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How the Republicans can get debt under control

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Until I came to work in the US, I had little understanding of the federal government's long-term fiscal challenge.

The UK's long-term debt outlook was only too familiar, and pretty frightening – mainly because it concerned an ageing population interacting with pay-as-you-go state pension and healthcare systems. But there was, at least in the near-term, a consensus of sorts for fiscal restraint and reducing the debt-to-GDP ratio.

Not so in America. Sustained budget deficits under George W Bush, followed by the financial crisis and subsequent Obama stimulus, had seen debt held by the public explode from 32.6 per cent of GDP in 2002 to 77 per cent in 2016 – a level only previously touched following World War II.

While that debt spike fell quickly due to military spending cuts and high growth, projections now show that debt-to-GDP levels will rise rapidly in the coming decades. The Congressional Budget Office (CBO) projects the deficit will widen to 5.2 per cent of GDP even by 2027, ballooning public debt further to 91.2 per cent of GDP.

In the two decades following that, debt is expected to climb even further to 150 per cent of GDP on unchanged policies, driven both by surging Social Security and Medicare spending and debt interest payments. This ignores any deficit-widening effects of the recent tax cuts.

Most people realise status quo policies are unsustainable. But so far, Congress has been reluctant to act. Hooked on borrowing, it's far easier to sustain programs knowing the costs are spread across future generations. Entitlements, the key driver of debt, seem untouchable, in part because the American public consider these to be "earned rights". Meanwhile, the ideological divide between Democrats and Republicans on the size and scope of the state has paralysed previous attempts to strike a grand bargain to ease the debt path.

Yet delaying action only worsens the long-term outlook. Getting the debt-to-GDP ratio back to a historic norm of 40 per cent by 2047 will require permanent spending cuts equivalent to 3.1 per cent of GDP (15 per cent of federal spending, excluding debt interest). Putting off such restraint until 2028 would require annual cuts of 4.6 per cent of GDP thenceforth to achieve the same goal.

It is welcome, then, that House speaker Paul Ryan tasked a Congressional Republican working group late last year with proposing budget reform to constrain federal debt. The so-called "debt ceiling" has clearly been a failure, with significant economic costs, and many Republicans yearn for an alternative.

As we know, politicians can be prone to "deficit bias", which is why over the last three decades as many as 96 countries have made use of long-lasting constraints on spending, tax revenues, deficits or debt called "fiscal rules".

Clearly, some have been more successful than others. Given the utter failure of the Maastricht rules in the eurozone, and the UK's ever-changing fiscal targets, fiscal rules are neither necessary nor sufficient for containing debt. Yet well-designed strictures can help improve the functioning of fiscal policy, binding politicians to good outcomes.

The trick is to find the sweet spot between rules being strict and transparent enough to have real consequences, and being flexible enough to ride out recessions and unforeseen circumstances.

I have reviewed the extensive literature on fiscal rules for a forthcoming paper, including those in US states and the federal government, Switzerland, Chile and the UK. Here are the 10 key lessons I learned from my research, which the GOP should keep in mind:

1 Political will is needed to achieve fiscal discipline and sustain rules, particularly without constitutional backing.

Governments around the world, including the UK of late, and the US in the 1980s, tend to abandon or circumvent rules when they get tough

2 Rules must have provisions to deal with recessions or worse-than-expected growth.

Inflexible rules, such as strict deficit targets or hard annual balanced budget rules tend not to endure when shocks hit. With fiscal rules, "tougher" is not always better, and certainly not more durable.

3 Fiscal rules should primarily cap spending, since that is the variable that politicians directly control.

Tax revenues are, to a large extent, determined by the health of the economy, the prospects for which can be uncertain. Deficits, likewise, are merely a byproduct of spending and tax revenues.

4 A falling debt-to-GDP can be obtained through balancing spending and revenues over the economic cycle.

This can be roughly achieved by setting caps for spending to trends in tax revenues or to an estimate of revenues if the economy were at full potential. Both allow automatic stabilisers to operate and borrowing to adjust to the state of the economy, but ensure falling debt-to-GDP in the medium-term.

5 Spending caps should include all spending to minimise creative accounting.

There is lots of evidence that otherwise politicians redefine spending, e.g. by calling consumption spending "investment".

6 Long-term entitlement spending requires a secondary rule.

Structural balanced budget rules do not restrict politicians today from making entitlements more generous for future generations. Restrictions preventing new entitlement promises are therefore desirable to ensure long-term sustainability.

7 Formulaic rules, which use trends to estimate revenues, are simpler, more transparent and less prone to over-optimism.

The alternative, predicting potential revenues, requires estimating a host of unknowns, including the potential of the economy, and how revenues respond to moving towards potential.

8 The rule should correct for missed targets.

Deviations in spending outcomes from caps should not be ignored. As with the Swiss "debt brake", deviations should be used to adjust future spending caps to ensure the overall budget really does balance over the cycle.

9 There should be a clear but limited escape clause for genuine emergency situations and wards.

This should require a high-threshold vote, with a well-acknowledged pathway back to achieving balance.

10 The best way to obtain credibility for a fiscal rule is to get to the stage where it binds.

Pushing targets for achieving balance further into the future is especially dangerous given the risk of a changed political consensus and new economic downturns. You need to make the rule the norm quickly.

The Republicans have a chance to implement a spending-cap fiscal rule in the coming years. They should heed these lessons and seek to get the debt-to-GDP ratio back on a downward path in anticipation of the fiscal headwinds to come. But this will require political will, and a sophisticated approach that is durable to changing economic trends.

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