

Testimony

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On

“The Need for a Balanced Budget Amendment to the Constitution”

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Thank you for the opportunity to testify on behalf of the Balanced Budget Amendment.

I have been working on federal budget issues in Washington for more than 30 years and when I first started, the budget was just less than \$1 trillion and the deficit was just over \$100 billion. At the time, a \$100 billion budget deficit was seen as financially ruinous and a symptom of our political disregard for future generations. I worked for Ronald Reagan when we embarrassingly proposed the first \$1 trillion budget in 1986.

I shudder when I think about what has happened in the succeeding 30 years. First, the budget is not \$1 trillion, but it is now \$4 trillion and inflation only accounts for about half of this increase. Deficits of the unthinkable level of \$100 billion have now reached as high as \$1.5 trillion and are headed back in that direction. And the national debt of \$3 trillion is now \$19 trillion.

We are tempting fate here. It seems as though we are in a contest to see how fiscally reckless we can be in Washington before the whole system collapses. It is like the game of Jenga that I play with my kids, where we keep putting blocks on top of the tower and hope that it doesn't topple on our watch. But it eventually crashes.

I was at first not a big fan of a balanced budget amendment and I have to confess that I believed the critics who said, we just need to show some backbone and courage; we don't need to mess with the Constitution. But neither party has shown the courage or backbone to do anything about federal spending and borrowing. They won't – and the institution is inherently incapable of doing so. To ask Congress to restrain its spending is like asking a cat to put a bell on itself. So \$17 trillion of debt later, I now believe a new fiscal constitution is necessary for America. And it will only happen when the people rise up and demand it. The first step is for Congress to pass the BBA and send it to the states and people where we can then have a great and long overdue national debate about our fiscal future.

A balanced budget amendment should set new rules that outlaw federal borrowing except in extraordinary circumstances. It should take a supermajority to authorize new borrowing. It should also take a supermajority vote to raise taxes. S.J. Res. 6 does this and so I strongly support it.

### False Criticisms of the Balanced Budget Amendment

I would like to address a few of the false concerns about the Balanced Budget Amendment.

The first is the idea that deficits are good for the economy when times are tough. This was the Keynesian notion that it is appropriate and even proper to borrow during times of economic stagnation and that there is a “multiplier effect” to government spending and borrowing.

This is clearly false in theory and in practice. Government spending and borrowing doesn't stimulate growth, because it crowds out private sector spending and resources. When the government borrows, it must issue bonds and someone must purchase the bonds. Every dollar the government receives from bondholders to spend is exactly offset by a dollar the bondholders withdraw from the economy in buying the bonds. This is money that could have been spent or money that could have been loaned to a private business, but is now diverted to the government. So the net effect of government borrowing and spending on the economy even in the short term is at best zero, and probably negative because government gets a lower return on its spending than private actors.

History confirms this. After eight years of the first grand Keynesian experiment -- the New Deal during the Great Depression -- the unemployment rate in 1939 was 20.7 percent and output was still growing at a crawl, seven years after Franklin Delano Roosevelt took office. That's some victory. As Burton Folsom, author of the Depression history *New Deal or Raw Deal*, has argued: "The greatest myth of the twentieth century is that Franklin Roosevelt's New Deal ended the Great Depression."<sup>1</sup>

Japan has employed textbook Keynesianism for 20 years and nearly the whole island has been paved over by public works projects financed by record levels of debt, yet the economy continues to flounder and asset values are still only half what they were in 1990.

The most thorough recent repudiation of Keynes has been the Great Recession of 2008–2011. Never in modern times has the premise that open-checkbook government spending and pedal- to-the-metal money creation lead to economic growth been put to such a large-scale trial. The government borrowed \$7 trillion in six years and produced the flimsiest recovery among all recessions post-World War II.

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<sup>1</sup> Folsom, Burton W. *New Deal or Raw Deal?: How FDR's Economic Legacy Has Damaged America*. New York, NY: Threshold Editions, 2008. Xiii.

The Obama economics team predicted a “multiplier effect” from all of the Obama debt spending. Obama’s Agriculture Secretary Tom Vilsack forecast that food stamps would be an “economic stimulus” and that “every dollar of benefits generates \$1.84 in the economy in terms of economic activity.”<sup>2</sup> They saw no negative effects from giving people money and food in exchange for not working. If Vilsack had been right then we should have put every American on food stamps.

Here are the facts. When President Obama came into office, the recession, which started in December, 2007, was already 12 months old. There have been 11 other recessions since the Great Depression. The average duration of those recessions was 10 months. So the recovery was already overdue when he came into office. All he really had to do was stay out of the way. But he didn’t stay out of the way. He took the country on an unprecedented, throwback, Keynesian economics bender, which only delayed rather than promoted recovery, just as it did in the 1930s.

The Obama stimulus bill was almost a complete failure in creating jobs even using Barack Obama’s own economic analysis. Mr. Obama’s White House economics team famously predicted in 2009 that every dollar of additional federal borrowing would lead to about \$1.50 cents of additional economic activity due to the supposed “multiplier effect” of government spending on private activity.<sup>3</sup>

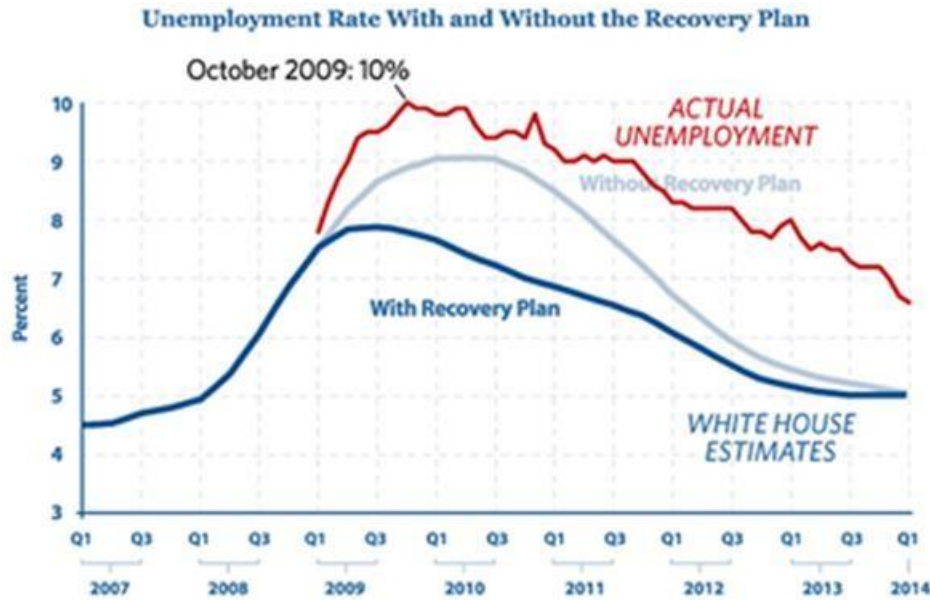
The White House economics team also analyzed what would happen to unemployment during the first several years of the coming recovery with and without the \$800 billion stimulus bill. Not only did unemployment turn out to be higher than was projected with the extra spending, but the unemployment rate was also consistently higher with the stimulus spending than the White House had projected would be the case if Congress had not borrowed and spent all this money (see chart below). So we would have been better off doing nothing. Apologists like Paul Krugman of the New York Times argue that the stimulus “wasn’t big enough.”<sup>4</sup> But over the last six years the U.S. government has increased the debt by more than \$7 trillion. It seems highly implausible that more debt would have led to more growth.

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<sup>2</sup> “Obama Ag Secretary Vilsack: Food Stamps Are A ‘Stimulus’”, *Real Clear Politics*, August 16, 2011, [http://www.realclearpolitics.com/video/2011/08/16/obama\\_ag\\_secretary\\_vilsack\\_food\\_stamps\\_are\\_a\\_stimulus.html](http://www.realclearpolitics.com/video/2011/08/16/obama_ag_secretary_vilsack_food_stamps_are_a_stimulus.html) (Accessed January 6, 2016).

<sup>3</sup> Mark Zandi, “The Economic Outlook and Stimulus Options,” *Moody’s Economy.com*, Testimony before the U.S. Senate Budget Committee, November 19, 2008, Table 1, p. 10, [https://www.economy.com/markzandi/documents/Senate\\_Budget\\_Committee\\_11\\_19\\_08.pdf](https://www.economy.com/markzandi/documents/Senate_Budget_Committee_11_19_08.pdf) (accessed January 8, 2016); Zandi asserts that for each dollar of new government spending: temporary food stamps adds \$1.73 to the economy, extended unemployment benefits adds \$1.63, increased infrastructure spending adds \$1.59, and aid to state and local governments adds \$1.38. Jointly, these figures imply that, in a recession, a typical dollar in new deficit spending expands the economy by roughly \$1.50.

<sup>4</sup> Paul Krugman, “How Did We Know The Stimulus Was Too Small,” *The New York Times*, July 28, 2010, [http://krugman.blogs.nytimes.com/2010/07/28/how-did-we-know-the-stimulus-was-too-small/?\\_r=0](http://krugman.blogs.nytimes.com/2010/07/28/how-did-we-know-the-stimulus-was-too-small/?_r=0) (accessed January 7, 2016).



Source: "The Job Impact of the American Recovery and Reinvestment Plan," 2009, president's Council of Economic Advisers; Bureau of Labor Statistics, Labor Department. Graphic: The Heritage Foundation, April 2015.

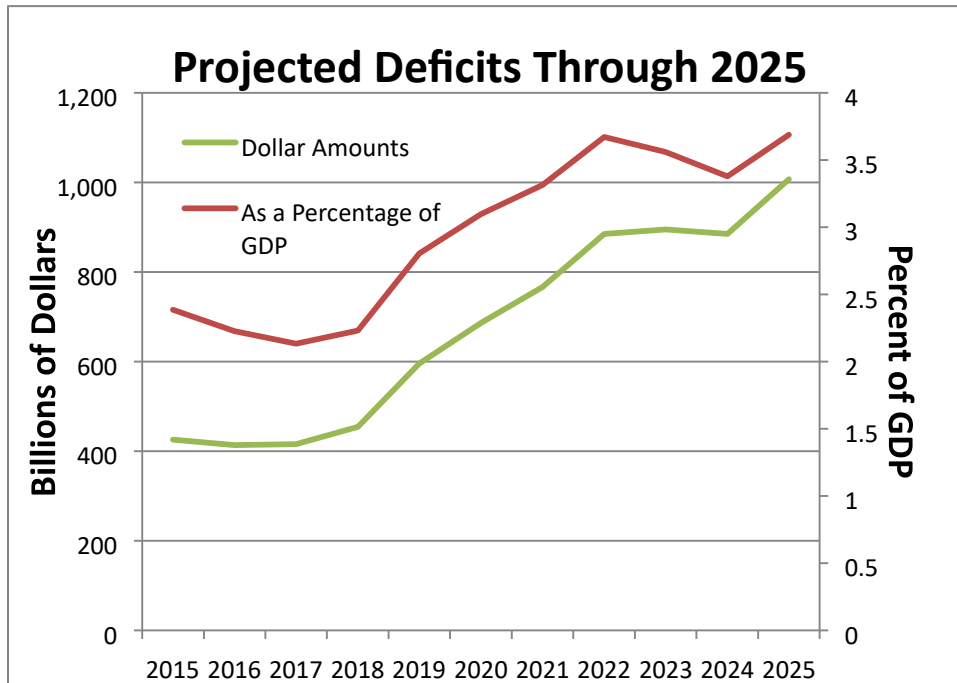
In sum, we have had higher unemployment with the stimulus than we would have had without the stimulus – by Obama’s own admission. What is worse is that the money has all been spent. Now the U.S. is only left with debt repayments and very slow growth.

The second myth is that our deficit is under control now. No it isn't. Our debt burden is expected to escalate over the next two decades at least as baby boomers continue to move into partial and then full retirement. Boomers will eventually collect hundreds of billions and then over time trillions of dollars of benefits through the government’s biggest three income transfer programs: Social Security, Medicare, and Medicaid. The money will come from their children and grandchildren one way or the other.

The Congressional Budget Office sees publicly-held debt rising to 107 percent of GDP by the year 2040.<sup>5</sup> If things don't go as planned, an alternative scenario has the debt rising to 175% of GDP over the same time period. Almost every independent economist and financial analyst agrees that debt levels this high are dangerous and debilitating to America’s economic superpower status.

In short, a grim fiscal future may soon confront us. But it is not inevitable. The course can be changed before the average family of four owes close to \$500,000 in federal debt.

<sup>5</sup> Congressional Budget Office, "The 2015 Long-Term Budget Outlook," Table 6-1: Long-Run Effects on the Federal Budget of the Fiscal Policies in Various Budget Scenarios, June 16, 2015, <https://www.cbo.gov/publication/50250> (Accessed January 4, 2016).



The third myth of our debt is that we can't grow our way out of this problem. Maybe not entirely, but without growth we will never cut spending enough and raise enough revenue to get anywhere near balance.

One very big reason the burden of the debt has exploded so suddenly has been the slow growth of the economy over the past decade or so. The relationship between economic growth and the debt is often under-appreciated. Each extra percentage point of growth over a decade generates at least \$2 trillion of additional revenues over a decade. But one percentage point lower growth operates in the opposite fashion with roughly \$2 trillion in lower revenues after a decade. The negative feedback loop of debt is self-reinforcing. A slow economy leads to more debt, which leads to a slower economy, and the cycle keeps getting worse.

We've been diverted away from high growth in the last decade and a half. Here's a way of quantifying the problem. The U.S. economy sustained a real rate of economic growth of 3.3% from 1945 to 1973, and achieved closer to 3.4% sustained real growth from 1982 to 2007. Over the past decade growth has slowed to an anemic 1.5%.<sup>6</sup>

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<sup>6</sup> Bureau of Economic Analysis

At a real rate of economic growth of 3.3%, national output and income would double every 21 years. After another 21 years it would double again, achieving nearly four times the original level. After another 21 years, it would double yet again, achieving nearly eight times the original national output and income. So by 2060 we would have at least \$60 trillion more GDP and that would substantially reduce the burden of the debt.

What Are the Risks from Our National Debt?

I see four immediate dangers to our high and rising levels of debt:

1) America is vulnerable to an interest rate move that could make financing the debt and deficit spending massively expensive.

Government borrowing in an advanced nation with sophisticated financial markets like the United States doesn't seem to impact interest rates much. But what happens if for other reasons interest rates rise? What is the government's exposure to an interest rate spike?

For the past five years or so, interest rates on 10 year Treasury bills have hovered around 2% with a slight upward movement in the last couple of years.

But what happens if this low-interest rate party comes to an end? We have already seen over the last 18 months a gradual rise in interest rates. If that trend continues or accelerates, the economic and financial repercussions could be severe.

CBO performed a sensitivity analysis of the federal government's expenditures for interest payments based on a higher interest rate scenario in the future.

CBO's baseline model projects that publicly-held debt will rise to 107 percent of GDP by 2040. According to the sensitivity analysis, if interest rates each year are on average 0.75 percentage points higher (hardly an unrealistic assumption) than in the baseline, then the public debt in 2040 will climb even higher, to 130 percent of GDP.

The average rate on ten year treasuries is a little over 6 percent. This is 2.75 percentage points higher than today. If rates migrate to their historical average, then interest rate charges over 10 years will rise by roughly \$4.0 trillion. This means the cost for interest on the debt will nearly double from \$400 billion a year to \$800 billion a year. Interest rate payments will then rival or even exceed national defense spending, Social Security, and Medicare as the most expensive item in the budget.

By the way, Congress labors mightily to come up with deficit reduction plans to come up with plans that will erase \$3 trillion from the debt over 10 years. If interest rates rise to

just their traditional levels, the harmful impact of those higher rates would erase every penny of the progress from the most ambitious of all imaginable deficit reduction plans. .

Next we have to consider a “worse case scenario” with rates rising to 7%. Although we think the likelihood of this scenario playing out is small, it is worth considering the down side risk. Under that scenario, interest payments alone rise to above \$1 trillion a year. This would make interest payments by far the single largest expenditure item in the budget. It would mean that well over half of all income taxes paid would be used to pay for interest on the debt. More and more taxes would be paid not for current services like roads, bridges, health care, national security, the courts, law enforcement, etc., but to pay for past spending. This could send the federal government into a debt death spiral of everrising taxes to pay for ever rising levels of debt.

2) The national debt could necessitate the largest tax increase in American history – which would severely damage the U.S. economy.

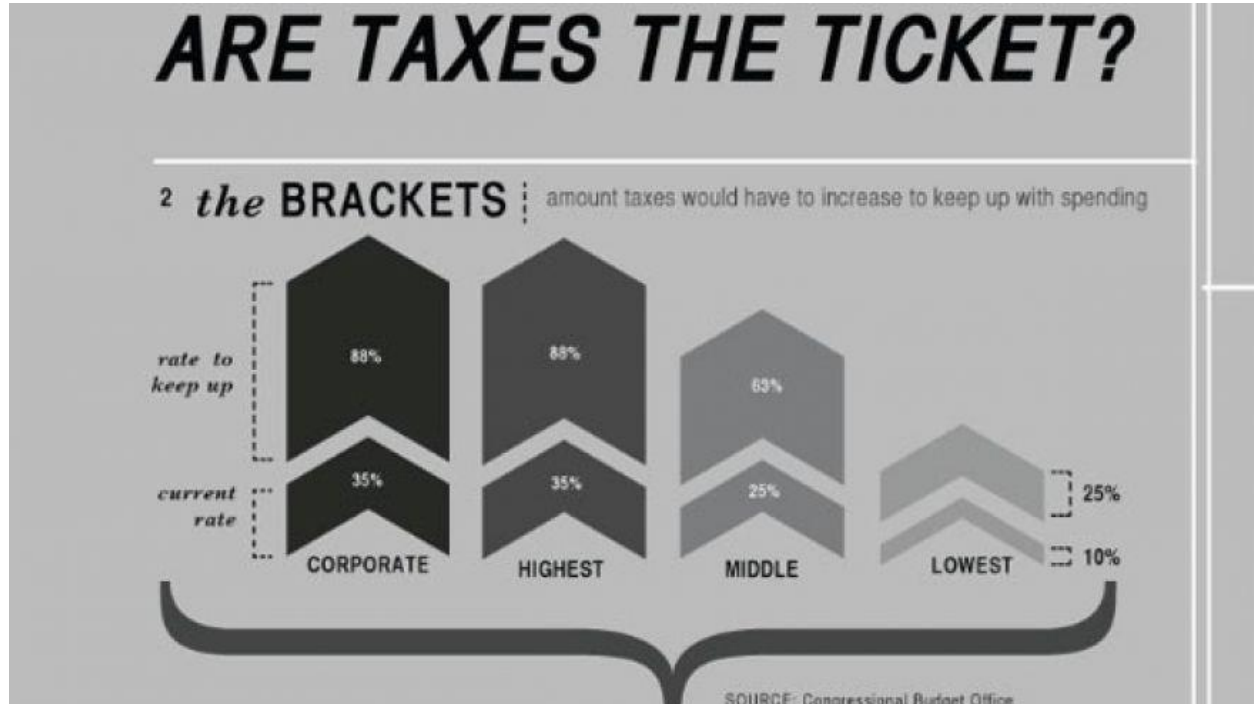
A second major economic threat from the debt is the potential tax increases that might be necessary in the future to pay down the debt. Bills have to be paid at some point. No one and no government can borrow forever at ever rising levels. Economic growth will reduce the carrying cost of the debt, but it won't erase it.

So the issue becomes: what happens if Congress tries to finance deficit reduction by raising taxes? How much are taxpayers going to be on the hook to pay for past and continuing borrowing? We have to add here the cost of unfunded liabilities as well. While these are not legal obligations to pay, as are government bonds, it seems unlikely that Congress is likely to renege on past promises to pay Social Security and Medicare benefits as more than 70 million baby boomers continue to retire. The borrowing costs will certainly rise and as deficits and interest payments rise, as is expected by the Congressional Budget Office. CBO projects higher not lower deficits in the years to come.

The pressure to raise taxes could be insurmountable politically. This pressure will come from lobbying groups that want to retain high levels of spending on social security, medicare, education, and national defense programs. If spending isn't cut, how high could taxes have to rise to cover the costs of paying for current programs?

Several years ago the Congressional Budget Office provided these calculations. CBO found that if spending isn't cut, tax rates on corporations would have to rise to 88% on corporations, near 90% on individuals, and the middle class tax rate would more than double to more than 60%. The following chart shows the numbers versus current tax rates.

The impact of tax rates this high would be economically catastrophic. On the corporate side, the U.S. already has the highest rate in the world at 35%. An 88% corporate tax rate would induce nearly every Fortune 100 company in America to leave for foreign shores. This would be a devastating turn of events for workers as millions of jobs were outsourced to foreign countries with much lower tax rates.



On the individual side, tax rates of near 90% would cause less work, less investment, and less business formation. Most businesses pay their taxes through the individual tax code, so an 80 or 90% tax rate would slow business creation and expansion to a crawl. The last time rates were this high was in the 1970s when the economy stalled out in a series of crippling recessions. The average individual tax rate around the world is between 30 and 40%, under this CBO scenario, the U.S. tax rate would be double the average. American competitiveness in global markets would be crippled.

Higher tax rates are a deterrent to growth. We know, for example, that low tax rate states, have much faster job growth and economic output than high tax states. Texas with no income tax, had more job creation from 2007-13 than all other states combined.<sup>7</sup> A study by ALEC found that since 1970, the no-income tax states had twice the pace of job creation as the high income tax states. The U.S. economy boomed in the 1920s, 1960s and 1980s when tax rates were lowered. High tax eras like the 1930s, the 1970s and the Obama years are associated with recession and/or slow growth. We estimate that income tax rates of more than 50% would have a very negative effect on capital investment in the United States and the worry is the sizable and

<sup>7</sup> U.S. Census Bureau



growing federal debt makes this scenario more plausible in the years to come. This is one giant risk premium from the debt.

CBO, makes this point about the risks of rising tax rates: “Increases in marginal tax rates on labor and capital income reduce output and income below what they would be with lower rates (all else held equal).”<sup>8</sup> That recognition deserves to be applauded, though we think CBO doesn’t even accurately account for the full contractionary effect that such higher marginal tax rates would produce.

3) Current high levels of debt make America vulnerable to a financial crisis if another recession hits.

Usually, as recoveries from recession roll on, we squirrel away extra revenues in a rainy day fund – states do this, for example – to have money in reserve to prepare for the next recession. Uncle Sam doesn’t have a rainy day fund. In fact, seven years into a recovery, the government is still running half trillion dollar deficits, with the forecast that these deficits will migrate back up to \$1 trillion on the current course.

The U.S. is in no financial shape to weather a new recession. If the economy dips into negative territory in the next few years, which would be predictable, based on historical boom and bust cycles, neither family nor federal finances are in any condition to weather the storm. Federal revenues would crash and spending would spike. Something has to give.

Here is the danger, with a normal recession hitting, we could easily see debt levels rise to 300% of GDP and that has historically been a hole too deep for a nation to dig out of. This could trigger the kind of debt death spiral that would cause a severe loss of living standards in the U.S. It is the Greece scenario. The prudent course of action is to cut spending and debt now, so as to be better prepared financially for the next market crash.

4) Federal deficit spending is already “crowding out” private sector borrowing and capital investment.

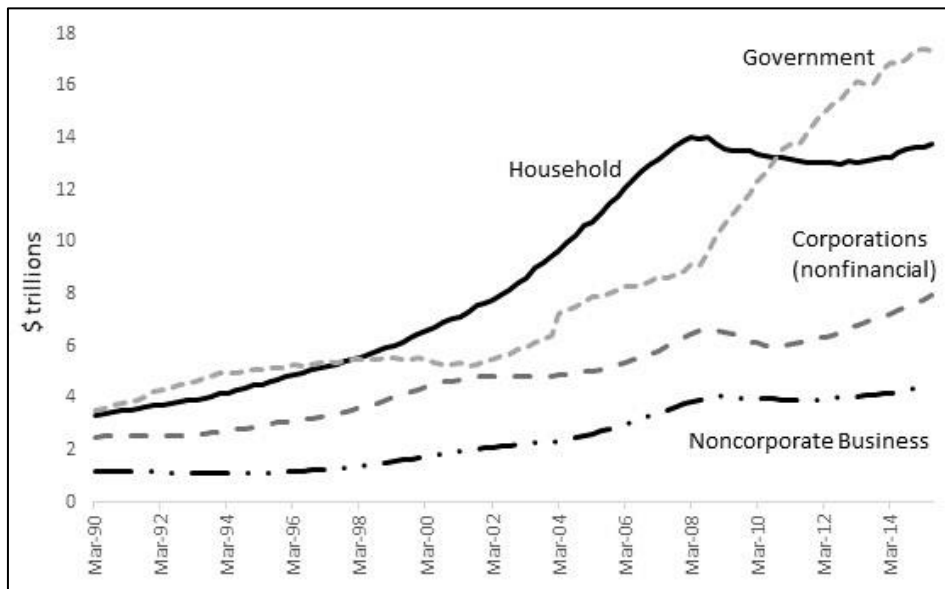
As discussed above, we don’t see much evidence that the debt and deficits of the federal government are raising interest rates. But we do observe a related unhealthy “squeezing out” phenomenon from the deluge of government borrowing. With our colleague David Malpass, we have discovered a disturbing pattern in which massive government borrowing has corresponded with a flattening out and even declining level of borrowing in the private sector. Tight credit is a major problem in the economy. That is

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<sup>8</sup> CBO Long-Term Outlook pg. 78

driven by new financial regulations for sure. But it is also being driven in part by government's pushing out private borrowing.

Since 2007 two of every three dollars of credit in the U.S. economy has been diverted to government, and only one of three finances private sector activity. When private investment dries up, so do living standards and wages.



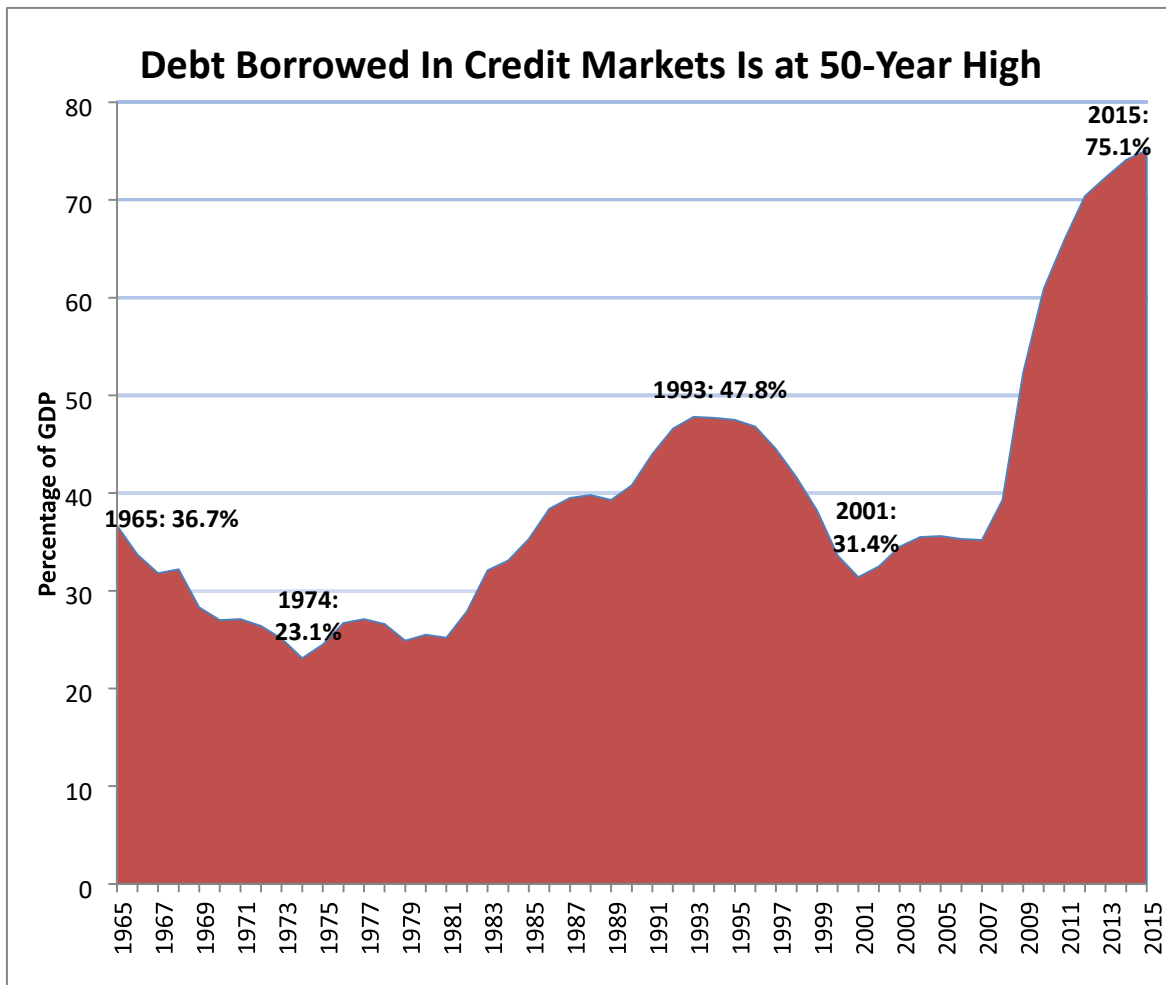
Sources: Federal Reserve, Encima Global

### Conclusion: Living on Borrowed Time and Dollars

The 2014 Congressional Concurrent Resolution on the Budget states, "Interest payments on the debt (the 'legacy cost' of deficit spending) will sum to a staggering \$5.6 trillion over the next decade according to the Congressional Budget Office." This is the case even though CBO assumes the real rate of interest on federal debt remains below 1 percent throughout the entire 10 year period. As previously stated, if the rate rises, the borrowing costs and deficits will accelerate and the ten year forecast looks daunting.

They also look dangerous and debilitating. For much of the post war period the ratio of U.S. government debt to the size of the economy averaged about 36 percent. Under President Obama, the debt ratio has shot up to exceed 75 percent in 2013. Even that isn't what is so worrisome.

It is that the debt is not expected to fall back down again but to remain at this new high-level plateau and if anything continue to climb. Only a balanced budget amendment to the Constitution will reverse this frightening fiscal future.



Source: Office of Management and Budget, Historical Tables, Table 7.1-Federal Debt at the End of Year: 1940-2020, February 2015, <https://www.whitehouse.gov/omb/budget/Historicals> (accessed January 8, 2016).