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# THE REAL DEBT CRISIS: WHAT CAN BE DONE?

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The specter of a credit downgrade looms, and it is frightful. A downgrade threatens to push interest rates higher, making it more difficult for consumers to borrow, for businesses to hire, and for the economy to grow. But even more frightening is the cause of the potential downgrade: unsustainable deficits fueled by government spending. There is, however, a way to exorcise this threat. The experience of nearly two dozen developed economies suggests that the surest way for policy makers to rein in destructive deficits and stabilize the debt is to cut spending, not increase revenue.

## THE THREAT

On July 14, Standard & Poor's (S&P) issued a warning to Washington: within months, policy makers must craft a "credible solution" to reduce deficits by at least $4 trillion over the next 10 to 12 years.[2] If they fail, the ratings agency will downgrade the nation's nearly century-old and highly coveted "AAA" credit rating. S&P made it clear that if policy makers raise the debt ceiling without such a solution they would still downgrade the United States:

> If such an agreement [to raise the debt ceiling] is reached, but we do not believe that it likely will stabilize the U.S.' debt dynamics, we, again all other things unchanged, would expect to lower the long-term 'AAA' rating, affirm the 'A-1+' short-term rating, and assign a negative outlook on the long-term rating.[3]

Many worry that if such a downgrade were to occur, it would trigger a spike in interest rates, necessitating larger interest payments and further exacerbating the problem.[4] This is certainly a concern. But a credit downgrade would be merely one symptom of a deeper and far more dangerous disease: explosive, unsustainable deficit spending.

As shown in Figure 1, the Congressional Budget Office estimates that, absent fundamental changes, the U.S. debt-to-GDP ratio will reach 90 percent within 7 years and be over 100 percent by 2021.[5] These figures are important. Examining 200-years' worth of data from over 40 countries, Carmen Reinhart and

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[1] Matthew Mitchell is a research fellow at the Mercatus Center at George Mason University. He thanks Veronique de Rugy, Emma Elliott, Jason Fichtner, Brian Hooks, Angela Kuck, and Jennifer Zambone for numerous and helpful improvements.

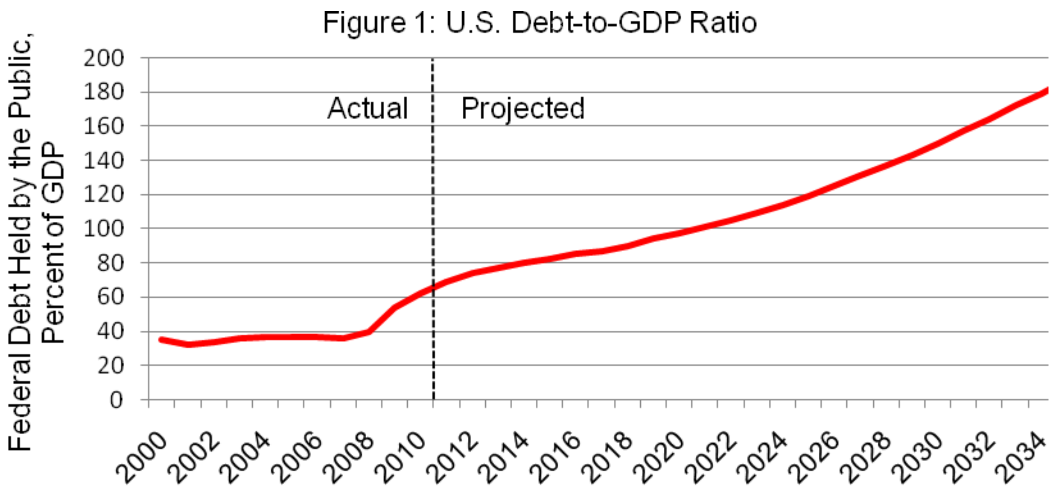
[2] Standard & Poor's, "United States of America 'AAA/A-1+' ratings Placed on Credit Watch Negative on Rising Risk of Policy Stalemate," *Global Credit Portal, Ratings Direct*, July 14, 2011, http://www.getliberty.org/files/SP20110714.pdf: "We may lower the long-term rating on the U.S. by one or more notches into the 'AA' category in the next three months, if we conclude that Congress and the Administration have not achieved a credible solution to the rising U.S. government debt burden and are not likely to achieve one in the foreseeable future."

[3] Ibid.

[4] See, for example, Tom Lauricella and Matt Phillips, "Downgrade Threat Looms: U.S. Could Lose Top Rating; Obama Issues Stark Warning as Boehner Slams Spending," *Wall Street Journal*, July 26, 2011, A1.

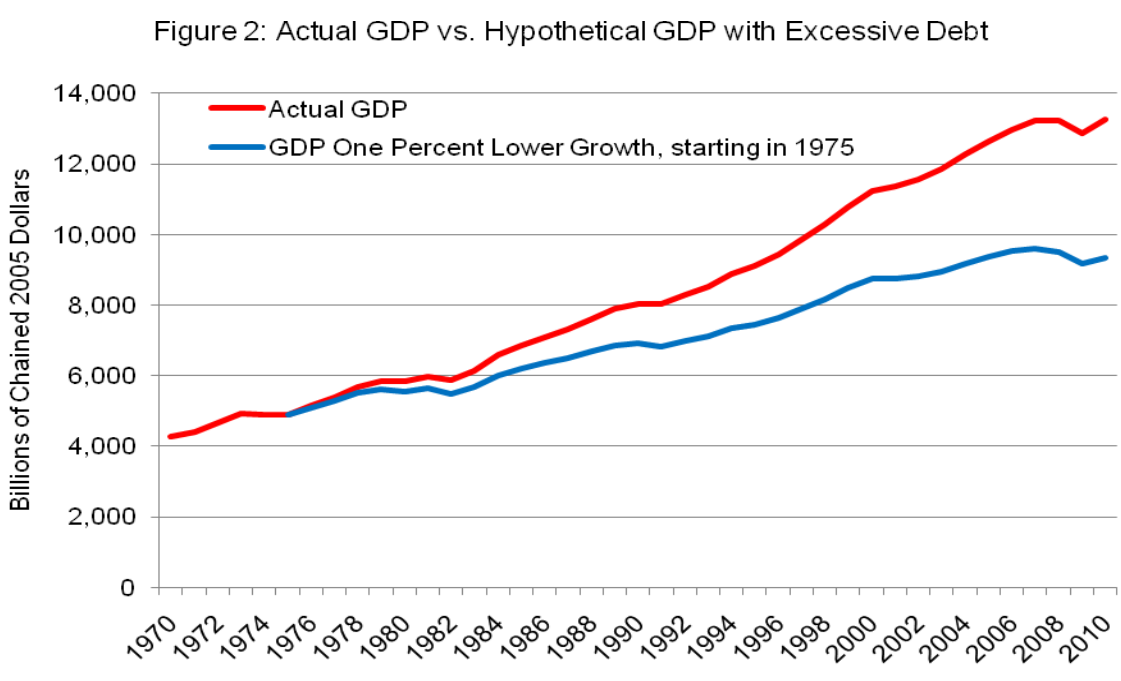
[5] Congressional Budget Office, *2011 Long-term Budget Outlook*, Alternative Fiscal Scenario, June 2011, http://www.cbo.gov/doc.cfm?index=11579.

Kenneth Rogoff have found that debt-to-GDP ratios in excess of 90 percent tend to be associated with economic growth that is about 1 percentage point slower than otherwise.[6]




Source: Congressional Budget Office, *Long-term Budget Outlook*, Alternative Fiscal Scenario, June 2011, http://www.cbo.gov/doc.cfm?index=12212 .

Figure 2 puts this in perspective.




Sources: Author's calculation and Bureau of Economic Analysis, National Income and Product Accounts: http://www.bea.gov/.

[6] Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," *NBER Working Paper No. 15639*, 2010, http://www.nber.org/papers/w15639.

If, starting in 1975, the U.S. had grown 1 percentage point slower than it actually did, the nation's current economy would be just 70 percent of its actual size. A smaller economy means fewer goods and services, fewer opportunities for employment, and a diminished standard of living. As the operator of the world's reserve currency, the U.S. may be able to sustain debt levels above 90 percent before encountering the sort of slowdown that Reinhart and Rogoff document. But not even the United States can withstand the debt levels that are being projected within the next few decades.

## WHAT IS THE MOST EFFECTIVE WAY TO REDUCE DEBT?

If policy makers wish to maintain the United States' standard of living, what actions offer them the best chance of meeting S&P's deficit-reduction goal? What policies are most likely to stabilize the U.S. debt-to-GDP ratio? As the United States is not the first nation to wrestle with destructive deficits, it can learn from the measures that others have taken to stabilize their governments' finances.

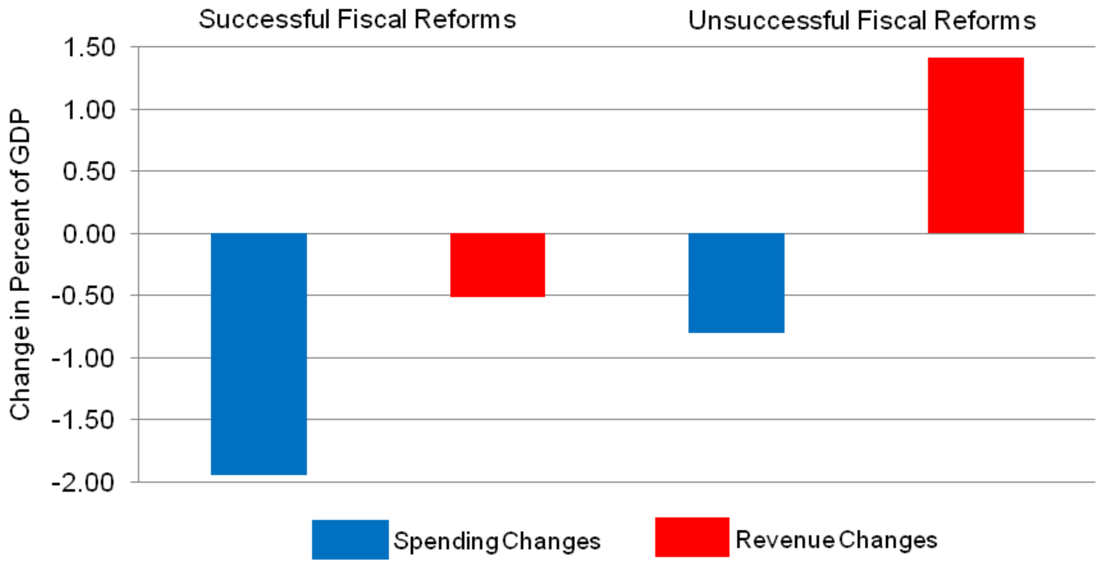
Examining 37 years of data from 21 similarly situated nations, Alberto Alesina and Silvia Ardagna identified 107 separate efforts to get debt levels under control.[7] Alesina and Ardagna broke down these "fiscal adjustment episodes" according to how successful they were (i.e., did they manage to rein in the debt?) and how they affected the economy (i.e., did they cause the economy to expand or contract?). First, consider the instances in which fiscal reform worked. As shown by the two left bars in Figure 3, when fiscal reforms actually succeeded in reducing debt, spending as a share of GDP fell by about 2 percentage points while revenue also fell by half a percentage point. Thus, not only does successful fiscal reform seem to require significant spending reductions, it also tends to occur when revenue is reduced.

Contrast this with the instances in which fiscal reform failed to reduce debt as shown by the two right bars in Figure 3. Fiscal reform failed to reduce debt when the spending reductions were modest (only 0.8 percentage points as a share of GDP) and revenue increased rather substantially (1.41 percent of GDP). Thus, fiscal reform efforts are more likely to succeed in limiting debt when they focus on spending cuts rather than revenue increases, a point borne out by several other studies.[8]

[7] Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," *NBER Working Paper No. w.15438*, 2009, http://www.nber.org/papers/w15438. The 21 nations were, like the United States, members of the Organization for Economic Co-operation and Development (OECD).

[8] See also Alberto Alesina and Roberto Perotti, "Reducing Budget Deficits," *1994-95 Discussion Paper Series No. 759,* 1995, http://academiccommons.columbia.edu/catalog/ac:100232; Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *NBER Working Paper No. 5730*, 1997, http://ideas.repec.org/p/nbr/nberwo/5730.html; Alberto Alesina and Silvia Ardagna, "Tales of Fiscal Adjustment," *Economic Policy,* Vol. 13, No. 27 (1998): 489-545, http://www.economics.harvard.edu/faculty/ardagna/files/Economic_Policy_1998_b.pdf; Ben Broadbent and Kevin Daly, "Limiting the Fallout from Fiscal Adjustment," *Goldman Sachs Global Economics Paper*, *No. 195* (2010), http://www2.goldmansachs.com/ideas/global-economic-outlook/limiting-the-fallout-doc.pdf; David Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, Douglas Laxton, and Andrea Pescatori, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook: Recovery, Risk and Rebalancing* (Washington, DC: International Monetary Fund, 2010), http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf; John McDermott and Robert Wescott, "An Empirical Analysis of Fiscal Adjustments," *International Monetary Fund Staff Papers*, Vol. 43 (1996): 725-53, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=882959; OECD, "IV. Fiscal Consolidation: Lessons from Past Experience," in *OECD Economic Outlook*, 2007, http://www.oecd.org/dataoecd/21/33/38628499.pdf; Roberto Perotti, "Fiscal Policy in Good Times and Bad," *The Quarterly Journal of Economics*, Vol. 114 (1999): 1399-436, http://didattica.unibocconi.it/mypage/upload/49621_20090119_052630_BADTIMES.PDF; and Andrew Biggs, Kevin Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," *AEI Economic Policy Working Paper* No. 2010-04, 2010, http://www.aei.org/docLib/20101227-Econ-WP-2010-04.pdf.

Figure 3: Spending and Revenue Changes in Successful and Unsuccessful Reform Efforts




Source: Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," *NBER Working Paper No. w.15438*, 2009.

If fiscal reform efforts are more successful when they focus on spending reductions rather than tax increases, what shape should these spending cuts take? The evidence suggests that cuts in entitlement spending and government employment tend to increase the odds of success.[9] Some researchers believe that this increased success occurs because markets interpret policy makers' willingness to stand up to entrenched interests as evidence of a credible commitment to reform.[10]

## WILL FISCAL REFORM HURT?

Some people worry that aggressive spending reductions will harm the economy.[11] Conveniently, Alesina and Ardagna also looked at what happened to economies after reform. Sometimes they expanded rapidly; sometimes they didn't. The researchers found that among the instances in which significant economic growth followed reform, the country had reduced spending by about 2.19 percentage points as a share of GDP while raising revenue by 0.34 percentage points (See Figure 4). In contrast, in the instances in which significant growth did not follow reform, the country had reduced spending only slightly (0.7 percent of GDP) while markedly increasing revenue (1.2 percent of GDP). Thus, Alesina and Ardagna's work suggests that the most economically damaging variety of fiscal reform is that which focuses on large revenue increases and modest spending reductions.[12]

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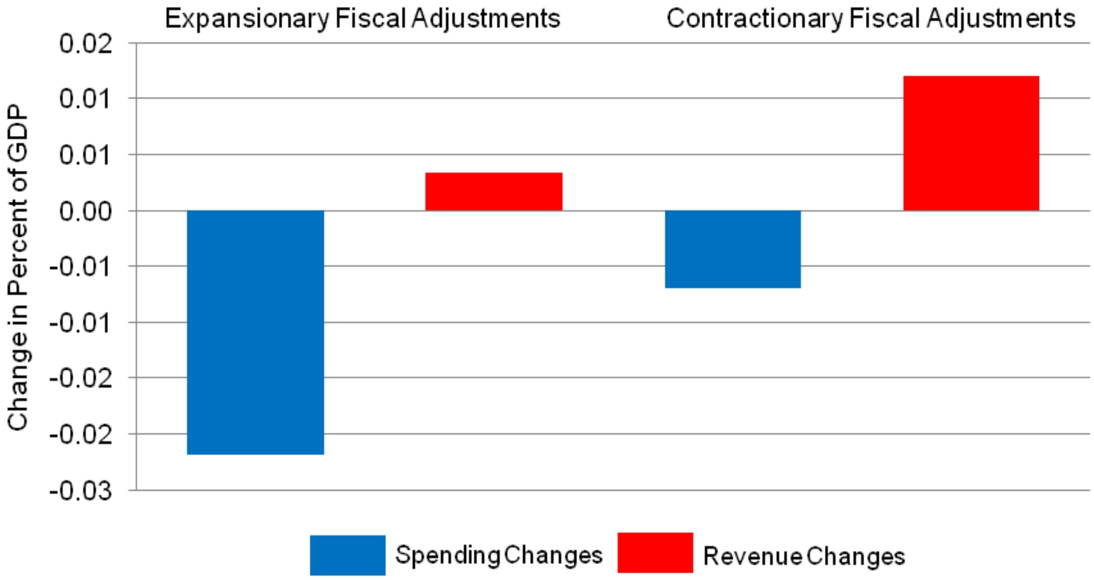
[9] See, for example, Alesina and Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects"; OECD, "IV. Fiscal Consolidation: Lessons from Past Experience"; or Biggs, Hassett, and Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked." See also the discussion in David Romer, *Advanced Macroeconomics, 2nd ed.,* (New York: McGraw-Hill/Irwin, 2001), 546-47.

[10] OECD, "IV. Fiscal Consolidation: Lessons from Past Experience": "A greater weight on cuts in social spending tended to increase the chances of success. A reason for this could be that governments more committed to achieving fiscal sustainability may also be more likely to reform politically sensitive areas. As a by-product of doing so, they may at the same time bolster the credibility of the consolidation strategy, thereby improving its chances of success."

[11] See, for example, Ezra Klein, "GOP Spending Cuts Would Cost 700,000 Jobs," *Washington Post Wonkbook*, March 1, 2011, http://voices.washingtonpost.com/ezra-klein/2011/03/wonkbook_gop_spending_cuts_wou.html.

[12] On the harmful effects of tax increases, see Christina Romer and David Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review* 100 (June 2010): 763-801.

Figure 4: Spending and Revenue Changes in Expansionary and Contractionary Reform Efforts




Source: Alesina, Alberto and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," *NBER Working Paper No. w.15438*, 2009.

The idea that spending reductions might stimulate the economy is somewhat controversial. While the correlations are relatively clear, some question whether causation truly runs from spending cuts to growth.[13] Expansionary spending cuts could be the result of accommodative monetary policy, currency devaluation, interest rate reductions, and/or increases in net exports, all of which may occur at the same time that a country reduces spending.

The point, however, is not that spending-cut-focused reforms are a reliable route to short-term growth. Alesina notes that they are about as likely to boost short-term growth as are stimulus efforts and the evidence on those is decidedly mixed.[14] Instead, spending cuts are warranted because they are the surest way to avoid the sort of long-run debt-induced stagnation depicted in Figure 2 above.

## CONCLUSION

Absent policy change, the U.S. government will accumulate dangerous debt levels within a matter of decades. Ratings agencies now warn that if policy makers fail to credibly commit to fiscal reform, the nation's perfect credit score is in jeopardy. Ours is not the first nation to wrestle with this problem and the experience of others suggests that spending reductions—not revenue increases—have the greatest chance of meeting the challenge.

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[13] See, for example, David Leigh, et al., "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation."
[14] See Alberto Alesina, "Fiscal Adjustments: What Do We Know and What Are We Doing?" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010), 5: "Fiscal adjustments (reductions) on the spending side are almost as likely to be associated with high growth…as fiscal expansions on the spending side." On the limited impact of fiscal stimulus, see John Cogan, Tobias Cwik, John Taylor, and Volker Wieland, "New Keynesian Versus Old Keynesian Government Spending Multipliers," *Journal of Economic Dynamics and Control*, 34 (3), March 2010, pp. 281-95, http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/New_Keynesian_vs_Old_Keynesian_Government_Spending_Multipliers_Journal_of_Economic_Dynamic_and_Control.pdf; See also Robert Barro and Charles Redlick, "Macroeconomic Effects from Government Purchases and Taxes" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010), http://mercatus.org/sites/default/files/publication/Macroeconomic%20effects%20from%20government%20purchases%20and%20taxes.pdf.

## RECENT RESEARCH ON THIS TOPIC

"The Debt-limit Debate: Addressing Key Concerns," Economics Perspectives, Mercatus Center at George Mason University, June 30, 2011.

Veronique de Rugy and Jason Fichtner, "The Debt-limit Debate," *Mercatus On Policy* No. 91 (Arlington, VA: Mercatus Center at George Mason University, May 2011).

Veronique de Rugy and Jason Fichtner, "The Debt Ceiling: What Is at Stake?" Research Summary (Arlington, VA: Mercatus Center at George Mason University, April 28, 2011).

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Matthew Mitchell is a research fellow at the Mercatus Center at George Mason University with the State and Local Policy Project. His primary research interests include economic freedom and economic growth, government spending, state and local tax policy, public choice, and institutional economics. He received his Ph.D. in economics from George Mason University and a B.A. in political science and B.S. in economics from Arizona State University.

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