

**THE WAY FORWARD FROM GOVERNMENT
SHUTDOWN AND DEBT-CEILING CONFRONTATION
TOWARD LONG-TERM FISCAL SUSTAINABILITY
AND ECONOMIC GROWTH**

HEARING

BEFORE THE

**JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES**

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

OCTOBER 11, 2013

Printed for the use of the Joint Economic Committee



U.S. GOVERNMENT PRINTING OFFICE

85-408

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

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FRIDAY, OCTOBER 11, 2013

UNITED STATES CONGRESS,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:03 a.m., in Room 1100, Longworth House Office Building, Hon. Kevin Brady, Chairman, presiding.

Representatives present: Brady of Texas, Campbell, Amash, Paulsen, Hanna, Carolyn B. Maloney, Sanchez, and Delaney.

Senators present: Klobuchar, Casey, and Murphy.

Staff present: Doug Branch, Gail Cohen, Christina Forsberg, Connie Foster, Niles Godes, Colleen Healy, J.D. Mateus, and Patrick Miller, Robert O'Quinn, and Sue Sweet.

**OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A
U.S. REPRESENTATIVE FROM TEXAS**

Chairman Brady. Well, good morning, everyone. Welcome to the Joint Economic Committee hearing today, titled, "The Way Forward from Government Shutdown and Debt-Ceiling Confrontation Toward Long-Term Fiscal Sustainability and Economic Growth."

And I want to welcome our witnesses and Members to a real committee hearing room, by the way.

Vice Chair Klobuchar. It is nice.

Chairman Brady. Had to kind of plug that in.

I have a prepared statement, but today I am just going to submit that for the record. It seems to me, at this point in time, we need a lot less political posturing and talking points and a lot more meaningful discussion about how we go forward, both parties, on some rules and 21st-century approaches that really tackle the size of the government that we want, that will serve our country, that is sustainable and actually helps grow our economy.

Vice Chairman Klobuchar and I have tried to set a nuts-and-bolts approach on JEC hearings, sort of open, thoughtful, constructive dialogue. And I can't think of a more important time to be doing exactly that.

So I will submit my remarks for the record, and I will turn to Vice Chair Klobuchar.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 26.]

**OPENING STATEMENT OF HON. AMY KLOBUCHAR, VICE
CHAIR, A U.S. SENATOR FROM MINNESOTA**

Vice Chair Klobuchar. Well, thank you, Mr. Chairman. And thank you for having this at this gorgeous room. I feel honored to be here.

And thank you for our witnesses for coming somewhat at the last minute here for this important hearing on the way forward, as we hope that the shutdown will end soon.

Like the chairman, I will submit my remarks for the record. And I am hopeful. There are some discussions going on yesterday, today that we hope will resolve this soon so that we can work on those very important things that both of you have come and testified about in the past, which is bringing our debt down in a balanced way and doing it in a way that doesn't set us back, which I believe this shutdown and the potential default on our debt ceiling could do.

So I appreciate that people are in discussions and that we may have some positive news down the road here.

Thank you, Mr. Chairman.

Chairman Brady. All right. Thank you.

[The prepared statement of Vice Chair Klobuchar appears in the Submissions for the Record on page 27.]

Chairman Brady. And Members may submit their remarks for the record.

Let me introduce our guests today, who are well-known to this committee and to the economic world.

Dr. Kevin Hassett is the John G. Searle senior fellow and director of economic policy studies at the American Enterprise Institute. He was a senior economist at the Board of Governors of the Federal Reserve System and a policy consultant of the Treasury Department during the George H.W. Bush and Clinton administrations. He has written several papers on fundamental tax reform and has coauthored a book with renowned economist Glenn Hubbard, entitled "Tax Policy and Investment." He has a B.A. from Swarthmore College and a Ph.D. in economics from the University of Pennsylvania.

Dr. Mark Zandi is the chief economist for Moody's Analytics. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets. He is well-known in this Congress and in, again, the economic world. Dr. Zandi earned his B.S. from the Wharton School of the University of Pennsylvania and his master's and Ph.D. at the University of Pennsylvania.

I, on behalf of Vice Chairman Klobuchar, welcome you. I think the timing is exactly right for this discussion. Both of you bring to the table ideas on how we tackle the big issues.

My fear has always been, in Washington, we step over dollars to get to dimes, when it comes to taking the real steps forward. Both of you are thinking more long-term to a day when we are not facing shutdowns and debt ceilings every other month.

So, Dr. Hassett, with that, I will invite your testimony. Welcome.

STATEMENT OF DR. KEVIN A. HASSETT, JOHN G. SEARLE SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. Hassett. Thank you very much, Chairman Brady and Vice Chair Klobuchar.

The first part of my testimony, which I will summarize very briefly, looks into the impact of struggles like that that we are currently having on measures of policy uncertainty. And I discuss the academic literature that suggests that debt-limit showdowns and budget poker, like we are playing, historically has led to very high levels of policy uncertainty and that that has harmed the economy quite identifiably. And so I think that it is crucial that we think of a better way to do it, and perhaps now is a good time to have that conversation.

My next observation in my testimony is that most developed countries around the world have significantly more advanced budgetary rules than we do in the U.S., often encoding specific targets that constrain the action of policymakers. And I know you are all really busy, but if you have time to look at anything in my testimony, the chart that says “Percentage of OECD Countries with Fiscal Rules” is something that I would actually commend to your attention.

The IMF recently compiled a database of 87 countries and then compiled the fiscal rules that they use in each country. And it is actually a pretty astonishing chart, if you see that almost 90 percent of countries have either a budget-balance rule, which constrains their deficit as a share of GDP—have a budget-balance rule; a debt rule, where aggregate debt as a share of GDP is capped at some number. That is about 70 percent of the countries. And, increasingly, countries are relying on expenditure rules, as well, and even revenue rules, where they cap these at some point.

To fast-forward to the conclusion of my testimony before I go into the details a little bit more, my recommendation to Congress would be to look seriously at the practices of other countries—there is a lot of experience, a lot of, you know, legal language in how to do this—and consider adopting a firm budget rule that could even be a cap as a way out of future messes like the one that we are in. So if we had a cap of spending to GDP—and I will talk about the nuances of how to do that in a bit—then, if we are below the cap, the continuing resolution and the debt limit could automatically increase. We could agree to do that when we adopt the cap. Of course, negotiating the cap would be a challenge, but it is a challenge that I think that we should try to step up to.

The evidence from Europe shows that, in many cases, limits to budget deficits are probably ineffective. And I think that economists have studied this, and they have found that the problem is that it is easy to tinker with projections to appear to come into balance.

Imagine if we said, well, our budget rule is going to be that the 10-year number needs to be this or that. Well, we can't have a deficit bigger than X, you know, 10 years from now, of GDP, that that would be easy to game and highly dependent on assumptions. It creates a situation where one side will favor lower taxes and also be focused on deficits. One side favors lower taxes and lower spend-

ing, for example, while the other side might favor higher taxes and higher spending. And each can point to their plan as meeting the deficit ceiling, when, in fact, I think the argument is ultimately going to be about the size of government. Because of that, my testimony suggests that what we ought to do is consider a rule that caps the size of government at some number that we all agree to.

In order to help stimulate the thinking and debate about what that cap might look like, I have another chart that compares non-interest spending, which—a proposal of Mr. Brady's from a few years ago helped convince me that you shouldn't include interest spending if you are going to have a budget cap, because you don't really control the interest rate, certainly, at the long end—and it compares it to potential GDP, which is something that would kind of smooth out the cyclical ups and downs of such a cap.

We wouldn't want to be in a situation where spending went up a little bit because of built-in stabilizers and GDP went down a little bit because we are in a recession, and then, all of a sudden, our spending-to-GDP goes above the cap and we are doing something harsh like sequestration.

In order to think about what a rule might look like and to form your own opinion, I have another chart that shows U.S. noninterest spending as a percent of potential GDP, which, again, I think is a good measure to pin this to because it wouldn't have the problem of fluctuating with the economy. That was about 16 percent in 2001, climbed to a little above 22 percent in 2009, and is projected to go back down to about 18½ percent by the end of the budget window.

I think that if you took a number in there and agreed to set that as the limit of spending to GDP, potential GDP, and then agreed that if we were below the limit then we automatically increase the debt limit and automatically had a continuing resolution, then we would accomplish two goals: We would have a constructive debate about the size of government, about the thing that really is in dispute, and we would exit the world that is described in my first chart, which shows how much policy uncertainty has been skyrocketing at times when we have debates like this.

I think that, to conclude, countries around the world have increasingly relied upon budget rules to help constrain the growth of government but also to make government fiscal policy more transparent. People know, sort of, how bad it can possibly be. Although these rules have been ineffective, it seems like the data suggests that increasingly countries are relying on spending rules because that is the direct target that is really in the end the thing that you have to constrain if you are worried about the deficit.

Thank you very much for your attention.

[The prepared statement of Dr. Kevin A. Hassett appears in the Submissions for the Record on page 29.]

Chairman Brady. Great. Thank you, Dr. Hassett.

Chairman Brady. Dr. Zandi, welcome.

**STATEMENT OF MARK ZANDI, CHIEF ECONOMIST, MOODY'S
ANALYTICS, WEST CHESTER, PA**

Dr. Zandi. Thank you, Chairman Brady, Vice Chair Klobuchar, and the rest of the committee. I am an employee of the Moody's Corporation, but the opinions I express today are my own.

I will make three points in my remarks.

The first point is that the government shutdown and the brinkmanship over the debt limit are doing significant damage to the economy. Even if, let's say, the government reopened on Monday and the debt limit were increased, I think the damage done so far would shave about a half a percentage point from GDP growth in the fourth quarter. So that is, before all of this, I expected growth this quarter of about 2½ percent, and now I expect growth of closer to 2—still growth, but meaningfully lower.

If the shutdown continues through the end of the month, even with an increase in the debt limit, let's say, to November 22nd, I think that would result in a hit to GDP in the fourth quarter of about 1½ percentage points, 1½ percentage points. So it will still grow, but it will be a significant hit to growth.

If the shutdown continues through to Thanksgiving, and, again, even assuming that the debt limit is increased to November 22nd, I think the economy will stall out, that we will basically go nowhere in Q4. And, obviously, at that point, the risks that we fall back into recession will begin to increase.

Now, that is bad; not raising the debt limit is significantly worse. If we breach the debt limit and the Treasury misses a payment to somebody, a Social Security recipient or a bondholder, that would be the prescription for a very dark, deep recession.

And I don't really think it matters whether the Treasury prioritizes interest payments or not. Even if they do, and they decide to not pay their other bills, I think investors would take that as a signal that we have big problems, and at the very least they would stop buying bonds. And just as a note, there is about \$100 billion a week in Treasury bonds that roll over that need to be purchased. And I think they will start selling.

So interest rates will spike, stock prices will fall, confidence—consumer business confidence, which is already weakening, will evaporate, and we will be in a deep recession. And there is no policy response to that. You know, I can't see what the Federal Reserve would do in that kind of situation. And, by definition, Congress and the administration would be doing nothing.

So point number one is what we are doing now is doing damage. And this is going to mount day by day.

Point number two: Stopgap, temporary measures to extend the debt limit, reopen the government for a brief period, are better than not doing that, but that also does damage to the economy.

Kevin mentioned political uncertainty, policy uncertainty, and I think that is a very significant constraint on economic growth, and it has been over the past 5 years. I have done a little bit of my own work in this area, and based on my assessment, if we hadn't seen this increase in uncertainty, political uncertainty, over the past 5 years, GDP would be roughly \$150 billion greater than it is today, we would have over 1.1 million more jobs, and the unemployment rate would be seven-tenths of a percentage point lower. Now, other

folks are doing this work, as well, and they are finding similar kinds of estimates, even more significant impacts from this kind of political brinkmanship.

So I think it is very important that policymakers figure out a way to get off the front pages. And I think if you do, we are off and running, that the private—a lot of good things going on in the private sector, and those good things will shine through if lawmakers can find a way to get rid of this brinkmanship for an extended period.

Finally, point number three: I think it is entirely appropriate and reasonable for lawmakers, obviously, to address our long-term fiscal challenges. We have many. And I think it will require both entitlement reform and tax reform.

I would make two recommendations in the current context. The first is, I think corporate tax reform is a good place to start. There is a fair amount of common ground here. And I think revenue-neutral corporate tax reform would go a long way to improving competitiveness and long-term economic growth.

And I also would recommend that, once we have gotten through the current debate, extend the debt limit, reopen the government, that we should examine, as Dr. Hassett has said, implementing new budget rules. I am not entirely on board with the rule he has proposed, but I am entirely sympathetic with the intent of what he is trying to do.

And I think that is an appropriate place for Congress to look, because we need to figure out a way. If we can't repeal the debt-limit law, which is very anachronistic and counterproductive, we have to figure out a way to make this less of an issue going forward.

Thank you.

[The prepared statement of Dr. Mark Zandi appears in the Submissions for the Record on page 35.]

Chairman Brady. Thank you, Doctor.

Let's begin with common ground.

One, America is not going to default. We are going to raise its debt limit on time. The question is, can we come together to find a way to deal with government finances that are out of whack today, become more exacerbated over time, and just financially are unsustainable and also weigh, I think, on investors' view of the country today.

Secondly, I think we can agree, sequester was not built to last, for a number of reasons. And it also ignores, you know, a large swath of the government spending, as well. And I think there is agreement there has to be a better way, there has to be a better way than what we are doing today.

So, looking at the rules that doctor—one, I was amazed at the chart, to see the number of countries that have some of those different type of rules in place.

For us, as we look at issues, from balanced budget, which, clearly, you know, a number of us support, to spending rules—sequester would be an example of it—looking at debt to GDP, Dr. Hassett, your point is that the best measurement of government or the one we should focus on is the size of the government relative to the size of the economy. Can you tell us why?

Dr. Hassett. Sure. It is actually—there are many reasons. It goes back to work that I did more than a decade ago, when I started to look at political opinions about the deficit and found that it is very often the party in opposition that cares the most about the deficit and becomes the deficit-hawk party because it is—you know, maybe it is hard to say “I don’t want that tax cut” or “I don’t want that program to help children” or whatever it is that one party might be proposing, but it is easy to say, “Oh, the deficit is going to be really terrible.”

And so I think that, really, in the end, my conclusion after studying a lot of American political history is that both parties, in equilibrium, have the same attitude toward the deficit, which is that they don’t like reducing it, that if you give people a free lunch, then they are happier voters, and that they don’t want it to be so big that it becomes a real problem, and that there is a space between, say, 2 percent of GDP and 6 percent of GDP where we have kind of wandered.

And so I think that what parties disagree about is the size and the scope of government, and that if we are having a debate about something other than that, then we are not actually debating the true issue, is my view. That is the first reason why.

The second thing is that I think that if we spend money, then we have to pay for it. And if you pay for it by paying all of it today or by borrowing from somebody and then paying, you know, 5 cents a year forever, that in present value it is the same. And so I think that, in the end, it is the spending that is the material thing that we need to address.

And I would encourage Congress to think of this problem not as setting a goal for spending, which is a very controversial thing, but setting a cap, setting a cap. So, look, if spending gets above this percent of GDP, then we have to go back to the old world where we have to increase the debt limit and have showdowns like this, a world that we don’t like to be in. If we are below that cap, then we function normally as a government.

And I think that if you could get to that debate, then you could start something that could be very positive in the long run and might, you know, if we continue to avoid our problems on entitlements, then we might start to run into that cap and then really have to have an entitlement reform down the road.

And so I think the very first order of business should be to say, let’s get out of this world where we have to every year push these things forward, like the continuing resolutions and the debt limits, and let’s just agree that we will continue along the lines of your MAP bill if we are below the cap.

And so I think that the argument for that is pretty sound and convincing to me but maybe not to Mr. Zandi.

Chairman Brady. Well, thank you, Doctor.

Dr. Zandi, as we look at the size of government, the debt, the spending rules, all that we have just discussed, should we be looking at the bigger picture, not just discretionary but entitlement spending as well? Is looking at that as a share of the economy the right goal?

We may disagree on what the size of that government is; you have to fill in those blanks in both parties. But is that a measure-

ment, is that a goal that would direct Congress toward looking at the right areas, how you grow the economy and how you deal with all of spending, not just a portion of it? Or is there a better way?

Dr. Zandi. Right. Well, as I said, I am very sympathetic to the idea that we should have budget rules, more comprehensive budget rules, that consider, as you said, all of government spending and also tax revenue and other revenue. I think that is important, particularly if we can use these new budget rules as a way to reduce the brinkmanship we have around the current process, the debt limit being the most notable example.

This is obviously becoming very counterproductive, so we need to figure a way to mitigate the threat posed by the debt limit. And I think the budget rules—using budget rules to do that is a logical approach and could reap some benefit in terms of better fiscal outcomes in the longer run. So I am very sympathetic with that idea.

I am less sympathetic to the idea that we should have only spending caps. And I will give you a couple, three reasons for that, and then I will give you a suggestion as to how I would approach it.

One is that it doesn't account for—or it may, but it is difficult to see how it would account for changing demographics that are going to be quite significant. I will just give you a number. Today, 13 percent of the population is over the age of 65. And if you are over the age of 65, you require a higher level of services than people that are of other ages. Over the next 25 years, that is going to rise to 21 to 22 percent of the population, according to the Bureau of Census. So that demographic fact is very important and significant and would affect how you would think about the size of government in terms of spending as a share of GDP. So that is something that needs to be considered in this context.

The other thing I worry about is the economy goes up and down and all around, as we know. We need to have some flexibility both in terms of the automatic stabilizers in the budget and discretionary response to recessions. There is a lot of debate about discretionary fiscal stimulus, and I understand that. It is a legitimate, very appropriate debate. But I do think that it is important that we maintain flexibility. And, a spending rule with those kinds of caps, unless somehow it can be adjusted to account for this fact, would make me nervous, and uncomfortable.

Chairman Brady. Well, I think Dr. Hassett's point about using potential GDP rather than GDP smooths those out, so you don't have government spending, you know, great in the boon times and then, you know, unsustainable cuts in the rough times when you actually need some of that spending to occur.

I think your point was, look, let's sort of put the guardrails, you know, in there that provide that.

Dr. Hassett. Or—and I think that Mr. Zandi, Dr. Zandi, would probably agree with this. If you look at countries that save for the rainy day—Sweden is an example—that, you know, their view is that maybe you want to have a stimulus if a recession strikes, and that is why you need to be, say, below the cap before.

And that is why I said that what we ought to do is start by having a cap, not a target, because then we have to stay below the cap enough so that if a recession hits then we can do something.

And the demographic point I could respond to, as well. It is just that that would affect your target, that as you think about—so, for example, some people say spending shouldn't be a higher percentage of GDP than it has been historically. But that is kind of unreasonable if you look at the aging of the population.

Chairman Brady. Yeah.

Dr. Hassett. You know, it is driving the increase in spending.

Chairman Brady. As I turn it over to the vice chair, I noticed in the 20 years from 1981 to 2000, the size of the government went from 22 percent of GDP to 18 percent. Population was still growing, entitlements were still continuing to expand. But during that period, as we lowered the size of government relative to the economy, you know, jobs along Main Street exploded—37 million jobs, about a 50 percent increase.

Clearly, we do have some demographic factors there, but there is a role there where we, I think, could have a good discussion about what size we want this government to be and then have those rules, the guardrails, to sort of keep us within that.

Dr. Zandi. And I think this is a great discussion. We are down into the weeds and the mechanics of it. I mean, I think that is appropriate.

And I do agree with you that using potential GDP mitigates some of my concern about the cyclicalities. But if you do a little bit of a calculation, it would have significantly constrained our ability to respond to the great recession. And that is the kind of thing that I worry about.

And I won't go on, but I will just say, in the same spirit, I think there are other approaches that I would take, or at least we could explore, that I think might mitigate some of these concerns and still address the issues that you have.

Chairman Brady. All right. Thank you.

Vice Chair Klobuchar.

Vice Chair Klobuchar. Thank you very much, Mr. Chairman.

Thank you. I feel like we are back again, "Groundhog Day." We just had the hearing on brinksmanship, and I appreciated your testimony there. And at the time, we issued a report on our side about the cost of brinksmanship, and now we did a new one on the cost of shutdown.

And I thought I would start, as we look at—the title of the hearing is "The Way Forward From Government Shutdown and Debt-Ceiling Confrontation." And I guess our first order of business, then, is to get out of it, because we are still right now in a government shutdown.

And I thought I would focus a little bit on that, Dr. Zandi. You talked about how we lost half a percent from GDP growth already, just from this 9, 10 days of a shutdown. And I think sometimes we have had some proposals to piecemeal-fund the government, to fund certain agencies.

And I just want to make clear for the record that what I have been hearing from a lot of my businesses actually isn't even the agencies that are suggested to be funded, which I have heard from citizens about. These are things like mining companies that have to get some simple permits approved, and that is by the EPA. And that is an example.

I have had a major manufacturer of planes come to me from our State. They can't get their planes approved for export because it has to go through a registry within the Commerce Department that is clearly shut down. And despite the good, good work of the Secretary, we can't change that right now, and it is millions and millions of dollars of inventory.

And so I wondered if you could expand a little on why this is that we are seeing this decrease with the shutdown. And then, also, your second point, which was about how, because of the brinkmanship on both the debt ceiling and the shutdown, that we have already lost a million jobs that we could have had in this country.

Dr. Zandi. Right. Well, the shutdown is increasingly disruptive with each passing day. The initial impact, rather modest, except for the poor folks that have been furloughed and aren't getting paid. But as the days pass, the examples that you provided and others are becoming quite significant.

Let me just mention a couple of other ones that are important. The mortgage market is being disrupted. If you want to close a mortgage loan, you need to get IRS tax records, you need to get a Social Security number. Those agencies are not open. Now, Fannie Mae and Freddie Mac are working hard to try to get around this problem, but it is a problem. And it is slowing down mortgage originations, the ability of potential buyers to get a loan. And, of course, that is key to housing and the housing recovery. And, as we know, that is vital to the economic recovery.

Small Business Administration—an increasing number of examples of small businesses that are unable to close loans. And, you know, for a day or two or a week or two, that may not be an issue, but now if it drags on into the second half of the month, then people can't open restaurants, they can't expand their operations. These are things that are going to really matter.

And you mentioned trade. A very good example, a lot of exports and imports need permits. And if you can't get a permit, you can't trade. And if we can't trade, that is going to do increasingly a significant amount of damage to the economy.

And just from my own parochial perspective as an economist, because I know folks that are sitting behind you worry about economic data, this is going to become a real problem pretty quickly, because it is this week that we collect the data to count the number of jobs in the month of October. And if we don't collect the data, then we won't even know what kind of damage we are doing to the economy very well.

So this is becoming a very significant issue, and we can't let this drag on.

Vice Chair Klobuchar. Right.

And then the second point you made in your testimony was about how, over time, the brinkmanship on either of these issues, keeping the government open or the debt ceiling, has resulted in lost jobs. Simply, is that because businesses are just sort of holding back because they don't know what we are going to do next?

Dr. Zandi. Yeah, exactly. You know, we have been put through an awful lot here. The last 5 years have been quite harrowing, and so people are really on edge. And so it doesn't take a lot to spook people in this current environment.

And, of course, what is going on in Washington is a big deal for a lot of people. It is very scary to people when we are starting to talk about—even if we are not going to default on the debt, just talking about that makes people incredibly nervous.

Now, it is not like people in businesses pull back in that environment, but what they do is stop doing what they normally do. And that mere fact alone causes the economy to start to seize up.

Vice Chair Klobuchar. So one of your main points here is, as we move forward, that we can't keep doing this, basically.

Dr. Zandi. We just—

Vice Chair Klobuchar. And so—yes, go ahead.

Dr. Zandi. Well, I just wanted to say, in my view, we have come a long way. The private sector is in really unbelievably good shape. Nonfinancial American businesses have restructured to reduce their cost structures; they are highly competitive. The only thing that is missing to a much stronger economic recovery is to get rid of this brinkmanship.

Vice Chair Klobuchar. And would the caps that we were talking about earlier, that both you and Dr. Hassett talked about, would they solve the problem, the fact that we have been blocked from going to a conference committee on the budget on the Senate side? We have a budget, the House has a budget.

Dr. Zandi. No, this is looking forward. You know, once we get beyond this, then we have to think about how we can't get back into this morass a year or two down the road. And these are the kinds of things I think you should be thinking about. But for the current point in time, we've got to get out of the mess.

Vice Chair Klobuchar. Yes.

And I want to hear—my last questions will just be your ideas, along the lines of what Dr. Hassett said, for these rules. But one of my points will be that we can put as many rules as we want in place, but if we don't approach things with the spirit of compromise, it is going to be very hard to do that kind of long-term debt reduction that—you and I have talked about this before—we believe we need to do based on the debt commission, a mixture of reform that the chairman mentioned and also looking at some of these spending cuts and trying to replace sequestration with something that makes more sense in terms of spending cuts.

Dr. Zandi. Precisely.

Vice Chair Klobuchar. Okay.

Could you just quickly at the end here talk about what—you were tailing off here because your time was up—some of the rules you thought would work?

Dr. Zandi. Sure. And this has to be thought through very, very carefully because there are a lot of moving parts. But, conceptually, I would be focused on as my threshold—Dr. Hassett has been focused on spending as a ratio to potential GDP. I think we should be focused on the structural budget deficit as a percent of GDP. If we do that, then we address some of the concerns I brought up in the context of the spending-to-potential GDP ratio.

Vice Chair Klobuchar. So you would use that as your measure?

Dr. Zandi. Yeah, I think that would be my preference.

Vice Chair Klobuchar. And are there other countries that do that?

Dr. Zandi. Yes. This has been increasingly used in European countries to address their fiscal issues. And since the crisis, they have been using that as a benchmark, and it has helped them to address their fiscal problems. So it has become more commonplace in countries that have significant fiscal problems.

And, you know, it is not a panacea. I mean, ultimately, at the end of the day, lawmakers have to execute on any threshold or rule. But I think that addresses a lot of the concerns I have about the spending-GDP ratio that Dr. Hassett mentioned.

Vice Chair Klobuchar. Dr. Hassett, do you want to respond to that idea?

Dr. Hassett. Oh, sure. Dr. Zandi is right that most European countries have a target of 3 percent deficit or they have to be below a cap, and 60 percent debt-to-GDP. And the issue that motivated me to move toward spending is the realization that those caps haven't been very effective.

And I think that if we look at the data, they are increasingly adopting hard spending caps. And I think it is in part because the deficit projections—because we are doing structural deficits and so on that have been kind of vague and easy to waive.

And I agree that if we just have a rule and we agree to ignore it, then it won't accomplish anything.

Vice Chair Klobuchar. Uh-huh.

Dr. Hassett. If we want to get out of the world—I think, by the way, that Dr. Zandi is understating the economic damage from the uncertainty. I think Steve Davis' work, which is very similar but, you know, I mean, it has a slightly different approach, is about twice as much, his estimates.

Dr. Zandi. Yeah. Yeah.

Dr. Hassett. And so we have to think about, well, what can we do in the spirit of compromise to make sure that we get out of this world where that first chart with all those spikes that cause economic damage is no longer the chart that we are looking at, or that it looks like a bad EKG after—

Vice Chair Klobuchar. Right.

And, Dr. Zandi, your concern about short-term after short-term is you just keep creating that uncertainty if we keep doing short-term deals.

Dr. Zandi. Yeah. I mean, I think people have been on sort of a, every sixth month we kind of go down this path. And, you know, if we keep doing that, I don't think we are going to get out of the box we are in, in terms of economic growth.

We are stuck in a 2-percent-growth world. And the only reason we are not growing 3 or 4 percent, in my view—there are other reasons, but the key reason is literally what is going on in Washington around these issues.

Vice Chair Klobuchar. Thank you very much.

Chairman Brady. Thank you.

Let's focus, because this committee is a little different than others, about the way forward and how we find some common ground on the bigger issues facing us.

Dr.—Mr. Campbell.

Representative Campbell. You promoted me to a doctor. Thank you very much, Mr. Chairman, but I don't belong down there.

You know, as you have suggested, we have had a little trouble getting along up here on the dais and with the White House, as well. So in the next 4 minutes, I just want to see if we can get you guys to get along or to agree.

Following up on Senator Klobuchar's things about talking with Dr. Hassett's spending cap and now Dr. Zandi's budget deficit or ratio to GDP—and, Dr. Hassett, you mentioned, just did in response to Dr. Zandi's proposal, that hasn't worked very well.

Let me ask you both, any of these sorts of caps—I come from California, a State which has a balanced-budget constitutional amendment. Hasn't had a balanced budget in the last 14 years in spite of a balanced-budget constitutional amendment. I am also a CPA, so I observed all of the different things that are done in order to create a balanced budget when it is, in some cases, \$20 billion, \$30 billion, which is 20, 30 percent, out of balance.

How do you deal with that in either of these scenarios with any kind of cap, be it debt or deficit or be it spending?

Dr. Zandi. Either of us?

Go ahead, Kevin.

Representative Campbell. Either, yeah.

Dr. Hassett. Okay. I think that, first, Dr. Zandi and I have disagreed about a lot of stuff, but if he is here saying this current circumstance is causing economic harm and then I am saying it is probably twice as big as he says—and I think his team is more in favor of the economic-harm point right now—or the Democratic team, not necessarily your team—but if that is—we have to accept that we need to get out of that world.

And I think that, you know, maybe one reason we are in that world is that people have recognized, some have recently written about this, that it seems like the minority party very often feels like the debt limit is one of the only times they have a chance to influence legislation. And it has been pretty common for that to happen. We need to get out of that world.

And so, then, you know, if we adopt a rule, we adopt the rule because it is the cost or the price that we pay to get out of that world. And then, when we do that, we should all acknowledge that, well, if we don't obey the rule, then we are going to have to go back into that world that is so damaging. And it ought to be that everybody should agree that we don't want to do that. And I think that, absent that kind of almost economic patriotism, then of course the rule won't work.

But I think the rules need to be adopted so that we get out of this world where—you know, I mean, Steve Davis' estimates were really astonishing, that GDP is probably about 3.2 percent lower and there are 2.3 million fewer jobs today because we have been playing these brinksmanship games.

Representative Campbell. Okay. So are you—

Dr. Hassett. And so we have to adopt a rule so that those 2.3 million people would have a job.

Representative Campbell. Are you okay, then, or not okay with the rule that Dr. Zandi suggested relative to debt and—

Dr. Hassett. Sure. You know what? I would rather have a spending rule, but I think that if, you know, one side is really adamant it is a deficit rule, then you could accomplish the same thing. You could accomplish the same thing, you know, because it is very hard to increase taxes as a share of GDP.

I think a spending rule is more targeted, is more precise, it is a better rule, but I would take virtually any rule over the circumstance that we have today.

Representative Campbell. Dr. Zandi.

Dr. Zandi. Yeah, let me just say a few things quickly.

One is that, to your point, no rule solves our problems, right? At the end of the day, it takes political will to come together. So a rule is helpful, but it is not a solution.

The second point is the current rule we have de facto is the debt limit, and that is a counterproductive rule given what we are seeing happening on a regular basis. It is not, as Chairman Bernanke has said, the way to run a railroad. So we have to get rid of that or at least neuter that as the way we are operating, because it is doing significant damage to us. And it seems to me that if we don't change that, it will continue to do so. And either party will do it to each other.

Representative Campbell. Let me just, in the last 30 seconds, do you agree with that point, Dr. Hassett?

Dr. Hassett. Yeah.

Representative Campbell. You do. Okay. Thank you.

Dr. Zandi. And then I think this next question, well, what do we replace it with, how do we make this better, that is a very good debate. And Kevin and I and others should fully engage on this and exactly how we would do that, because we each have our concerns about how to do it.

But, in my view, the structural deficit to potential GDP fundamentally is important in this way. And this may be where we disagree a little bit. In my view, our long-term fiscal issues are both a spending problem and a revenue problem. It is a revenue problem because of the demographic reason I just gave you. Right? Just the simple aging of the population. You don't want to say that we don't need more revenue to pay for the services to people just because they went over the age of 65 and require more government services just by definition.

So, in my view, it is a spending issue. I am on board with that. The cost of medical care is the key spending issue. But it is also a revenue issue because of the demographics. And we need a budget rule that is sensitive to both of those.

Representative Campbell. Right.

Chairman Brady. Thank you. The time has expired.

Representative Sanchez.

Representative Sanchez. Thank you, Mr. Chairman.

Thank you, gentlemen, for being before us.

You know, I represent a big manufacturing area, actually, out in Orange County, California. It is tied a lot to NASA and commercial air and defense industry. And I have a set of brothers, a pair of brothers, who went bankrupt in this recession, having a leasing company, because capital dried up. And now they are back at it, starting from nothing. And they have been at it for about 6

months, and they told me the other day that capital had finally started to flow, that banks are getting back into putting money out.

It is a little bit more difficult for the very same triple A people they had before borrowing, in some cases for services like the trash cans that get picked up at our homes, but in a lot of cases big manufacturing equipment as with machine shops and things that are in my district. They are also, my brothers, located in my district.

And so things had begun to loosen up a little bit. Triple A type of credit companies who had not been able to get anything in the last 3 or 4 years and had gone away were coming back and being able to make deals. They also work with SBA to get—you know, because it is about money for these companies so that they can expand and they can hire.

And all of a sudden, in the last 2 weeks, everything shut down, everything shut down with respect to capital, because banks are afraid to loan, because people are afraid to sign on the line, because—

Dr. Zandi. What do they lease?

Representative Sanchez. They lease equipment.

Dr. Zandi. Equipment, okay.

Representative Sanchez. They lease equipment. So it can be anywhere from, like I said, trash cans—

Dr. Zandi. Yeah.

Representative Sanchez [continuing]. For the trash cans that sit on my driveway once a week, to big capital machinery.

Dr. Zandi. Where in California?

Representative Sanchez. Orange County, California, a very big manufacturing area for the aerospace and other industries.

So all of a sudden, the brakes are on. And, actually, people are losing money, and some of them, as you know, are losing their homes, even if they have equity in them, because when you are a small business, you are putting everything you have on the line.

And so I guess my question is, we keep seeing this every time that we play these games in Washington, DC. So if you had to pick one thing that maybe we do have a rule and hold constant to, would that be something like the debt limit? Would that be spending? Would that be caps? Would that be an aggregate amount on entitlement as a percentage of GDP?

Is there any one thing that we should really consider to hold constant so that we stop doing what I see right now happening in my area?

Dr. Hassett. Thank you for the question.

And I think there is. I think that if we agreed 5 years ago that this is the range that we think is, you know, open to debate about what spending-to-potential GDP should be, and if we are outside of that range, then we will go back to the old world where we have these debt-limit struggles, but if we are inside of the range, then the debt limit automatically increases and there is none of this uncertainty and the government can't be shut down, that if we had done that 5 years ago, then about 2.3 million more Americans would be working today. That is the estimate. And Mark says about half of that, I think.

Representative Sanchez. And my—

Dr. Hassett. And so that we need to adopt a rule like that. And if it is a deficit rule or a spending rule, that is something we will have to flesh out. But I think either rule that made it so that we accomplished our budgetary objectives but did so in a way that moved away from the brinksmanship could have significant benefits.

And I really appreciate the fact that you put a human face, really, on the negative economic consequences.

Representative Sanchez. Yeah. And my fear is that if we put a rule, like we did sequester—which we are now all under and we know is kind of backfiring on us. I think most economists have agreed that it is probably about 1.8 percent of less growth happening because we are under sequester. And yet, at the same time, we are cutting down that, but we are doing it in very inefficient ways. And, again, I see it getting right back into, for example, defense manufacturing in my district.

So how do we—Dr. Zandi, do you agree that it should be that spending issue? Or do you think something is even more important than that for us to try to rally around to stop this every-2-weeks thing going on?

Dr. Zandi. Right. Well, you know, this is the first time I have heard that credit has stopped flowing. That is an interesting anecdote. I would like to explore that a little bit more because I hadn't heard that. So if that is the case and that is widespread across the country, that is a problem. So, interesting to hear that—sorry to hear that, but interesting to hear it.

I think that, principle number one, to get to your issue about every couple of weeks, every few months, I think we really need to, again, rethink the debt limit. It is a very bad law. And it would be nice if we could repeal it and, if we could repeal it, replace it with something.

And, in my view—and I am open, really I am, I am open to discussing and thinking about this more deeply with everybody. But at this point, my intuition is that you would want to do something like a cap related to the structural deficit to potential GDP.

Structural deficit means abstracting from the impact of the ups and downs in the economy on the budget, right? And potential GDP means what can the economy produce in a normal state.

If you do that, I think that is kind of a reasonable approach to addressing both our long-term spending issues and our long-term revenue issues, and it is a balance.

But, again, at the end of the day, no rule will solve our issues unless we have the will to do it, to execute on it.

Representative Sanchez. Thank you, Doctor.

I am sorry, I have to—

Chairman Brady. No, no. All time has expired.

We have votes called, but there are only two. Should not be long. So I will recognize Senator Murphy, and then we will recess briefly after that and hopefully be right back at it.

Senator Murphy. Thank you, Chairman Brady.

Thank you to both of our panelists for being here today.

There was obviously a ripple of optimism in the markets yesterday that we were on the verge of getting at least a partial deal.

We will see by the end of the day as to whether that optimism was merited.

But what we also heard yesterday was that JPMorgan is pulling their investments in Treasuries out of their mutual funds that mature between October 16th and November 6th. And that is mirrored by a decision that Fidelity made, as well.

That is a limited action because they are only pulling out from Treasuries that mature during, essentially, the next 30 days, but I think it invites a conversation about whether we should be so optimistic that the United States is going to remain as the world's reserve currency if we continue to go through these series of manufactured crises. If you sort of look at the history of reserve currencies, they, you know, tend to last 100 to 200 years, they change. Now, we haven't gone through our 200-year cycle yet.

But I wanted to ask two questions to both of you, I guess.

Let me start with you, Dr. Zandi. A, are we at any risk of losing our position as the reserve currency of the world? Or is it just a matter of relativity, that as nervous as people are about the dollar these days, they are, frankly, more nervous about other currencies? And if that were to ever happen, what are the consequences to the United States of losing that position?

Dr. Zandi. I think it is very unlikely in the current context that we would lose that position as the globe's reserve currency for the key—one of the key reasons you just articulated, and that is what would take the place of the U.S. There is no obvious answer to that.

But having said that, we are doing damage to our credibility, and it is going to cost us, right? I mean, investors are going to demand a higher interest rate to compensate for any potential risk.

And they are now putting a number to that risk. And even if it is one basis point, one-one-hundredth of a percentage point, that is a problem because we have \$12 trillion in publicly traded debt. That is a big number. You multiply anything by that, that is a big number. And so that is deadweight lost to us as taxpayers.

So we are doing real damage by going down this brinkmanship path. And each time we go down the brinkmanship path, the cost is going to rise.

And one other thing I will say: So far, at least, lawmakers have been able to sign a piece of legislation before actually breaching the debt limit and not paying a bill. If we keep going down this path, at some point we could make a mistake. And if we make a mistake and not pay a bill—and, by the way, it doesn't really matter if we pay on the Treasury interest payments. If we don't pay somebody our obligation, that is going to cost us very, very dearly, and the rest of the world is going to be looking for options at that point.

So, no, I don't think we are at significant risk of losing that reserve currency status, but we are certainly not making it easy for people to believe in us.

Senator Murphy. Dr. Hassett.

Dr. Hassett. Thanks for the question. It is a good one and one we should follow up on, too, because my knowledge of the literature is about 10 years old.

But the question is that we are in a situation where we can print dollars that cost us nothing, really, to make and then give them to

people, and they give us BMWs, say, and because they really want to hold the dollars, and that that is an advantageous position for us to be in.

The last time I checked, the estimates of this sort of seigniorage benefits of being the reserve currency were pretty small in the end, that it wasn't a really big thing. And so, if we stop being the reserve currency, there is also potentially a benefit, which—some of my more left-wing friends actually wish we weren't the reserve currency, said this at dinner parties and so on. Because then, you know, if everybody wants to hold dollars, then it bids up the price of a dollar and it makes it harder for us to have manufacturing jobs and so on.

So the costs and benefits of being the reserve currency are, I think, not obviously hugely positive, the last time I checked. But I would like to follow up with you on that.

That said, I don't think that this episode is likely to change that calculus of what Mr. Brady said at the beginning of the hearing, that, look, there is no way that we are going to default or miss interest payments or miss payments. If that is true, then I don't think this episode would influence it.

But even if we did, I kind of wonder if the Treasury market effect would be large, in the sense that, suppose that your interest payment didn't come on October 18th and you were holding a Treasury bill that was worth a dollar you thought, but then you were surprised by the fact that you didn't get the interest payment, at what price would you sell it to me for? Would you sell it to me for 90 cents? Like, in the end, I think you are probably going to believe that you are going to get that interest payment in the end, you are going to be made whole, and that you wouldn't really want to take that much of a discount.

But I think, as Mr. Zandi said, even if it is a one-basis-point change that we build into the system, that it could be a significant factor.

Senator Murphy. I agree that we are likely safe in large part because there isn't any other place to go. That is a really bad strategy to rely on; that we will continue to be the reserve currency simply because every other country's currency or economic situation is more screwed up than ours. That is, frankly, a recipe for ultimate failure if that is essentially why you remain confident about your economy's role in the world.

Dr. Hassett. If I may add one point, too, which is if you look at Angus Madison's data on world GDP back thousands of years, it has pretty much always been the case that China is about a third of world GDP, which we kind of peaked at about a little while ago. And China really messed things up starting in the 1850s. But my guess is that they are going to go back being about a third of the world GDP at some point in the next 50 to 100 years. And at that point, we are no longer even the biggest game in town, and we probably wouldn't be the reserve currency any more.

Dr. Zandi. Can I make just one quick point? You know, we do have—

Senator Murphy. Vice Chairman Klobuchar has completely ignored the fact that I am over my time. So go ahead.

Dr. Zandi. Well, Treasury did miss a payment back in 1979. It was an accident, and it was only to a few investors. And there has been some good academic research trying to assess what that meant in terms of the cost. And it was very costly. You know, investors were made whole very quickly. It was actually just a paper mistake. We didn't have computers. It was a paper mistake. And it is not—you know, it is billions and tens of billions of dollars. So that kind of gives you a sense of what a mistake could mean for us, particularly in the current context with, again, with \$12 trillion in debt outstanding.

The other thing I just want to say, the reserve currency status is a very important status. It gives us enormous economic benefit. You know, the seigniorage is just one little piece of it. But the fact that trade in the world is done in dollars is huge. It is a significant advantage to us in many, many ways. So I think it is very important for us to work hard to continue to preserve the faith in our financial stability so that we maintain that reserve status. It is very important.

Senator Murphy. Thank you.

Vice Chair Klobuchar [presiding]. Thank you very much, Senator Murphy.

We are going to now take a recess until our House Members return. I personally am going to go back and look at the library back there. Thank you.

[Recess.]

Okay. We are back for the hearing. And Representative Delaney is here to ask questions. Thank you.

Representative Delaney. I join my colleagues in thanking Dr. Zandi and Dr. Hassett for joining us here today. When I think about your testimony, which was very thoughtful, it seems to me that we have to think about this issue in the context of really what the realities are of the situation we face today and are likely to face for a very long time, because I think those do inform, to some extent, how we think about this issue.

One reality, unfortunately, is that we have a very large current debt burden in this country, \$17 trillion, right, which is obviously a very big and significant number. The second reality is that that number is likely to grow across time, unless we make fundamental reforms to our entitlement programs, based on the demographic analysis that you both alluded to in your comments.

The third reality, at least in my judgment, is that we are underinvesting in certain areas that actually have been proven and demonstrated to have a good economic payback: infrastructure, certain aspects of education, et cetera.

So when you look at these facts, if you look at these kind of macro drivers of our fiscal situation over the next 20 or 30 years, it is hard to come to a conclusion that we will have anything but a reasonably high level of debt in this country.

And so I think, Dr. Zandi, you made a good point about what effects the shutdown and the debt ceiling brinksmanship, if you will, are having on the economy on a very current basis. I also worry that it would seem to me that if I was one of our foreign counterparts right now, because unlike other countries that have managed high debt levels, like Japan, which largely borrowed from

itself, we are in a position where we borrow from foreign counterparties. And it would seem to me that these actions would somehow cause them to begin the process of slowly calibrating how they think about the United States as a counterparty, which will inevitably result on the margin and perhaps hard to measure in the short term, but on the margin, in higher debt levels or debt costs.

And that is a particularly imprudent thing to do if you acknowledge my first set of facts, that we will likely have high levels of debt for a very long time. And so I think we just have to have more of a conversation about the importance of these counterparties to us for a very long time, unfortunately, and think about our actions in that context, because if this was an enterprise other than government, you would be working very hard to instill confidence in your lenders so that they would lend you money at the lowest possible rate, as opposed to creating a situation of instability.

But my question really goes to Dr. Hassett, because I think you framed very well the options we have around putting in place governors or mechanisms to deal with the fiscal situation of the country across the long term and again in the context of what we just discussed. And so it seems to me that there would be things you would want to do if this was an enterprise other than government. The first thing is you would want to have some current test to look at your current situation and say, is the fiscal—the current fiscal situation concerning? And that would be something along the lines of a current test of debt-to-GDP levels, et cetera. But you would also want that to somehow interrelate with a longer-term test, right? Because it is one thing to have low debt levels currently, but have an explosion occurring in 10 or 15 years, right? That is not a good situation. Similarly, if you have a high level of debt, but you are doing things across the long term that are going to bring it down, it may be more manageable. So how could we possibly come up with a framework for having effectively a current and a long-term measurement and having those interplay so that we could have a process for managing this somewhat inevitable fiscal situation we have as a country over the next 20, 30 years, that is sensible, that is kind of ratio-based, as opposed to absolute-dollar-based? Because again, you would only come up with an absolute dollar test if you were truly trying to have a forcing function to create conflict, right, which some may think we need. But you would never come up with that. You would come up with a percentage, or ratio, et cetera, to GDP or other things. So how do we come up with something that is logical and sensible, because this is likely to be a reoccurring theme, and how do we come up with something that both measures current and long-term situation, and how would those possibly interplay?

Dr. Hassett. I will go first.

Mr. Delaney, I think that your question actually is probably motivated from looking at the chart and figuring out something, which is that the only way that you get sort of 80, 90 percent of the people having both budget balance rules and debt rules is that a lot of people have both. A lot of countries have both. And so I think that having more than one rule is one way that countries have processed your thought, which is, let's try to have a rule that looks at, say, debt. And ideally, if we were going to construct a perfect

measure we would include implicit liabilities in that. And then we will have a rule, a second rule that requires that our deficit not be bigger, our structural deficit not be bigger than 3 percent. So they have these multiple rules precisely because they want to keep their eye both on short-term violations of prudence and long term.

Representative Delaney. And how do those rules interrelate? Can you violate the short-term rule provided you are on target in the long term? Do they have those kind of dynamics, or are they both viewed as kind of uncompromising standards that you can never violate? How does it work typically?

Dr. Hassett. Yes, typically they are stand alone, independent rules, and you have to obey them all. It is kind of like when you tell a teenager, no drinking and be home by 11. So the rules are independent rules, and they have to obey them all.

Representative Delaney. But therefore, you probably build more tolerance into each of them. So since you have two steps or two tests, theoretically, you would build in more tolerance in each of them because either of them—so I would just be interested in any thoughts you have as to what specific rules we put in place. I think that is my time.

Dr. Hassett. I could follow up on that.

Representative Delaney. Thank you, Doctor.

Chairman Brady [presiding]. Thank you.

One, before I recognize Representative Paulsen, I want to take this opportunity to thank the vice chairman for setting a great tone, bipartisan tone on this issue and others throughout the Joint Economic Committee. It really is a delight to work with you on these issues. They are all big picture issues. We need to find those solutions. And couldn't find a better partner in doing it.

Vice Chair Klobuchar. Thank you, Mr. Chairman.

I really like the tone we have had in this committee. And this hearing is another example of it. Thank you.

Chairman Brady. Now if Minnesota just would quit dominating this committee, I would feel so much better.

Speaking of that, Representative Paulsen.

Representative Paulsen. Thank you, Mr. Chairman.

And let me just first echo the comments you made about working with Senator Klobuchar. This is a timely hearing. It is a timely hearing because this is a committee that includes both House Members and Senate Members, and looking at what is the way forward on some very significant issues. And it is an opportunity to find some solutions, so we don't move from manufactured crisis, from one to the next, actually look at some long-term framework discussions to get spending under control, to rein in deficits, and ultimately to lower our debt pattern.

Let me just start here. The International Monetary Fund recently lowered the global outlook forecast this week, and it factored in, of course, the current U.S. Government shutdown, the impending approaching debt limit deadline that's coming up. And compared to July, the IMF cut the U.S. forecast growth rate and shaved it down to 1.6 percent this year and then shaved it down to 2.6 percent next year. And so I remember when this debate was going on 2 years ago, of course, the ratings agencies were all giving their warnings at that time about if long-term liabilities aren't ad-

dressed, don't be surprised if the outlook down the road is downgraded or you get a little nick on that from our bond rating, et cetera.

So if the debt ceiling is raised without any plan nor sustainable government spending down the road, what signals would that send to the markets or to foreign investors down the road? So is it prudent now, would it not be prudent to make spending reductions part of the discussion for a way forward, if you will, as part of the debt ceiling? Does that make sense?

Dr. Hassett.

Dr. Hassett. Mr. Paulsen, in the piece I wrote on this topic in the Wall Street Journal last week, I stated what I think about this, which I think is kind of the correct fact, which is that we have got this strange debt limit rule that has led to a lot of brinksmanship over time. And it has been pretty common, 27 out of 53 times the debt limit was passed with some extra legislation, to include other stuff. And that a full assessment of whether this has had a complete negative effect would involve estimating the positive impact of the things that were attached over the years by often the opposition party to the debt limit increase. And then we would have to evaluate whether, well, could they have happened without the debt limit shenanigans? And I think there are a lot of unknowables there.

But I think that you are correct that as we think about legislative accomplishments historically, you know, we have to recognize that because the debt limit is something that has to happen, that gives the minority power some leverage, then it has allowed legislation to pass that may have had a positive impact, even on net if you go back and tally it all up. But it is not completely knowable because there are so many different policies.

And so I think that it is absolutely important to get spending under control. And that is why, so if it were me, I would take the deal, let's adopt a spending cap and agree never to go down this road again, and then I will give you all the debt limit increase that you want. And that is a trade that I would make right now.

Representative Paulsen. Okay. And Dr. Zandi, you mentioned earlier about the revenue problem with demographics being the way they are and support for corporate tax reform, revenue neutral, to kind of drive the economy. I mean, I tend to agree we need pro-growth policies in particular to bring in more revenue. Can you give us some other comments regarding the opportunity to have pro-growth tax reform, long term horizon, that can be a component of some of these discussions?

Dr. Zandi. Well, I think tax reform broadly would be obviously ideal. But corporate tax reform feels doable to me in the current context.

There is a general view that, and I think appropriately so, that if we can make the corporate tax code obviously more efficient, fewer loopholes and deductions, and use that extra revenue to bring down marginal rates for businesses, that that would be very important to improving the competitiveness of U.S. companies. So I think that is a very good place to focus. And I think there could bear some fruit.

You know, it is one of those things that isn't going to matter a lot to the economy in any given year, but when you look back over a period of a decade or a generation, it could add up to significant benefit to the economy and ultimately help alleviate some of our long-term fiscal issues.

Can I say, one thing, though, in response to your first point?

Representative Paulsen. Yes.

Dr. Zandi. Under current law, if you lawmakers do nothing, then under reasonable economic assumptions, they are CBO assumptions and they are pretty consensus-oriented, the deficits will continue to decline to a point where the Nation's debt-to-GDP ratio will stabilize. And this is the case through the end of the decade, through 2020.

So I think that the most important thing would be for us to just get beyond the brinksmanship. And I think it is less important to get those spending cuts in the near term if what it means is that we can just get moving forward and let the private economy start to shine through. I think that is the most important thing we need to do right now.

Representative Paulsen. Thank you, Mr. Chairman.

Chairman Brady. Thank you.

Former Chairman Maloney will be here in just a moment.

You know, as we work through this, Dr. Zandi, Dr. Hassett, what is the most important takeaway for us at this moment in time as we move forward from short-term brinksmanship to long-term solutions? What is the most important thing for us to keep in mind?

Dr. Zandi. In my view, that what Congress and the administration are doing now, what Washington is doing right now is incredibly counterproductive.

Chairman Brady. I agree.

Dr. Zandi. Just simply get out of the way, do nothing, and we will be okay. The economy will engage. We will get a lot more jobs and growth. Unemployment will decline. And our long-term fiscal issues won't be solved, but they will look a lot better.

Chairman Brady. Dr. Hassett.

Dr. Hassett. You know, I think that when I am thinking about the costs of things like what we are doing today, I often like to do the thought experiment, well, what if we had done the right thing in the past? And I would circle back to my earlier comment that if 5 years ago, we had sat down and adopted two rules, maybe a deficit rule and a spending rule, or something like that, and then agreed not to introduce these pockets of high uncertainty, then there might be 2.3 more million Americans working today and a lot fewer long-term unemployed. So when we don't address these big policy problems, and we let them just sit there and fester, then we do really, really lasting damage to the economy. And it seems sometimes like it is easy to ignore the damage politically, but it really is true that if 5 years ago, we had done the right there thing there would be a couple million more people working today who really need jobs. And so the costs of ignoring this problem are enormous. And we need to do something so that we can get out of this brinksmanship game.

Chairman Brady. That uncertainty chart, which is pretty compelling, I think certainly reinforced back home.

Are there other elements that contribute to this uncertainty? Fiscal issues, some regulatory issues, tax. I do think the Affordable Care Act has introduced uncertainty both in the health care world and along Main Street. Monetary policy is a question we deal with each day. Are there these other elements that we ought to be addressing as well?

Dr. Zandi. Yeah. It goes beyond the brinksmanship, certainly. And I am not making any comment on the merits of financial regulatory reform or health care reform. In my view, in terms of health care reform, there are negatives from a macroeconomic perspective and there are positives from a macroeconomic perspective, and they wash out. I don't know a professional economist who does this for a living that changed their economic forecast long run because of the passage of health care reform. But having said that—

Chairman Brady. Reference the uncertainty issue.

Dr. Zandi. There are adjustment costs from moving from here to there. And that is what we are feeling right now. And that does create uncertainty. And it makes people nervous in the context of all the other things that are going on.

But the political brinksmanship is at this point in time now the key factor driving this angst, this uncertainty. But you are right, there are other things going on.

Dr. Hassett. And Mr. Brady, I could follow up with your staff that Steve Davis at the University of Chicago, his measure of uncertainty can be decomposed into submeasures, I think there might be about 10 of them, that measure the other kinds of uncertainty and the different types, like fiscal policy versus monetary policy uncertainty, the different types of policy uncertainty that contribute to the overall index. And you can watch how that evolves over time. And we can present a chart to you.

Chairman Brady. It seems like that index is in inverse proportion to our popularity ratings in Congress. As the uncertainty goes up, the other one seems to go down.

I don't know if Representative Maloney will make it here today. Unless other Members wish to inquire, I would like to thank you both for being here today. Hugely helpful information. We would like to keep this discussion in a bipartisan manner going forward.

With that, the hearing is adjourned.

(Whereupon, at 11:20 a.m., the committee was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIR, JOINT ECONOMIC COMMITTEE

Vice Chair Klobuchar, distinguished witnesses, and my fellow Americans.

Today, the federal government remains partially shut down, and the Treasury estimates that it will hit the debt ceiling on Thursday, October 17th. If President Obama and Congress cannot reach an agreement to increase the debt ceiling by the middle of next week, the United States could default on its obligations, the economic consequences of which are too grim to contemplate.

Time is too short for the Washington “blame game.” America will not default on our debt. Nor will the debt ceiling be lifted without addressing the unsustainability of the government’s finances. Given our divided government, any solution therefore must be bipartisan.

In the past, Democrats and Republicans have used the debt ceiling as a responsible means to shore-up America’s financial house—the Omnibus Budget Reconciliation Act of 1990 came about through debt ceiling and sequester negotiations between congressional Democrats and President Bush, and the Budget Control Act of 2011 came about through debt ceiling negotiations between House Republicans and President Obama.

Negotiations over the debt ceiling provide both parties with an opportunity to enact a 21st century strategy to put America’s finances in order for the long haul. Therefore, I’m proposing a way forward for President Obama, Leader Reid, and Speaker Boehner to reach a bipartisan solution.

To build an office building, you start with the foundation, erect the steel skeleton, and then build out the specific offices. In past fiscal battles, however, Washington has often gotten the order wrong. Budget negotiations have often failed because we began by arguing over specific tax changes or spending cuts before we agreed on a goal and how to measure the progress toward the goal.

As Nobel laureate Milton Friedman taught, the best single measure of Washington’s burden on Main Street is federal spending as a share of the economy. In the near term, the Budget Control Act of 2011 has helped to restrain runaway federal spending, producing the first back-to-back decline in federal spending in a half century. Yet, the Act wasn’t built to last, capping only discretionary spending. Indeed, the Congressional Budget Office (CBO) projects that the explosive growth of entitlements will cause federal spending to balloon to 26% of GDP over the next 25 years. That’s a long-term problem both parties agree we cannot ignore.

Therefore, the first objective of any negotiations over the debt ceiling should be to set a reasonable limit for federal spending in comparison to the size of America’s economy. Then the negotiations should establish a glide path to bring federal spending within the limit over time and guardrails to keep future Congresses and Presidents within those limits. How you set those limits matter.

A smart, bipartisan spending limit would restrain the spending that Congress can control—program and entitlement spending—while acknowledging the spending Congress cannot control—interest payments on the federal debt.

So how best to tie controllable federal spending to the size of the economy? GDP as a measurement is revised looking backward and fluctuates with the business cycle, allowing unsustainable spending blowouts in boom years, but then requiring politically unsustainable, economically unwise reductions during recessions. A far more stable denominator for any sustainable spending limit would be potential GDP. This is a long standing economic metric that reflects what GDP would be at full employment with no inflation. The Congressional Budget Office already calculates potential GDP in its annual Budget and Economic Outlook. Its projections of GDP in years 6 through 10 are considered potential GDP. By using this metric as the denominator, we can eliminate the boom-and-bust problems associated with GDP and create a more solid foundation for lawmakers to build upon.

What should be the target level of a spending cap? The prosperous 1990s can serve as a model. From 1981 to 2001, total federal spending declined from nearly 23% of GDP to under 18% while the population soared and entitlements grew. The economy, far from suffering, generated more than 35 million new jobs along Main Street—an increase of nearly 50%.

That’s why I would recommend a steady glide path that would lower controllable spending over 10 years to 16.5% of potential GDP, bringing the size of the federal government back to a long-term sustainable level close to its average in the second Clinton term. President Obama and congressional Democrats might prefer a higher spending cap. But once we agree on the metrics—the foundation of a modern, enforceable spending cap—we can negotiate on the appropriate level to right-size America’s government for the 21st century.

Budget innovations should also change Washington’s thinking. Under this new foundation, to increase federal spending lawmakers would have to increase the na-

tion's economic output potential. That requires growing the labor force at a faster pace—a good thing—and increasing productivity, also a good thing. Savings can get us halfway back to sustainable fiscal ground, but economic growth is needed to finish the job.

This would also create a strong incentive for the President and Congress to tackle tax reform and entitlement reform. Dave Camp, Chairman of the House Ways & Means Committee, has proposed establishing a firm timetable for each chamber in Congress to consider and pass their best idea of a simpler, fairer, flatter tax code. Lawmakers in both parties, non-partisan commissions, and the White House have proposed ideas to extend the life of Social Security and Medicare. Along with establishing smart, bipartisan spending guardrails, these are long-term approaches that could directly correlate with meaningful extensions of the debt ceiling.

Now is the time to enact a 21st century solution to ensure America's fiscal future. I look forward to the testimony of today's witnesses.

PREPARED STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, JOINT ECONOMIC COMMITTEE

I would like to thank Chairman Brady for holding today's hearing and thank our distinguished witnesses for being here this morning.

I think the way forward is clear: we need to end the shutdown and pay our bills.

The first order of business is for the House to approve the straightforward bill the Senate passed on September 27 that would have prevented the shutdown in the first place. The government has now been shut down for more than a week and a half, and the costs are mounting.

I released a report this week that lays out 10 ways the shutdown is hurting the economy. Here are just a few examples.

First, the shutdown is harming consumers and slowing economic growth. Our witness today, Mark Zandi, warned this Committee last month that shuttering the government for three or four weeks would do significant economic damage, reducing real gross domestic product by 1.4 percentage points in the 4th quarter.

Housing is another area that is being hurt . . . and it has been a bright spot of the economic recovery. But now the Federal Housing Administration and the Department of Veterans Affairs are facing delays in insuring new home loans, likely holding up home purchases. More than 22 percent of all mortgages are backed by one of those agencies.

The Small Business Administration is not processing new applications for loan programs, preventing small firms from accessing the capital they need.

Our national parks are shuttered, harming surrounding communities that depend on the economic activity generated by the parks. In 2011, visitors spent nearly \$13 billion in local communities around the parks.

There are public health implications, too. Cancer patients are being denied access to new clinical trials at the National Institutes of Health. The Centers for Disease Control and Prevention is unable to track flu outbreaks, just as flu season is ramping up. A typical flu season costs employers over \$10 billion per year.

Countless companies from aircraft manufacturers to mining companies to agricultural businesses have come to me reporting major delays because products cannot get approved and permits cannot get issued. Piecemeal funding of the government will not solve this since the delayed approvals reported to me cover every agency from the Food and Drug Administration to the Department of Commerce to the EPA.

The federal agencies that are supposed to be gathering economic statistics aren't doing so. That means that the Federal Reserve, businesses and investors are flying in the dark.

This simply can't go on. We need to open NIH so that cancer patients can get access to clinical trials . . . let the SBA guarantee affordable loans to small businesses again . . . let the FHA and VA insure loans so that people can get mortgages.

Those are just a few examples of many we could give. We need to re-open all of the federal government, and we need to do it now.

That's the first hurdle. We also need to deal with the next critical deadline, the deadline for paying our bills—or face default. According to the Treasury Department, on Thursday, October 17, our country will hit its legal borrowing limit. Congress is being asked to do what it has routinely done 70 times over the past 50 years, and that's pay our country's bills.

Let me be clear, this is about making good on commitments we've already made. This is about doing what regular Americans do every month when they pay their credit card bills.

Let's look back to 2011 and see what happens when we flirt with disaster by waiting until the last minute.

Treasury Secretary Tim Geithner sent a series of letters to Congress about the looming debt ceiling in 2011, starting on January 6 of that year. On May 2nd, he announced that the debt limit would be reached on August 2nd.

On July 14, 2011, Standard and Poor's warned it may downgrade the U.S. credit rating. They followed through on that and downgraded our credit rating on August 5th—the first time in history.

The results of the game of chicken Congress played were ugly: the Dow Jones dropped more than 2,000 points in late July and early August of that year. Consumer confidence plummeted. \$2.4 trillion in household wealth was lost.

The delay in reaching an agreement to pay our bills, and the resulting uncertainty, meant that the Treasury had to pay higher yields than otherwise would have been necessary, costing taxpayers \$1.3 billion for fiscal year 2011 alone.

All of this harm occurred before we reached the debt limit. We can't let that happen again.

Despite the lessons of history, we've been hearing from a number of people who seem to think this is no big deal. Congressman Joe Barton said "We are not going to default on the public debt. That doesn't mean that we have to pay every bill the day it comes in."

At last month's JEC hearing on the debt ceiling, Dan Mitchell of the conservative Cato Institute said, "There's no need to fret about a default."

No need to fret? That's not what history teaches us.

Make no mistake; this brinkmanship has consequences for our economy. We cannot afford to go down this path again, because this time around the fall could be much harder.

And what if Congress doesn't act by next week and our nation defaults? According to Fed Chairman Ben Bernanke, the results would be "catastrophic."

A default would disrupt financial markets, limit access to credit and raise financing costs. It would trigger a run on money market funds and force the federal government to renege on commitments to individuals, businesses and governments.

For consumers, higher credit costs would mean less borrowing for purchases of homes, cars or other durable goods. Businesses could face difficulties accessing short-term debt to finance payrolls.

As Warren Buffett said when talking about the threat of a default, "it ought to be banned as a weapon. It should be like nuclear bombs, basically too horrible to use."

I agree with Chairman Brady that we need to move forward on a long-term deficit reduction plan that addresses both revenue and spending. I have long advocated for a smart and balanced plan that puts our nation on a sustainable fiscal path.

I have supported the Gang of Six, the Gang of Eight and the work of the Debt Commission.

While Congress has already made significant progress—achieving \$2.4 trillion in deficit reduction over 10 years—we all agree that more needs to be done to get our fiscal house in order. But our first order of business must be to open the government and raise the debt ceiling. We cannot negotiate long-term fiscal responsibility with the threat of economic chaos over the heads of the American people.

Our country cannot afford to keep lurching from crisis to crisis. I hope today's hearing will help make it clear that we need to end this current crisis. After we do that, both parties and both chambers will have a real opportunity for a bipartisan effort to reach a long-term deficit reduction strategy.



American Enterprise Institute for Public Policy Research

Testimony before the Joint Economic Committee

**The Way Forward from Government Shutdown and Debt Ceiling Confrontation
toward Long-Term Fiscal Sustainability and Economic Growth**

Kevin A. Hassett

John G. Searle Senior Fellow

Director of Economic Policy Studies

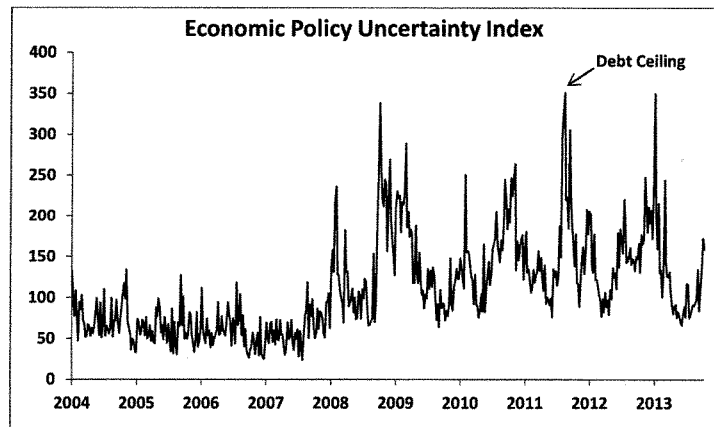
American Enterprise Institute

October 11, 2013

*The views expressed in this testimony are those of the author alone and do not necessarily represent
the views of the American Enterprise Institute.*

Chairman Brady, Vice Chair Klobuchar, and Members of the Committee, thank you for inviting me here today to discuss possible solutions to the government shutdown and debt ceiling debate and ways to move our country forward in a fiscally-sustainable way.

We meet today in the midst of a historic government shutdown, with the government's debt limit rapidly approaching. In a recent article, my colleague Abby McCloskey and I reviewed the history of debt limit increases and concluded that debt limit struggles have been quite common in recent U.S. history, and have lead more often than not to legislation that ties increases in the debt limit to specific factors. While a full accounting of the costs and benefits of these prior actions would require estimates of the long run impact of the policies that were enabled by debt limit actions, there is little dispute in the economics literature that struggles like that of 2011 increase economic policy uncertainty, and this heightened uncertainty has negative economic consequences. A recent path-breaking paper by Baker, Bloom, and Davis¹, shows these effects clearly. The authors compile a unique index of policy uncertainty, which draws on news coverage of uncertainty in policy decisions, the number of federal-tax-code provisions set to expire, and the disagreement among forecasters about economic variables one year in the future. They use this index to estimate the impact of policy uncertainty on the economy, finding massive negative effects; their results imply that a 112-point rise in their policy-uncertainty index - which occurred between 2006 and 2011 - would reduce real GDP by 3.2 percent and employment by 2.3 million jobs. The chart below shows the large spike in uncertainty that occurred during the debt-ceiling debate in 2011. It should not be in dispute that we can do better.



Source: FRED; Baker, Bloom, and Davis

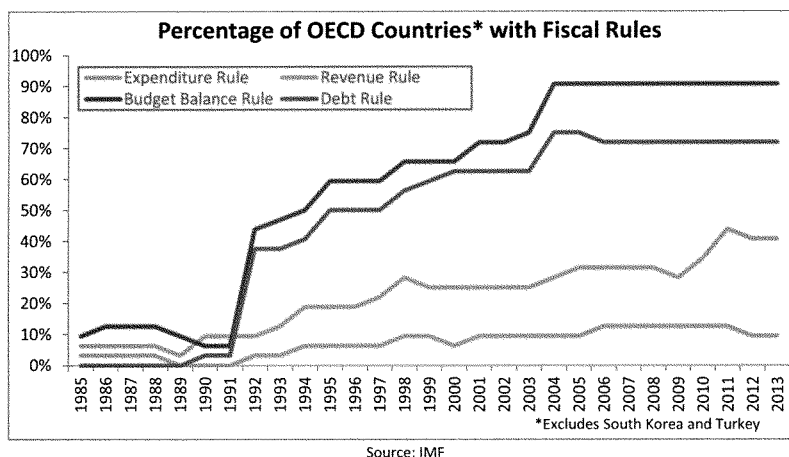
¹ Baker, Scott R., Nicholas Bloom, and Steven J. Davis. "Measuring Policy Uncertainty." Working Paper. May 19, 2013.

The purpose of my testimony is to review the budgetary practices of other countries, and draw lessons for U.S. policy, with the objective of helping lawmakers assure that this be the last time that our nation endures anything like our current mess.

My first observation is that most developed countries around the world have significantly more advanced budgetary rules than we do in the U.S., often encoding specific targets that constrain the actions of policymakers.

Budgetary Rules in Other Countries

The IMF recently compiled a database of 87 countries² and the fiscal rules that they use in their budgetary processes. The analysis broke the fiscal rules into four categories – expenditure rules, which set limits on total spending or on certain types of spending; revenue rules, which set floors or ceiling for revenues; budget balance rules, which constrain deficits that contribute to central government debt (either by limiting the amount that a deficit can be in an individual year, or by specifying that there should be a balance over a certain cycle); and finally, debt rules, which set an explicit limit or target for public debt. The U.S. currently has one fiscal rule in place, according to the IMF – the sequester agreed upon in 2011 which acts as an expenditure rule.



OECD countries have clearly moved towards having a greater number of fiscal rules over time. As the authors of one IMF study³ state:

“Over the past two decades, fiscal rules have spread worldwide. In 1990, only five countries—Germany, Indonesia, Japan, Luxembourg, and the United States—had fiscal rules in place that

² The Fiscal Rules dataset can be accessed at <http://www.imf.org/external/datamapper/FiscalRules/map/map.htm>

³ Schaechter, Andrea, Tidiane Kinda, Nina Budina, and Anke Weber. “Fiscal Rules in Response to the Crisis – Toward the “Next Generation” Rules. A New Dataset.” IMF Working Paper WP/12/187. July 2012.

covered at least the central government level. In Japan and Germany, fiscal rules have a long tradition dating back to as early as 1947 and 1969, respectively, though adherence to the rule was weak for most years. Over the next two decades, the number of countries with national and/or supranational fiscal rules surged to 76 by end-March 2012 ... This includes, most recently, responses to the crisis with a view to provide credible commitment to long-term fiscal discipline.”

In addition to countries adopting their own fiscal rules, there are some supra-national rules (by the EU, along with a few other currency unions in the Caribbean and Africa) that band countries together. In the EU, the Maastricht Treaty, signed in 1992, set a limit of three percent of GDP for deficits and 60 percent of GDP debt for EU member states. Following the financial crisis and recession from 2007-2009, in which many EU member states experienced large deficits and growing debt, a new Fiscal Compact was agreed to. Twenty five member states signed an agreement in 2012 requiring countries to adopt national legislation limiting annual structural deficits to 0.5 percent of GDP and implementing new rules on debt reduction to achieve the eventual goal of 60 percent debt to GDP ratios.

Although many EU countries have relied upon budget rules to push deficits back to lower levels following the Great Recession, there are certainly exceptions, and one could not possibly assert that they have been a ringing success. In a recent study, Frankel and Schreger (2012)⁴ show that one of the reasons that Eurozone countries have frequently exceeded the 3 percent deficit rules is overly optimistic growth forecasts that allow central governments to project meeting deficit targets that they in fact end up missing. This is especially true of countries that have previously violated their 3 percent deficit cap. However, countries that have an independent fiscal institution that produces budget forecasts tended to have less overly-optimistic forecasts than countries that did not.

The evidence from Europe shows that in many cases, limits to budget deficits can be ineffective because it is easy to tinker with projections to appear to come into balance, when a deficit limit is in fact going to be breached. Limits to budget deficits also have the disadvantage that they require agreement on both spending and revenue, without providing a guide to the proper level of either. This creates a situation where one side favors lower taxes and lower spending, for example, while the other side favors a higher tax and higher spending level – and each can point to their own plan as meeting the deficit ceiling.

Perhaps because of these problems, countries have increasingly begun to rely on specific expenditure targets, either top line numbers, or as a percentage of GDP. The adoption of such targets makes a great deal of sense. Some policymakers may like the government to be larger, some might like it to be smaller, but everyone should agree that bills eventually have to be paid. By focusing budget rules on the key variable in dispute, countries around the world are beginning to assure that the focus of policy debate is on the actual substance of the debate.

The data suggest, then, that we might well seek to adopt a new set of budget rules that set a limit on spending, and then agree to automatically pass continuing resolutions and debt limit increases, provided

⁴ Frankel, Jeffrey A. and Jesse Schreger. 2012. Over-optimistic Official Forecasts in the Eurozone and Fiscal rules. NBER Working Paper 18283.

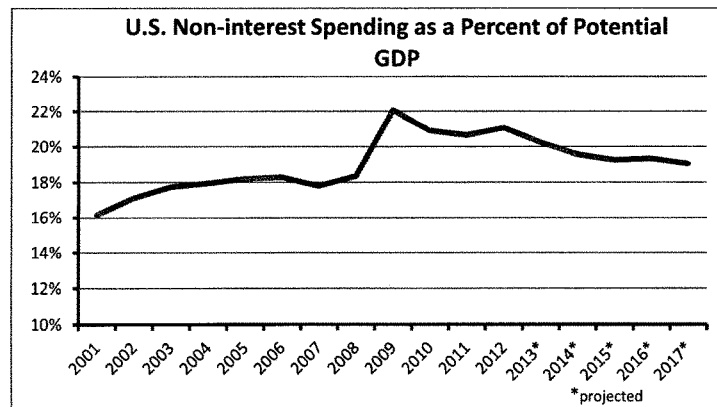
that the government is spending at or below the target. While establishing that target would certainly be difficult, existing proposals, such as one put forward several years ago by Chairman Brady, provide a useful guide to the possible concerns.

Limiting Spending

A hard limit on spending is impractical, because the cost of providing government would necessarily increase as the economy and wages grow. As such, I encourage you to consider a policy that limits spending as a share of GDP. A direct limit on such spending would also be poor long run policy, since a contraction in GDP might lead spending, which includes built in stabilizers, to increase as a share of GDP in a desirable fashion. There are several possible methods to adjust for this. One is to cyclically adjust the variables, another is to rely on spending as a share of potential GDP. Potential GDP is a measure calculated by the Congressional Budget Office that estimates the level that GDP in the U.S. economy would be if the economy were operating at a high level of resource use (including full employment). It is meant to be a measure of a sustainable output. In a recession, GDP generally falls below potential GDP as resources remain unused. Potential GDP then allows the estimate of GDP to be smoothed over peaks and troughs in the business cycle.

Marking spending to potential GDP would be an effective way to enact budget legislation that is transparent and difficult to game. The CBO's methods for calculating it are well established, and it would be easy to agree to consequences that would reduce spending in real time in response to a surge in spending that pushed the government past the agree upon caps.

The target percent of potential GDP that lawmakers might prefer would, of course, be in the eye of the beholder. As can be seen in the next chart, in recent years government's share of potential GDP has varied from about 16 percent to as bit more than 22 percent. That would seem to be a reasonable range to begin the discussion in.



Source: Congressional Budget Office; Office of Management and Budget

As each lawmaker forms his or her own opinion about the appropriate number, it will clearly depend on their own assessment of the possible benefits of government spending programs, such as infrastructure spending, or clean energy subsidies. But as those benefits are considered, I would also urge you to keep in mind the benefits of budgetary restraint. While there is a good deal of uncertainty concerning the size of the government multiplier effect in the short run, the long run impact of government spending on growth has a fairly robust underpinning in the empirical growth literature. Barro (1989⁵, 1991⁶) examines the impact of government consumption and investment spending on economic growth in a series of cross-country growth regressions. He concludes that public consumption spending has a robust negative relationship with growth and investment while public investment spending has an insignificant effect on economic growth. Grier and Tullock (1989)⁷ find that an increase of one percent in government growth reduces average GDP growth by 0.32 percentage points. In other words, there is a strong negative effect of the growth of government consumption as a fraction of GDP. Alesina, et al. (1999)⁸ find similar negative results of government spending on economic performance, as measured by business investment, in an analysis of OECD countries. Folster and Henrekson (2001)⁹ find a negative growth effect of large public expenditures in cross-country analysis.

Conclusion

Countries around the world have increasingly relied upon budgetary rules to help constrain the growth of government. I encourage Congress to consider adopting a budget rule that caps spending in the U.S. (other than interest payments) at some agreed upon fraction of GDP. If spending is below that cap, than government debt limits should be automatically lifted, and the government should stay open. The economic benefits from the reduced uncertainty that would follow could well be significant.

⁵ Barro, Robert J. 1989. "A Cross-Country Study of Growth, Saving and Government." NBER Working Paper No. 2855. January.

⁶ Barro, Robert J. 1991. "Economic Growth in a Cross-Section of Countries." *Quarterly Journal of Economics* 106 (2): 407-43.

⁷ Grier, Kevin. B, and Gordon Tullock. "An Empirical Analysis of Cross-National Economic Growth, 1951–80." *Journal of Monetary Economics* 24 (2): 259–276.

⁸ Alesina, Alberto, et. al. 1999. "Fiscal Policy, Profits, and Investment." NBER Working Paper 7207. July.

⁹ Fölster, Stefan, and Magnus Henrekson. 2001. "Growth Effects of Government Expenditure and Taxation in Rich Countries." *European Economic Review* 45 (8): 1501–1520.=

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Joint Economic Committee

*"The Way Forward From Government Shutdown and Debt-Ceiling Confrontation
Toward Long-Term Fiscal Sustainability and Economic Growth"*

October 11, 2013

The impasse in Washington over funding the federal government and increasing the Treasury debt ceiling is significantly damaging the economy. Stock prices are grinding lower and consumer confidence is weakening. The economic harm will mount significantly each day the government remains shut and the debt ceiling is not raised. If policymakers are unable to reach agreement on these issues by the end of October, the economy will face another severe recession.

To resolve the budget impasse, policymakers should not add to the significant fiscal austerity already in place, which is set to last through mid-decade. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. In 2013, this fiscal drag is as large as it has been since the defense drawdown after World War II.

Moreover, because of fiscal austerity and the economic recovery, the federal government's fiscal situation has improved markedly. The budget deficit in just-ended fiscal 2013 was less than half its size at the recession's deepest point in 2009. Under current law and using reasonable economic assumptions, the deficit will continue to narrow through mid-decade, causing the debt-to-GDP ratio to stabilize.

As part of any budget deal, lawmakers should reverse the sequester. The second year of budget sequestration will likely have greater consequences than the first, affecting many government programs in ways that nearly all agree are not desirable. A sizable share of the sequestration cuts to date has involved one-off adjustments, but future cuts will have to come from lasting reductions in operational budgets.

It would of course also be desirable for lawmakers to address the nation's long-term fiscal challenges. Although the fiscal situation should be stable through the end of this decade, the long-term outlook remains disconcerting. If Congress does not make significant changes to the entitlement programs and tax code, rising healthcare costs and an aging population will swamp the budget in the 2020s and 2030s. Both cuts in government spending and increases in tax revenues will be necessary to reasonably solve these long-term fiscal problems.

A grand bargain with comprehensive entitlement and tax reform is likely too much to hope for, but lawmakers can do some things now to address our long-term fiscal issues and help resolve the current impasse.

Revenue-neutral corporate tax reform that scales back tax expenditures in exchange for a lower top marginal corporate tax rate would also be a significant policy achievement. This would significantly improve the competitiveness of U.S. businesses and the economy's long-term growth. Much of the hard intellectual work necessary to accomplish this has been done, and there is general agreement among economists that this would provide a meaningful boost. As part of corporate tax reform, multinationals could be encouraged to repatriate their overseas profits with a temporarily lower tax rate. The resulting onetime boost to tax revenues could be used to finance infrastructure development here at home, also improving U.S. competitiveness and long-term growth.

New budget rules that recognize the magnitude of our long-term problems and encourage solutions would be especially helpful. These could include incorporating fiscal-gap accounting and generational accounting in the budget process, and significantly extending the current 10-year budget horizon to facilitate entitlement and tax reform.

Congress should 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. Absent repeal, an alternative would be to require debt-ceiling increases when spending, taxation and appropriations bills are passed. 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. 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 United States or the stability of world financial markets.

The U.S. economy remains frustratingly far from full employment. While there are many reasons for this, political brinkmanship around the federal budget and Treasury debt ceiling has been a significant contributing factor. Much progress has been made since the Great Recession, and the economy's prospects are improving, but this will continue only if policymakers can resolve their differences in the next few days.

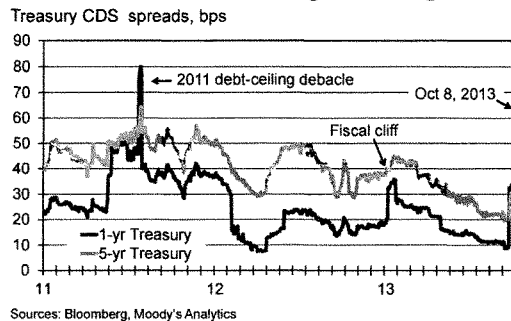
Economic cost

Financial market reaction to the events in Washington has been muted so far. It has become typical for Congress to run down the clock, but in the end it has never failed to

raise the debt ceiling when necessary. The motivation is clear: Any delay would have dire economic and political consequences. It is thus widely expected that Congress will do so again. Indeed, after several rounds of fiscal brinkmanship over the last few years, financial markets have become increasingly desensitized to it.

Nonetheless, anxiety over the budget battles in Washington is building in financial markets. Notably, the price of a credit default swap on a one-year Treasury bill has surged above 60 basis points, up from 10 basis points just a couple of weeks ago. For context, during the showdown over the debt limit in summer 2011, one-year CDS spreads rose to 80 basis points (see Chart 1). CDS spreads on five-year Treasuries are also on the rise.

Chart 1: Financial Market Angst Is Rising



Yields are also increasing on short-term Treasury bills that mature after October 17. Investors are requiring compensation for the possibility that the Treasury might not pay on time. While equities have held up better than bonds, they have been slowly grinding lower since mid-September. The Standard & Poor's 500 is off some 4% over this period.

Unfortunately, it appears that it will take a more substantial selloff in financial markets to give Washington the political will to reach agreement. A couple of days with the Dow Jones Industrial Average dropping several hundred points should generate enough heat for lawmakers to settle the conflict. Given investors' current complacency, however, this may not occur until just before October 17.

Consumer confidence has also begun to weaken. Daily surveys from Gallup and Rasmussen show a sharp decline in sentiment in recent days. Private sector data on retail activity and anecdotal evidence indicate that consumers' darkening mood has begun to weigh on sales.

It is important to note that with the federal government's statistical mills shuttered, it will become increasingly difficult to gauge the economy's strength. The Bureau of Labor Statistics did not release September job numbers, the first such interruption in data since the last government shutdown in 1996. The longer the government shutdown drags on, the greater the disruption to the data collection process and the quality of the information available when operations restart. The muddied data will be difficult to interpret, at a time when it will be critical to know what economic damage political brinkmanship is doing.

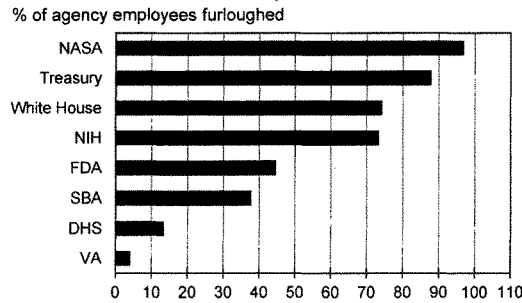
Even assuming lawmakers reopen the government and raise the debt ceiling just before the Treasury's announced deadline of October 17, the hit to fourth-quarter real GDP growth will be approximately half a percentage point. Instead of picking up pace at the end of the year as previously expected, the economy will remain stuck near a lackluster 2% real GDP growth rate.

Government shutdown

But if the government shutdown lasts longer, even assuming the debt limit is increased by October 17, the economic damage will mount quickly. A shutdown lasting through the end of October would by itself reduce real GDP growth as much as 1.5 percentage points in the fourth quarter. An interruption longer than one month would likely cause growth to stall in the quarter, and one longer than two months could precipitate another recession.¹

For context, the government shutdown in late 1995 and early 1996, the longest on record, lasted about three weeks. The economy's growth slowed notably as a result, even though the technology boom of that time made underlying growth much stronger than it is today.

Although the shutdown only affects nonessential discretionary spending, or about a fifth of total federal spending, it is becoming increasingly disruptive to the economy.² Some 400,000 government employees have been furloughed, and while they will ultimately receive retroactive pay, this will not happen until after the government is reopened (see Chart 2). The same delays in pay affect another 800,000 employees who are still working. Not getting paid for a few days or even a couple of weeks will not make a big difference in their spending behavior, but these workers will likely turn much more cautious if this drags on much longer. Many do not have the financial resources to maintain spending for very long without current income.

Chart 2: Government Shutdown Is Disruptive

Tourist destinations across the country from the Grand Canyon to Gettysburg PA are suffering. International trade is being impeded as exporters and importers are unable to get the requisite government permits needed to ship their goods. The housing recovery is increasingly at risk as lending by the Federal Housing Administration slows and other lenders have trouble getting tax and Social Security information needed to close mortgage loans. Small-business lending is also being hampered by the closing of the Small Business Administration.

Treasury debt ceiling

The economic cost of the government shutdown is significant, but it is small in comparison to the cost of not increasing the \$16.7 trillion debt limit in a timely way. According to Treasury Secretary Jack Lew, October 17 is when the extraordinary measures the Treasury has been using since May to stay under the limit will no longer work.³ Unable to borrow at that point, the government will only be able to pay bills with the cash it has on hand, about \$30 billion per day.

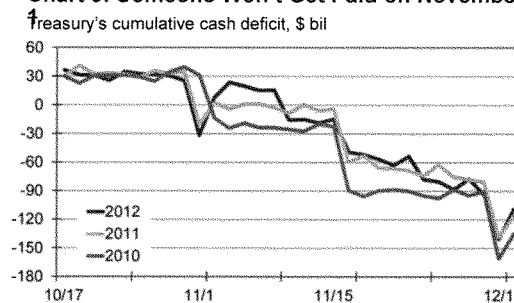
The Treasury might be able to pay holders of U.S. government securities first, as those payments are handled by a different computer system than other government obligations. But the Treasury believes it is not legally viable to do so, and politically it would be very difficult to pay bond investors before Social Security recipients. Even if the Treasury did pay bond investors first, this would not stop investors 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. The Federal Reserve could increase its bond buying, but any benefits would likely be overwhelmed as global investors sold U.S. securities. Financial markets would surely be spooked. Sometime in late October, there would be a TARP moment, harkening back to that day in October 2008 when Congress failed to pass the Troubled Asset Relief Program and stock prices cratered.

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 the inspector general. Based on the timing of outlays and tax receipts, this would probably mean delaying more than a week more than \$60 billion in payments due November 1 to Social Security recipients, veterans and active-duty military. This would almost surely eviscerate 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 (see Chart 3). This is approximately 9% of annual GDP.

Chart 3: Someone Won't Get Paid on November



In contrast with previous recessions, moreover, government would have no tools available to cushion the blow. With Congress and the administration still at loggerheads, there would be no fiscal policy response, and with short-term interest rates at zero and the Fed's balance sheet already bloated, it is unclear what the central bank could do to support the economy.

This would be a cataclysmic economic scenario. The downturn would be at least as severe as the Great Recession. That means real GDP would decline by about 5%, close to 10 million jobs would be lost, and unemployment would rise to 12%. 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.

Political uncertainty

Even if lawmakers come to terms in coming days, the harsh political vitriol and repeated threats to shut government or not pay its bills have weighed heavily on sentiment and meaningfully harmed economic growth. Businesses are more reluctant to invest and hire, and entrepreneurs are less likely to attempt startups. Financial institutions are more circumspect about lending and households are more cautious about spending. While many factors are at work here, Washington's heated budget battles are a significant contributor.

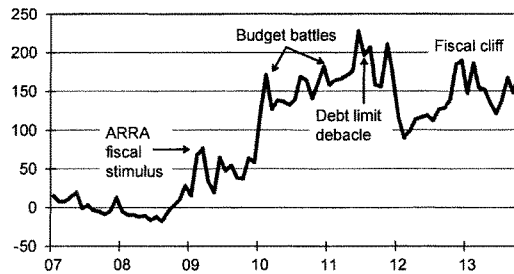
Half the CEOs in the Business Roundtable's third-quarter outlook survey said Washington's battles have affected their hiring plans over the next six months. Shaky nerves stifle risk-taking and entrepreneurship, which is key to stronger growth.

The uncertainty created by Washington is evident in the Moody's Analytics political uncertainty index. The index is based on the credit default swap-implied expected default frequency for 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 0 in 2007, the year before the recession. 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 rose to a record high during the Treasury debt-ceiling showdown in the summer of 2011 (see Chart 4). Uncertainty also increased as the fiscal cliff approached in late 2012 and has been rising in recent weeks as the current fiscal impasse unfolded.

Chart 4: Political Uncertainty Remains High

Fiscal policy uncertainty, 2007Q4=0



Source: Moody's Analytics

Political uncertainty constrains business investment, especially in research and development, reduces hiring, and slows GDP growth. A statistical analysis shows that increased political uncertainty since the recession hit in 2008 has lowered real GDP by close to \$150 billion, reduced employment by 1.1 million jobs, and increased unemployment by 0.7 percentage point.⁴ If political uncertainty had simply remained unchanged from its 2007 level, the unemployment rate today would be 6.6% instead of 7.3%. If not for the logjam in Washington, the economy would now be much closer to full employment.⁵

No additional near-term fiscal austerity

In any agreement to increase the debt ceiling or extend funding for the federal government, lawmakers should avoid adding to the fiscal austerity in place through mid-decade. Congress has been appropriately focused on reducing the government's large budget deficits, but recent tax increases and government spending cuts have put a significant constraint on growth. Under current law, fiscal headwinds will continue to blow hard in 2014 and 2015. It would be wise not to add to those headwinds, and allow the private economy to gather momentum.

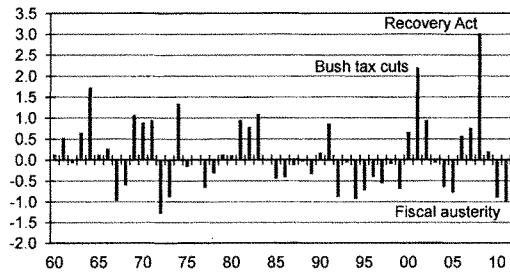
Although the U.S. economy has begun its fifth year of recovery from the debilitating Great Recession, it remains fragile. Growth has been modest, with real GDP expanding close to 2% per year since the recovery began, and payrolls are still nearly 2 million jobs shy of their prerecession peak. The nation's 7.3% unemployment rate remains well above most estimates of full employment, which is closer to 5.5%. And this understates the stress in the job market given the large number of potential workers who have left the labor force because of a lack of perceived job opportunities.

The private economy has made significant strides since the recession. American companies have strong balance sheets with low debt and lots of cash, and they have done an excellent job reducing their costs. By most measures, they are highly competitive. The financial system is much better capitalized and liquid, and increasingly willing and able to extend credit. Households have also significantly reduced their debt loads, which are now about as low as they have ever been. Higher house prices and stock values are also supporting households' better financial condition.

But the strengthening private economy is not evident in the nation's overall performance because of fiscal austerity. In calendar year 2013, the drag on the economy from federal tax increases and spending cuts will amount to 1.5 percentage points of real GDP growth. That is, if fiscal policy were simply neutral with respect to the economy, real GDP growth this year would be closer to a strong 3.5% (2 percentage points in real GDP growth plus 1.5 percentage points from the elimination of the fiscal drag). The fiscal drag will reach its apex in the current quarter, and over the course of 2013 will be greater than in any other year since the defense drawdown that followed World War II (see Chart 5).⁶

Chart 5: Fiscal Headwinds Are Blowing Hard

Real GDP growth impact of federal fiscal policy, fiscal yr, ppt



Source: Moody's Analytics

The federal government's improved fiscal situation also gives lawmakers some leeway. Tax revenues are rising at a double-digit pace and government spending is falling. The budget deficit for fiscal 2013 is set to come in well below \$700 billion.

This is still large, but it is half of what it was at its peak in fiscal 2009. Under current law and assuming the economic recovery stays intact, the deficit will continue to narrow through mid-decade. The nation's debt-to-GDP ratio, though uncomfortably high at more than 70%, will stabilize.

Given the still-fragile economic recovery, the austerity already in place, and a better near-term federal budget situation, policymakers should not add to the fiscal burden on the economy through mid-decade. This will help the private economy kick into higher gear, hasten a self-sustaining economic expansion, and promote a quicker return to full employment.

Replace the sequester

Policymakers should replace the cuts scheduled for the coming year as part of the sequester with other budget savings.

The impact of the current year's sequester, which began in March, is becoming more visible in the economic data. Hiring freezes announced early this year appear to have accelerated the decline in federal government employment. There has been an even larger impact on hours worked and personal income. Federal furloughs caused government wages and salaries to decline by half a percent in August alone. Cuts in procurement spending are also reducing support for private sector jobs, particularly among defense contractors, although the impact of the sequester on private employment is occurring gradually, with a significant lag.

A second year of sequestration will have greater consequences for the economy. The cuts will be larger and will start immediately, rather than beginning six months into the fiscal year as occurred this year. Because of lags between budgeting and actual spending, and between federal spending and its impact on the job market, the fallout from this year's cuts will carry over into 2014. A sizable share of the fiscal 2013 sequestration cuts was also made through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continuing the sequester would have particular implications for the Pentagon. While in fiscal 2013 sequestration cuts were divided evenly between security spending—on defense, homeland security and international affairs—and nonsecurity spending, in 2014 and beyond the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations. The potential for an escalation in military operations in Syria could increase the overseas contingency operations budget, which is not exempt.

Enact budget reforms

The statutory debt ceiling is an anachronistic law that if not repealed should be reformed so that it can no longer lead to a voluntary default on U.S. government obligations. Fiscal-gap and intergenerational accounting should also be adopted in the budget process.

Using the threat of a default on U.S. government obligations as a tool in fiscal policy negotiations has meaningful economic costs. Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing, 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.

Policymakers should also adopt the INFORM Act, which would require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting.⁷ 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.

Pass corporate tax reform

To break the budget impasse, policymakers should consider adopting revenue-neutral corporate tax reform. Reform that resulted in a lower marginal corporate tax rate would also help the competitiveness of U.S. companies and thus support stronger long-term economic growth.

Corporate tax reform, which involves reducing or eliminating tax expenditures in the corporate tax code and using the resulting additional revenues to reduce marginal rates for businesses, would also be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that result in lower effective tax rates. All the loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus long-term economic growth.

As part of corporate tax reform, multinational corporations would be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. This would give a onetime boost to tax revenues that could be used to finance needed infrastructure development in the U.S. This too would help the competitiveness of U.S. companies and thus long-term economic growth.

Conclusions

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

Despite this, the economic recovery is more than four years old, and the private economy has made enormous strides. 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. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is Congress' willingness to fund the government and make sure all its bills can be paid. If policymakers can find a way to do these things in the next few days, almost regardless of how awkward the process is, the still-fragile recovery will quickly become a self-sustaining expansion.

We are close to finally breaking free from the black hole of the Great Recession. All it takes is for Washington to come together.

¹ A thorough analysis of the causes, processes and effects of federal government shutdowns, including potential issues for Congress, can be found in “Shutdown of the Federal Government: Causes, Processes and Effect.” *Congressional Research Service Report for Congress*. August 6, 2013. <http://www.fas.org/sgp/crs/misc/RL34680.pdf>

² This includes programs that are funded through congressional appropriations, but are not considered vital such as national security, air traffic control, law enforcement, or the processing of benefit payments. Mandatory spending is not affected.

³ Secretary Lew’s letter to Congress can be found at <http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf>

⁴ 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.

⁵ 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 Obamacare, 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.

⁶ If fiscal austerity measures had not been implemented since early 2011, making federal fiscal policy neutral with respect to the economy, then real GDP would be nearly \$300 billion greater, there would be almost 2 million more jobs, and the unemployment rate would be more than a percentage point lower. This is based on a simulation of the Moody’s Analytics structural model of the U.S. economy. The simulation assumes that monetary policy would not have changed; that is, the Federal Reserve would have engaged in the same amount of quantitative easing despite the stronger economy.

⁷ The INFORM Act is described in detail at <http://www.theinformact.org/content/text-bill>