Commentary: Achieving Growth Amid Fiscal Imbalances

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The two papers just presented by Stephen Cecchetti and Katherine Baicker make persuasively argued and well-understood points. The United States, and indeed many countries around the world, are carrying excessively high debt burdens that are at levels where they are likely already harming economic growth, and which require concerted efforts to bring debt back down to sustainable levels. Looking forward, large, growing, and often misallocated health-care costs create the single largest fiscal threat in the United States.

I find there is little to quibble with in either of these papers, though they do raise further policy-related questions. Given the need for a number of policy decisions that require action in the short term, the immediate impact of these papers probably has far less to do with their academic contribution than their potential to influence policy decisions.

Let me first talk about Steve Cecchetti's paper, which looks at household, corporate and government debt, in an effort to pinpoint the levels at which debt negatively affects growth. The specific points or ranges by sector are an important contribution in identifying at what levels debt becomes problematic. Given that this field of work is not fully fleshed out, such findings are particularly useful to be able to point to in trying to guide policymakers.

It is not a stunning surprise that in many cases, and certainly in the case of the United States, debt levels are too high. The author is wise to point out that the levels at which debt become an economic drag should not be seen as the fiscal objectives to which to return. Rather, in order to maintain fiscal flexibility and the ability to respond to future crises through borrowing, if and as needed, as we did during this past crisis, governments should not just stabilize their debt or get it to the range which has been identified as problematic, but bring it back down to if not traditional levels, closer to them. This is an important policy reminder given the political pressure to stabilize debt at levels that are probably significantly too high.

The main question I have regarding the Cecchetti paper is how these findings are affected by the situation when many countries have to act to reduce their debt levels simultaneously. This is obviously relevant to the moment we are in. The International Monetary Fund has found that this can double the output cost—depending on monetary policy responses. This question of timing and interactions between countries is one I find myself returning to with the Rogoff-Reinhart work, here, and in other papers on sustainable debt levels, where it seems certain the number of countries struggling with high debt levels, and the size of the various economies involved will have profound impacts on how aggressive debt consolidation should be, the optimal timing of consolidation, and the likely output effects. I therefore wonder how we might incorporate these central questions into research on sovereign decisions about optimal debt consolidation paths.

A second point to emphasize is the importance of looking at the effects of the projected debt growth trajectory as well as the current debt levels. Not only are markets forward looking, but a key question is not just how much debt a country (or households or businesses) have but what the borrowed money has been spent on. Borrowing for consumption paints a very different picture than borrowing for productive investment. Looking at the projections of future debt levels relative to the economy captures the important question of where things are likely headed and what the debt has been spent on in so much as what effect it is projected to have on the size of the economy.

High levels of debt expected to return to closer to traditional levels, would obviously have very different economic effects than the same levels expected to grow. Likewise, debt ratios expected to shrink due to deficit reduction efforts compared to debt ratios expected to shrink due to economic growth would presumably lead to markedly different market responses and future macroeconomic conditions.

Regardless, the bottom-line finding is critical to the question of this panel, that whereas achieving growth is not always, generally, or even likely entirely consistent with debt consolidation, and that manageable levels of debt can be growth-enhancing, we are now at the levels where debt is likely a drag on growth and thus both a growth and debt reduction agendas must be pursued—probably simultaneously. The critical question is how.

I'll turn now to Katherine's paper on the twin problems of growing health costs creating a fiscal squeeze and the high inefficiencies of how we finance and deliver health care. This is an excellent overview of the shortcoming of our current system, which makes the point that health-care reform will probably be a grab bag of reforms, with multiple rounds and iterations—unlike something like Social Security, which we know how to fix and can be done in one comprehensive plan. All pieces of the health-care industry will have to be considered, from the delivery system, to insurance design, to greater consumer cost sharing. Many of these changes will reduce costs; the most important ones are those that will slow the growth of spending and better allocate whatever level of resources we do spend.

Furthermore, I find the framework of looking at both types of inefficiencies—if we spend too much and if we spend it poorly—a very useful approach, as is highlighting that we can't properly analyze whether we spend too much, until we improve how health dollars are spent.

In terms of health policy—Katherine only touches on this, but I think a global health budget is not far off in the future—probably with multiple approaches for complying with the limits, which could include anything from premium support or competitive bidding, to ending Medicare as an open-ended program, to some type of public option. And the paper contains the important point that more needs to be done to determine the "right" growth limits, which would, under this global budget model, be how the government chooses to allocate resources between health and other priorities.

Katherine's point that we need not just more studying of effectiveness but an improved process for how the information is used is critical to health—but moreover, to the budget at large as well. Let me use that to segue into a brief discussion on the topic of growth during a time of fiscal imbalances.

The question of "how to do more in a time of dwindling public resources," is something I believe will dominate the policy agenda for the coming decade.

As Katherine points out, this will require collecting more information on performance, whether in health care using comparative effectiveness, or more broadly across the government policy spectrum—including tax expenditures—through cost-benefit analysis, performance budgeting and other metrics and methods of oversight.

But we already collect a lot of this information in government; we just don't properly use it. So the challenge of integrating performance metrics into the budget process and using the results to help allocate public funds is one area where policymakers should put their efforts. In some ways it is quite similar to one of the challenges of the information era—we have so much more information than ever before, but have yet to reach the stage of even beginning to use it effectively. Either way, nothing focuses the mind like tighter budgets, so perhaps one of the upsides of the inevitable and difficult consolidation process will be an uptick in public sector performance.

The second challenge is how to grow while borrowing less. And to return to Steve's point, the era of growth through debt is probably quickly coming to an end.

I wish I believed we were set for the expansionary consolidation model—the brass ring of debt reduction—but that will be harder to come by particularly since monetary policy has already done so much of the work to get us here, making it harder to rely on that potential upside to implementing a debt-reduction plan. And I continue to worry about the effect of multiple countries needing to deleverage at once.

However, there are a number of ways to engage in fiscal consolidation that can help fuel growth.

In the short term, in the United States, there remains significant disagreement about the effectiveness of further short-term fiscal stimulus. While some well-targeted measures seem sensible, on this I will only say the only conceivable way there will be additional significant stimulus is as part of a larger deficit reduction package—that's the politics of the situation, and that's how it should be.

Beyond that, a desirable debt-reduction plan would be comprehensive and multiyear. In all likelihood, reducing the debt may well hurt the economy in the very short run, but over the medium and long term, reducing the debt is likely to grow the economy. I'd be interested in Steve's thoughts on the output affects.

The more credible a plan, the less front-loaded it has to be to reassure markets, providing more fiscal space in the short term. This is clearly the desirable model, and it could lessen the short-term economic pain. To be credible a plan must:

- Be put in statute, not just promised,
- From the political economy perspective—it must be bipartisan so there isn't an immediate push by the opposing party to undo it,
- Include well-designed fiscal rules to ensure the savings are realized as planned. Such rules could include spending caps at the levels of an agreed upon plan, and broad-based automatic triggers that provide savings if policies fall short. The more difficult to override, the better. Importantly, these rules would be used to enforce policy actions already put in place, not merely force actions, as is the case with the new sequester we have recently adopted, which I am not overly optimistic about.

The credibility of a multiyear plan is key in order for it to positively affect both short and longer term conditions.

Furthermore, a multiyear plan will contribute to providing business and households more confidence and stability. It is also the only way to get at the larger structural reforms that can help the economy. On this list of desirable structural reforms, I would include:

- Tax reform akin to what the Bowles-Simpson Fiscal Commission proposed, which dramatically reduces tax expenditures, lowers rates —including corporate, and uses a share of the revenues for deficit reduction.
- Entitlement reform—particularly health and pensions. Not only because this is where the problem lies, but fundamental reforms would allow us to help transition the U.S. budget from a consumption-oriented budget to an investment-oriented one. An overhaul of major entitlement programs is critical in making this transformation as well as controlling government spending.
- Policies to promote productive aging and longer working lives. As Steve points out, the growing dependency ratios are terribly anti-growth.
- Finally, protecting productive public investments is also a key to this. There are many areas where we need to spend less, but also a number of areas on which we need to spend more. Our current incremental approach to deficit reduction is doing just the opposite of thoughtfully reassessing our priorities and their effects on economic growth, and we are instead chipping away at the absolute wrong parts of the budget.

So to conclude—I think we know the problems which Steve and Katherine expand on—excessive debt and an inefficient health sector. I think we know the model of reform that is most likely to promote growth: a multiyear comprehensive plan with gradual yet credible phase-ins. And I think we know the critical components of structural reforms that generate savings in the medium, and importantly, long term. We are left with what boils down to a political question: whether policymakers divided over different preferences on specific changes, will nonetheless be willing to act in making these needed fiscal reforms.