020, if no changes are made to current law, 92 cents of every federal tax dollar will go toward mandatory spending and interest. A decade from now this will rise to more than one dollar. This is not sustainable.

This written testimony will focus on the potential economic impact of political brinkmanship over increasing the Treasury debt limit. Such brinkmanship would be very costly to taxpayers, and under some scenarios catastrophic for the economy. This testimony will also provide a few suggestions policymakers may want to consider to address the nation's looming problem with deficits and debt.

**Treasury debt limit countdown**

In a letter to House Speaker Paul Ryan, Treasury Secretary Steve Mnuchin confirmed that the Treasury debt limit, which was suspended by the Bipartisan Budget Act of 2015, would be reinstated on March 16 and that he would start undertaking extraordinary measures to preserve the Treasury's cash to avoid defaulting on its obligations.

The Treasury looks to run out of room under the $19.9 trillion debt ceiling as soon as August, but no later than early October. Under the most likely scenario, the Treasury will be able to manage until the September 15 corporate tax deadline, when an inflow of tax receipts will provide another couple of weeks' worth of headroom under the limit. However, Congress will need to raise the limit by October 5 (see Chart 1).[1]




Any thought that Treasury would be able to pay holders of U.S. government securities first, and thus avoid defaulting on its obligation, is misplaced. Treasury has the technical ability to pay bond investors before others, as those payments are handled by a different computer system than other government obligations, but the Treasury believes it is not legally viable to do so, and politically it would be very difficult to pay bond investors before, say, Social Security recipients.

Even if the Treasury did pay bond investors first, this would not stop investors from demanding a much higher interest rate for the legal uncertainty and the real possibility that they may not get paid on time in the future. Bond investors, especially those overseas, would reasonably ask whether Congress would actually allow them to be paid ahead of American seniors.

Deciding which other bills receive priority would be all but impossible, as the Treasury could not sort through the blizzard of payments due each day. More likely, the Treasury would delay all payments until it received enough cash to pay a specific day's bills, as outlined in a 2012 report by Treasury's inspector general.

The Federal Reserve could restart quantitative easing—purchases of Treasury bonds—but any benefits would likely be overwhelmed as global investors sold U.S. securities. Financial markets would surely be spooked. Sometime in early October, there would be a TARP moment, harkening back to that day in autumn 2008 when Congress failed to pass the Troubled Asset Relief Program, and the stock market and other financial markets cratered.

There has been no discernible reaction in financial markets to a potential standoff over the debt limit so far. Credit default swaps on Treasury securities—the cost of insuring against a default by the Treasury—are currently close to a very low 5 basis points for one-year Treasuries, and less than 30 basis points for five-year securities. For context, in the summer of 2011 when brinkmanship around raising the debt limit was at its apex, CDS spreads on one-year Treasuries rose to as high as 80 basis points and those on five-year Treasuries to 65 basis points.

Markets are calm likely because it has become typical for Congress to run down the clock but in the end to raise the debt ceiling when absolutely necessary. It is thus widely expected that Congress will do so again. This is especially true now given that Republicans control both the executive and legislative branches of government. Investors cannot imagine that the deadline will be as disruptive as some recent experiences.

However, the House Republicans' inability to coalesce around a healthcare bill last week shows that policymaking is still rocky under a unified government. The longer it takes for policymakers to raise the debt limit, the more likely it will cost taxpayers money and harm the economy. And if policymakers fail to raise the limit before the Treasury runs out of cash and causes it to default on its obligations, it will be extraordinarily costly to taxpayers and do serious, even potentially catastrophic, damage to the economy.

**Economic impact**

The impact of political brinkmanship over the Treasury debt limit will show up first in higher interest rates. Just how costly this can be is evident from the reaction of Treasury investors during the last round of such brinkmanship in late 2013. A Moody's Analytics analysis of the period shows that investors nervous about a U.S. government default pushed 10-year Treasury yields up by 6 to 12 basis points at the height of their angst. Short-term interest rates also increased.[2]

Even though the Treasury ultimately did not default, and interest rates quickly fell back, the episode cost taxpayers an estimated nearly half-billion dollars in added interest costs. And this does not include the costs to households and businesses that also had to pay higher interest rates on the money they needed to borrow. Though these costs were relatively modest, they were unnecessarily incurred, and they surely would have been many multiple times greater if the Treasury actually had defaulted on its debt.

Brinkmanship around the debt limit will also quickly affect consumer and business sentiment and harm economic growth. Businesses will become more reluctant to invest and hire and entrepreneurs less likely to start companies. Financial institutions will be more circumspect about extending credit and households more cautious about their spending.

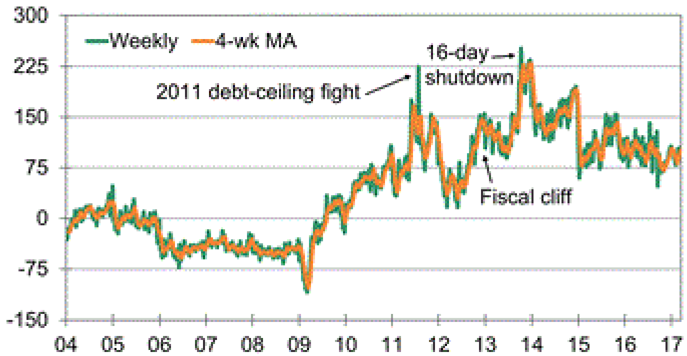
Uncertainty created by Washington is already very high, according to the Moody's Analytics political uncertainty index. The index is based on the CDS-implied probability of default on five-year Treasury bonds, the present value of future expiring tax provisions, and the share of businesses that cite legal and regulatory issues as their biggest problem in the Moody's Analytics weekly business survey. The index is set to equal zero in 2004-2005, near the end of the last business cycle. The higher the index, the greater the uncertainty.

The Moody's Analytics index rose significantly during the heated debate over the American Recovery and Reinvestment Act—the $830 billion fiscal stimulus—in early 2009. It surged during the budget debate in early 2010, and the Treasury debt-ceiling showdown in the summer of 2011 (see Chart 2). It hit a record high during the late 2013 government shutdown and has remained elevated ever since.

Political uncertainty is a corrosive on business investment, reduces hiring, and slows GDP growth. A statistical analysis shows that increased political uncertainty since the 2008 recession has lowered real GDP by close to $180 billion, reduced employment by 1.2 million jobs, and increased unemployment by 0.7 percentage point.[3] If not for the logjams in Washington in recent years, and if policy uncertainty had simply remained unchanged from its prerecession level, the economy would have returned to full employment nearly a year ago.[4]

**Chart 2: Fiscal Uncertainty Remains Elevated**

Fiscal policy uncertainty, 2004-2005=0




Source: Moody's Analytics

If the debt limit is not increased in time and the Treasury actually were to default, not only would interest rates and policy uncertainty soar, but the federal government would have to significantly cut back on its spending. Based on the timing of outlays and tax receipts, this would probably mean delaying by more than a week about $60 billion in payments due November 1 to Social Security recipients, veterans, and active-duty military. This would almost surely undermine consumer and business confidence.

If the impasse over the debt limit lasts through November, the Treasury will have no choice but to eliminate a cash deficit of approximately $130 billion by slashing government spending.

In contrast with previous recessions, the Federal Reserve and fiscal policymakers would have few tools available to cushion the blow. With Congress and the administration still at loggerheads, there would be no fiscal policy response, and with already very low short-term interest rates and a bloated Federal Reserve balance sheet, it is unclear how much the central bank could do to support the economy.

This would be a cataclysmic economic scenario. Based on simulations of the Moody's Analytics model of the U.S. economy, the downturn would be at least as severe as the Great Recession. That means real GDP would decline by as much as 5%, close to 10 million jobs would be lost, and unemployment would rise back close to double digits. With this economic backdrop, stock prices would likely be cut in half, wiping out about $10 trillion in household wealth. Treasury yields would likely spike, at least until the debt limit is increased and debt payments are resumed.

## The path forward

Policymakers have yet to consider how they should go about increasing the debt limit. There are several approaches Republican leaders might take to address the issue, including raising the debt limit as part of a necessary spending bill, such as the spending legislation that will need to be enacted by September 30, the end of the current fiscal year. The debt limit could also be raised as part of the reconciliation process, and combining tax reform with a debt limit increase, for example. To do so, instructions to increase the debt limit would need to be included in the fiscal 2018 budget resolution sometime this summer.

Finally, Republican leaders could pass a debt limit increase as a standalone piece of legislation without any direct link to the budget process. Several recent debt limit increases have been passed this way. This option could be attractive if other legislation, such as tax reform, is not ready by the time the debt limit needs to be raised.

## Budget reforms

Congress could also use this opportunity to eliminate the statutory debt ceiling. It is an idiosyncratic, anachronistic and, as has been demonstrated, potentially destructive rule that is detrimental to sound economic policy.

Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing and tax and spending policy, by requiring "ability to pay" language in any legislation that adds to future deficits. Ability to pay is defined as sufficient projected tax revenue and borrowing authority to cover the current Congressional Budget Office deficit forecast. This requirement would be applied to all direct spending, taxation and annual appropriations bills. Any discrepancies that result from changes in the CBO forecast could be reconciled in the annual budget process.

The debt ceiling would still force lawmakers to think about the long-term fiscal impact of any legislation, but it would do so in the context of the spending and taxation bills that create the need for that debt. This proposal makes use of current CBO budget projections and scoring practices, and thus should cause no new compliance costs.

Another alternative would be to cap the ratio of the structural deficit to potential GDP for the coming year; as long as this remains below an agreed-upon threshold, the debt limit increase would be automatic.

Policymakers should also require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting.[5] This provides a more accurate calculation of the nation's long-term fiscal obligations and thus would create the basis for sounder budgeting and fiscal decision-making.

The fiscal gap describes the difference between the present value of projected government expenditures, including interest and principal payments on outstanding federal debt, and taxes and other receipts, including income accruing from the government's ownership of financial assets. Generational accounting measures the burden of closing the fiscal gap on today's and tomorrow's children, assuming they must do so on their own and that the burden on each generation is proportional to its labor earnings.

Fiscal-gap accounting and generational accounting are comprehensive and forward-looking, and determine the sustainability of fiscal policy and the burden of that policy on future generations. Fiscal-gap accounting has already been adopted by the Social Security Trustees and Medicare Trustees and is becoming more widely used in other countries.

Taking these steps would restore the fundamental economic relationship between budgeting and borrowing, and reduce the risk that political brinkmanship could damage the full faith and credit of the U.S. or the stability of world financial markets.

**Pro-growth policies**

It is also important for lawmakers to address the nation’s long-term fiscal challenges. Although the fiscal situation should be more or less stable during the next several years, the long-term outlook remains disconcerting. If Congress does not make significant changes to the tax code and entitlement programs, rising healthcare costs and an aging population will swamp the budget in coming decades.

Of course, the best way to address these looming challenges is to implement policies that will boost the economy’s long-term growth rate. For every one-tenth of 1% increase in long-run GDP growth, the federal budget deficit over the next decade would be reduced by almost $300 billion. Thus policies that increase GDP growth from say 2% per annum—the current consensus outlook for real GDP growth over the next decade—to 2.5% per annum, for example, would reduce annual budget deficits by a sizable $150 billion.

To achieve such a boost in the economy’s long-run growth and improvement in the nation’s finances, three key policies should be implemented: revenue-neutral corporate tax reform, immigration reform that significantly increases the number of legal immigrants permitted into the country, and a significant expansion in infrastructure spending.

**Corporate tax reform**

Revenue-neutral corporate tax reform that lowers marginal corporate tax rates and is paid for by scaling back or eliminating tax preferences in the code or other sources of revenue would support growth by improving the competitiveness of U.S. businesses. As part of corporate tax reform, policymakers should replace our current worldwide taxation system with a territorial system that has a minimum tax on overseas earnings. Multinationals should also be encouraged to repatriate their now sizable pile of overseas profits with a lower tax rate.

However, paying for any cuts to marginal rates will be difficult. Every 1-percentage point reduction in the corporate tax rate costs the Treasury approximately $120 billion over a 10-year period on a static basis. Thus, reducing the top rate from its current 35% to 25%, for example, would cost $1.2 trillion. The lower marginal rates will result in a stronger economy, and thus on a dynamic basis the cost will be closer to an estimated $900 billion, but this is still a very big number and a heavy lift for policymakers.

A phased-in so-called border adjustment tax would be a reasonable way to raise the needed revenue. Simply put, the idea behind the tax is to require all imported goods and services to effectively pay the corporate tax, but exempt all exports from the tax. Because the U.S. runs a close to $500 billion annual trade deficit, the tax would raise the revenue needed to lower the marginal rate to 25%.

The principal downside to the border adjustment tax is the uncertain incidence of the tax. That is, it is unclear who ultimately will pay for it. Much of the tax will be borne by foreign companies selling their wares in the U.S., but it could also be partially borne by U.S. consumers via higher costs for imported goods. U.S. retailers may also feel some ill effects. In theory, if phased in, U.S. consumers and retailers should not be harmed, but this depends on a range of assumptions including the impact of the tax on the value of the U.S. dollar. So in practice, we cannot know for sure what the incidence will be.

**Immigration reform**

Reform of the nation’s immigration laws would provide an even more effective way of boosting long-term economic growth. The Border Security, Economic Opportunity, and Immigration Modernization Act of 2013 is a good example of such reform. This legislation—also known as the Gang of Eight bill for the eight senators, including Republicans and Democrats, who crafted the legislation—passed the Senate in a bipartisan vote but stalled in the House and never became law.

This legislation expands existing employment-based immigration, including exempting from the cap on green cards foreigners with STEM graduate degrees or doctorates in any field. The number of temporary immigration visas for skilled and unskilled workers also increases. It would create a points-based immigration track that would reward individuals with greater education, English fluency, and other factors. Family-based immigration would be expanded by uncapping the annual number of green cards that can be issued to spouses and unmarried children of existing legal permanent residents. And perhaps most controversially, the reform includes a path to legalization for undocumented immigrants living in the country who meet certain criteria.

The Congressional Budget Office's economic analysis of this legislation found that it would increase legal immigration to the U.S. by approximately 1 million per year. Within a decade, the U.S. population would be about 3% larger than it would be without the change in immigration law. The legislation would result in a substantial increase in the number of both high-skilled and low-skilled immigrant workers.

According to the CBO, this legislation would increase real GDP by a substantial 3.3% within a decade compared with what GDP would have been without the change. The increase in population also lifts the labor force and employment. There would be close to 6 million more jobs in 10 years, as the additional population would add to the demand for goods and services and, in turn, the demand for labor. Productivity would also receive a measurable boost, as the "immigration of highly skilled immigrants would tend to generate additional technological advancements, such as new inventions and improvements in production processes."[6]

**Infrastructure investment**

A significant increase in public infrastructure investment would also support stronger longer-term growth. The federal government spends approximately $100 billion per year on infrastructure, mostly on transportation and water systems.[7] Federal financial support for infrastructure should be substantially increased via more direct spending and the formation of an infrastructure bank.

The bank would provide direct loans, loan guarantees, and other forms of credit enhancement, which would support hundreds of billions in more infrastructure spending. If fashioned off the Transportation Infrastructure Finance and Innovation Act program, the bank could fund a significant amount of additional investment. For example, if the bank received $25 billion in seed capital, it could support as much as $250 billion in federal loans over a five-year period. Those loans, in turn, could make up approximately one-third of total project costs, so in all the infrastructure bank could support as much as $750 billion in total additional infrastructure development. Although to be sure, the operation and success of such an infrastructure bank involves significant uncertainties.

An infrastructure bank could also help administer a Build America Bonds program, which was successful in financing a substantial amount of infrastructure development in the wake of the financial crisis.[8] This would be a significant change in the tax preferences that the federal government offers to buyers of municipal bonds, which are often issued to finance highway construction projects. Tax-exempt bonds are a relatively inefficient way to subsidize state and local governments' investment in infrastructure, because the revenue cost to the federal government may substantially exceed the interest-cost subsidy provided to the state and local governments.

**Possible budget changes**

Even if policymakers are able to implement these pro-growth policies, to fully address the nation's long-term fiscal problems, policymakers will still need to implement cuts in government spending and increases in tax revenues. What follows are a few suggestions.

Unfortunately, as economist like to say, there is no free lunch; any change in tax and spending policy requires hard choices. These suggestions significantly reduce future budget deficits, have limited broader economic consequences, and are sensitive to the distributional impacts on different groups. Taken together, these suggested changes will reduce budget deficits over the next decade by close to $1 trillion. But even more will need to be done, particularly with regard to the growth in future healthcare costs, but that is a subject for another day.

*Increase the maximum taxable earnings for the Social Security payroll tax*.

When payroll taxes for Social Security were first collected in 1937, about 92% of earnings from jobs covered by the program were below the maximum taxable amount. This has slipped substantially over the past more than a decade. Even as the maximum increases with the growth in average earnings, earnings for the highest-paid workers have grown much faster because of the skewing in incomes. In 2016, only 82% of earnings from employment covered by Social Security fell below the maximum taxable amount.

The suggestion would be to increase the taxable share of earnings from jobs covered by Social Security to 90%. The maximum taxable amount would increase to $245,000 in calendar year 2017. In later years, the maximum would grow at the same rate as average wages, as it does under current law.

Implementing such a policy change would increase federal revenues by an estimated $648 billion over the next decade, according to the Joint Committee on Taxation.[9]

*Use the chained consumer price index measure of inflation to index Social Security and other mandatory programs, and some parameters in the tax code.*

Cost-of-living adjustments for Social Security and other federal programs are indexed to increases in traditional measures of the consumer price index. The CPI measures overall inflation and is calculated by the Bureau of Labor Statistics. In addition to the traditional measures of the CPI, that agency computes another measure of inflation—the chained CPI—designed to account for changes in spending patterns and to eliminate several types of statistical biases that exist in the traditional CPI measures.

The suggestion would replace the traditional CPI beginning in 2018 with the chained CPI for indexing cost-of-living adjustments for Social Security and parameters of other programs. This change would also apply to various parameters in the tax code, such as income thresholds that divide the tax brackets. The chained CPI has grown by an average of about 0.25 percentage point more slowly per year over the past decade than the traditional CPI measures have, and the gap is likely to persist. Therefore, the option would reduce federal spending and increase revenues, and the benefits to the budget would grow each year as the effects of the change compounded.

Implementing such a policy change would lower federal spending by $182 billion through 2026, according to the CBO. And according to the Joint Committee on Taxation, it would increase federal revenues by $157 billion over the same period.

*Convert the mortgage interest deduction into a 15% tax credit.*

Homeowners can deduct the mortgage interest they pay on up to $1.1 million in mortgage debt if they itemize their deductions. Like all itemized deductions, the value is reduced as the homeowners' adjusted gross income increases above specified thresholds. Homeowners benefit from this deduction through higher house prices, as the value of the deduction is largely capitalized in house prices. And generally wealthier homeowners benefit, as they are the ones likely to itemize on their tax returns.

The suggestion is to gradually convert the tax deduction for mortgage interest to a 15% nonrefundable tax credit. This change would be phased in over six years, beginning in 2017. By 2022, the deduction would be replaced by a 15% credit; the maximum amount of mortgage debt that could be included in the credit calculation would be $500,000; and the credit could be applied only to interest on debt incurred on a first home. This change would promote homeownership, as lower- and middle-income households who are more likely to benefit are also more likely to be renters.

This suggestion would raise $105 billion in revenues over the next decade, according to the Joint Committee on Taxation. The increase in revenue would be substantially greater in subsequent decades.

**Conclusions**

Washington's budget battles in recent years have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and much anxiety among consumers, businesses and investors, impairing their willingness to spend, hire and invest.

Despite these political headwinds, the economic expansion is nearly 8 years old, making it the second longest in the nation's economic history. The economy is at full employment for the first time in a decade, and the benefits of the stronger economy are finally beginning to accrue to lower- and middle-income households. Business balance sheets are about as strong as they have ever been, the banking system is well capitalized, and households have significantly reduced their debt loads.

This is an opportune time for policymakers to address the nation's long-standing fiscal challenges. This includes eliminating the statutory debt limit; adopting fiscal gap and generational accounting; implementing pro-growth policies such as revenue-neutral corporate tax reform, immigration reform, and infrastructure investment; and making some modest adjustments to tax and spending policies.

Accomplishing this will require some deft policymaking, but it would put the American economy and the nation's finances on a solid foundation for decades to come.

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[1] These are similar to estimates done by the Congressional Budget Office.

[2] The referenced Moody's Analytics study is available upon request.

[3] These results are based on a structural vector autoregressive model of the U.S. economy. The model is used to estimate the extent to which surprise changes in political uncertainty produce changes in GDP, unemployment, the hiring rate, investment, jobs, and several other economic variables.

[4] It is difficult to statistically distinguish between political uncertainty and policy uncertainty. Political uncertainty is created by political brinkmanship and dysfunction in government. Policy uncertainty is created by potential changes in government spending, taxes and regulation. The 2011 showdown over the Treasury debt limit was especially hard on the economy, as it created a great deal of political uncertainty but also involved large changes to spending and tax policy. The current government funding and debt limit debates may have less economic impact, as they appear to involve more political than policy uncertainty. Despite current legislative efforts to defund the Affordable Care Act, such defunding seems very unlikely, and no other major policy changes are being debated, at least so far. Also mitigating the economic impact of the current debate is that businesspeople, consumers and investors appear to be increasingly desensitized to the political vitriol with each budget battle.

[5] This proposal is part of the INFORM Act.

[6] CBO continues that "total factor productivity (TFP, the average real output per unit of combined labor and capital services) would be higher by roughly 0.7% in 2023 than what would occur under current law. The increase in TFP would make workers and capital alike more productive, leading to higher GDP, higher wages, and higher interest rates."

[7] According to a CBO analysis, an additional approximately $300 billion per year is spent on infrastructure by state and local governments.

[8] Build America Bonds, which supported more than $180 billion in infrastructure spending during the financial crisis, are a more efficient way of helping to finance infrastructure spending than traditional tax-exempt municipal debt, as tax-exempt municipal debt ends up benefiting not just infrastructure projects but also high-income purchasers of the debt. See the statement of Frank Sammartino, assistant director for Tax Analysis of the Congressional Budget Office, in a hearing of the Senate Finance Committee.

[9] These estimates account for the reduction in individual income tax revenues that would result from employers' shifting some labor compensation from a taxable to a nontaxable form.