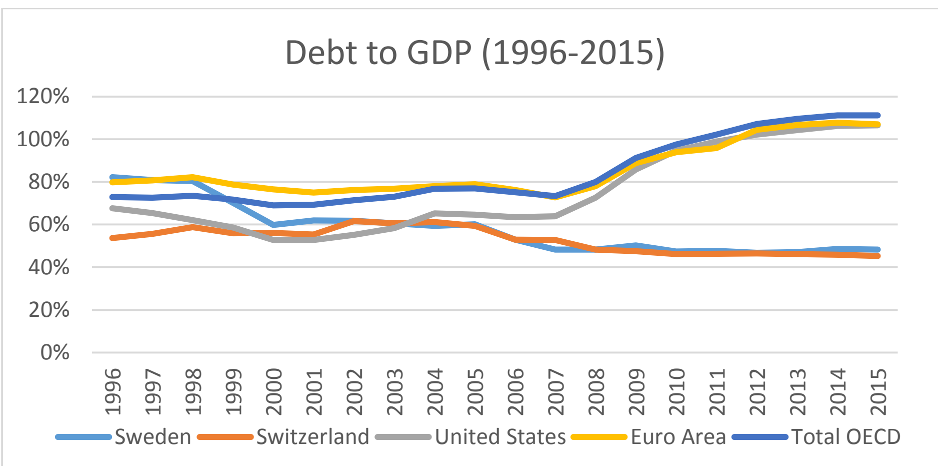
## DEBT LIMIT ALTERNATIVES: OVERVIEW

Since 1917, the United States has attempted to manage the country's debt via the debt ceiling. Congress is responsible for setting the maximum level of debt the country can issue and for raising that level when necessary. Congress also reserves the right to refuse to raise the ceiling, which it has never done.

Most elected officials, even those who support reducing spending, typically go along with increases for fear of creating a scenario in which the Treasury is unable to pay its bills. <u>This fear of default has defined debt limit standoffs.</u> But if the debt limit does not effectively restrain spending and debt, the question arises: *What will?* Unfortunately, academics and politicians alike have thus far neglected serious consideration of alternatives. The Institute to Reduce Spending sought to fill this void with an original dynamic study that evaluates alternatives and seeks to identify the most effective tool for controlling federal spending and debt.

## ORIGINAL ANALYSIS

Dr. Barry Poulson (UC-Boulder) and Dr. John Merrifield (UT-Austin) led a comprehensive analysis of fiscal rules in individual states and throughout the world and created an original dynamic model that utilized dynamic scoring to study the potential application of state and international rules to the U.S. federal system.




Source: OECD Vol. 2014/1 p. 292.

Perhaps unsurprisingly, **several OECD countries manage their debt far better than the United States does.** Merrifield and Poulson studied the existing rules-based approaches to fiscal restraint and determined that we could – and should – attempt to do better, too. They identified a proposed rule, the Merrifield-Poulson Fiscal Responsibility Rule ("MP Rule"), which one can judge against existing alternatives in U.S. states and worldwide in OECD countries, and via comparison to what they identify as the most effective foreign rule, the Swiss Debt Brake.

They assess these rules-based approaches by simulating their effects over the federal fiscal years 1994-2013, *studying what would be the end-year (2013) federal fiscal circumstances of the United States had the rule been adopted in FY 1993, and what would have been the transitional effects.*

This period saw two separate economic expansions, a major terrorist attack, three major overseas military operations, several natural disasters, and two economic contractions, including the Great Recession, providing an effective test of proposed rules over time.

Since the persistent rapid spending growth at the state and federal levels is consistent with Public Choice Theory, Poulson and Merrifield determined that a robust rule capping spending growth has to be a central element of the proposed MP Rule. The two best approximations of the general basis of demand for federal spending are **personal income growth** and **population plus inflation**, determining that the former was too volatile as a basis for capping federal spending growth. Therefore, the MP rule caps federal spending growth at a multiple of the sum of U.S. population growth and inflation.

## FINDINGS

Poulson and Merrifield's simulations assess the effects of varying the multiplier. They provide for annual deposits into an emergency fund to finance supplemental *appropriations supported with a super-majority vote of each house of Congress*, and conduct dynamic scoring of tax and spending changes. With seven multi-value parameters, the "Monte Carlo" simulation analysis generated 576 fiscal outcome observations; the fiscal outcome of every possible combination of the plausible parameter values. Regression analysis of the 576 simulation observations estimated the average marginal significance of each parameter choice to each key fiscal outcome.

If the United States had implemented the MP Fiscal Responsibility Rule with the preferred parameter values, the FY 2013 national debt would have been **$8.5 trillion**, 51% of its actual 2013 value, and 48.3% of GDP. Dynamic scoring indicated that the reduced federal spending would have left 2013 GDP at 5.1% above its trend value, based on the average rate of growth for the preceding 30 years, and 6.2% above actual 2013 GDP. The simulated rise in GDP would have entailed employment growth of approximately 11.3 million jobs.

## CONCLUSION

In short, the fiscal situation of the United States would have been markedly better if policymakers had followed the examples of their OECD counterparts and sought more binding rules on spending growth instead of relying on a clearly flawed debt limit system that ineffectively takes aim at the symptoms (rising debt) instead of the problem (rising spending).

Fiscal conservatives face a difficult but not insurmountable challenge under the current debt and spending rules. While the debt limit has been used to force fiscal concessions, it seems likely that a majority in Congress is losing the will for protracted fights, which experience shows can have unintended impacts on the economy while typically failing to produce lower debt.

Changing the status quo is not impossible, as the improved rule structures in several OECD countries demonstrate, and it is a goal well worth seeking if fiscal conservatives hope to achieve substantial and lasting spending reform. The first step in this process is to identify and analyze various alternatives, which our study sought to do.