



## DEBT REDUCTION DONE RIGHT: An economic growth strategy that will work

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The coming months will be filled with arguments over whether we as a nation should be focusing on fixing the *jobs problem* or the *debt problem*. No question, the sluggish economy, signs of a double dip recession, and persistent unemployment are not only troubling signs for what lies ahead for growth, but devastating to the millions of families directly affected.

The mounting federal debt also gives off ominous signs for the future. Our debt as a share of the economy is higher than it has ever been in the post-war period, and we are on track to continue adding to it forever. By the end of the decade we could easily be paying interest payments of nearly a trillion dollars per year, which can be described as nothing other than a tremendous waste. We know not only is the debt already probably a drag on the economy, but that at some point, unless changes are made, it will lead to a fiscal crisis.

It's harder, however, to see the direct effects of the debt. Unlike someone who can't find a job where the profound effects are felt each and every day, the debt is more like a quiet cancer on the economy, eating away at our well-being from a number of less visible angles.

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High debt levels harm the economy by diverting capital away from productive investments. Higher interest payments in the budget squeeze out other priorities – whether they are other spending or lower taxes – and leave the budget highly vulnerable to increases in interest rates. Excessive debt also leads to a loss of fiscal flexibility. We no longer have as much fiscal space to respond to emergencies whether they are economic, natural disasters, or security threats.

From an intergenerational perspective, debt reflects the basic policy of our spending, yet refusing to pay the bills, instead passing them to future generations, along with a lower standard of living than they would otherwise enjoy. This inequity is exacerbated by the fact that the bulk of our government spending goes to consumption — much of it for the elderly — rather than investments, which would at least have the potential to boost longer-term growth. Finally, numerous studies have recently found that the debt is already at such a high level that it is likely a drag on growth.

Still, because it is not an in-your-face kind of problem, the debt doesn't have the same sense of urgency that dealing with our jobs crisis does. *"Let's just fix this jobs problem -- then we can deal with the debt,"* is a comfortable fall-back position. And instead of looking at what is becoming increasingly clearly the interconnectedness of these two issues, as is too often the case in Washington, many policymakers are lining up in one camp or the other.

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On one side there is the focus on "stimulus camp" (though we don't call it stimulus anymore in polite circles, so I mean "jobs camp.") The policies coming out of here are primarily temporary in nature and involve ramping up spending or targeted tax cuts on particular areas of the economy.

There is the infrastructure bank. Spending on green jobs. Broadband. Investment incentives in all shapes and sizes. Rarely are these ideas paid for — though, to the President's credit, his are. But many of them manage to feel both tired and like they are trying too hard at the same time — not to mention the propensity to take one's favorite program and repackage it as a jobs measure.

We have had multiple rounds of stimulus in the past few years, and while it is frankly impossible to say how well they worked since we don't know what would have happened without them, it is also impossible to look at the economy and call them a rip-roaring success. So it ends up feeling as those further rounds of these stimulus/jobs measures will be the same mediocre medicine dressed up in slightly different packaging. Given that the definition of insanity is trying the same thing over and over again and expecting different results, we might then consider trying a different approach.

On the other side, there is an approach to deficit reduction that is shortsighted in nature and at odds with the recovery. Whereas stimulus dominated the economic agenda for the past few years, these deficit reduction measures have dominated for the past few months. First with the negotiation to avoid a government shutdown, then with the negotiation to avoid a default, the outcome continues to be immediate spending cuts from the discretionary side of the budget. This ignores: 1) that deficit reduction right now, as the economy is struggling to recover, should not be the goal; and, 2) that the discretionary part of the budget is not where the actual problems lie.

So, neither of these approaches will work to successfully grow the economy. Or fix the budget.

The solution, which has been laid out by Ben Bernanke of the Federal Reserve, Christine Lagarde at the International Monetary Fund, and Erskine Bowles and Alan Simpson and the President's Fiscal Commission, to name a few, is instead a multi-year, comprehensive fiscal plan that would set the budget on a glide path to stabilize the debt, but leave enough fiscal space up front keep to pushing the economy along.

Putting in place a deficit reduction plan to bring the debt back down to around 60 or 65 percent of GDP over a decade (still significantly higher than the historic average of below 40 percent, but more manageable at least) creates the opportunity to grow the economy in a number of ways that will not be achieved either through one-off stimulus measures or incremental spending cuts.

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First, it would take off the table the risk of a fiscal crisis. I know that only a few years ago, comparing the U.S. to Greece seemed inflammatory and absurd. However, recent events — including the well-deserved downgrade and the paralysis of our political system — now show the possibility of a full-blown fiscal crisis to be not nearly as remote as we would have liked to believe. Only by charting a new fiscal course will we remove that risk.

Second, implementing fiscal reforms that are comprehensive in nature, rather than incremental, offers the opportunity to restructure our budget and tax systems in ways to promote growth. The key here is switching from a consumption-oriented to an investment-oriented budget.

It is well-known that changes need to be made to Medicare, Medicaid and Social Security to deal with their internal imbalances and potential insolvency. But making reforms to entitlements also gives us the needed push to rethink our national priorities in general. Our budget emphasizes consumption over investment in a dangerously shortsighted manner. We spend many times more on people over 65 than we do in investing children under 18. The single largest commitment made by politicians of both political stripes when discussing how to fix our fiscal situation is to not touch benefits for anybody over the age of 55. Really? How about changing that to protect all at risk-children? Sorry, Dad -- but come on!

Instead, we should think about how to fix entitlements — I would argue through means testing and raising the retirement age — to both ensure the people who depend on the programs are not affected and to encourage longer, more productive working lives. Much of the savings will be needed to close the fiscal gap, but a significant portion should be set aside to increase public investments that work, including investments in early education, skills development, modernizing our infrastructure, and basic R&D.

On taxes, the revenue fight in Washington is a distraction. Of course we will need more revenues as part of a fiscal deal. Closing the gap without revenues would require such tremendous cuts that very few voters or politicians would support them once the trade-offs were made clear. But it is absolutely legitimate to point out that our fiscal problems are the result of spending growth, that revenues should not be increased until the necessary spending reforms have been made, and that even then, they should be increased through tax *reform* -- which is more likely to grow the economy -- rather than marginal tax rate increases -- which will harm it.

Tax reform is a no brainer. With lower individual and corporate tax rates and fewer tax expenditures, along the lines of what the Bowles-Simpson Commission recommended, the tax code could be simpler, fairer, and more pro-growth while also raising revenues to bring down the debt. Our mess of a tax code is littered with over 250 special credits, deductions, exemptions, and exclusions that cost us nearly \$1.1 trillion a year. These "tax expenditures" are truly just spending by another name. By focusing tax reforms on this area of the budget, we can reduce tax rates to more effectively encourage work and investment, and grow the economy and jobs, while also helping to reduce

deficits. No, this is not the same as saying that tax cuts pay for themselves. It merely reflects that when your starting point is such a crappy tax code, benefits of reform can be significant.

Without tax and spending policies to spur innovation and investment in human capital, there is little hope that we will achieve the economic growth and job expansion that we need to have. But again, none of this will come from the small-ball, incremental approach to deficit reduction.

Third, a credible, multi-year debt reduction plan can help free up enough fiscal space *upfront* to allow the economic recovery to continue to take hold. Rather than implementing immediate spending cuts and tax hikes, which would be economically disruptive, budgetary changes could be phased in more gradually, putting the debt on a glide path to stable and then declining levels. From a political perspective, the chances of including some bread-and-butter stimulus and jobs measures such as extending unemployment, payroll tax cuts, and aid to states, as part of an overall fiscal package rather than as a standalone, are significantly greater.

Finally, a multi-year plan will provide businesses and households more confidence and stability, allowing them to spend, invest, and plan in ways that will help the economy. For years in this country, we have been bubble hopping. We jumped from a stock market tech bubble, to a housing bubble, to a consumer credit bubble, to where we currently landed in a government debt bubble. There is no more space for either consumers to spend our way out of the sluggish economy or the government to borrow our way out. And there are no more bubbles to hop to.

Instead, we need to look to a business-driven recovery, but that will only happen if and when businesses have enough stability and understanding of the policies that will affect them for the coming years that they start spending the cash on their balance sheets in ways that will grow the economy and create jobs.

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Notice how those who were focused solely on the jobs agenda may give lip service to the need to reduce deficits somewhere down the road, but are rarely willing to offer a specific plan? And notice, too, how those for the incremental spending cut only approach to deficit reduction rely on nonspecific frameworks like a Balanced Budget Amendment or Cut Cap and Balance instead of focusing on what their real agenda should be -- specific reforms to entitlement programs?

Neither of these approaches will get the economy back on track, and neither will fix our structural fiscal problems. To accomplish this, lawmakers need to go big and put in place a multi-year debt deal that saves \$4 trillion. In so doing, we can provide the space for further stimulus measures, create better investment and growth incentives, and set the debt on a manageable course. It would also prove immensely reassuring to markets and rating agencies.

Other than political timidity, it is hard to see why anyone would pursue any other course.

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