

Focus on Economics

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Take It Easy? A look at the consolidation of public finances in the US

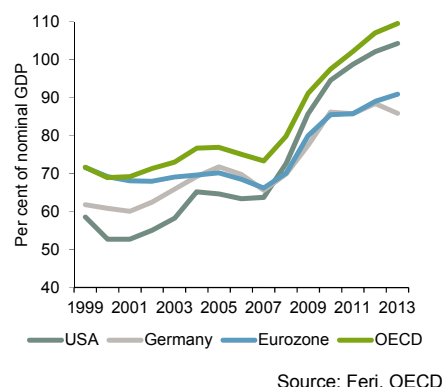
Author: Dr Tobias Rehbock, phone +49 (0) 69 7431-2686, research@kfw.de

There are no set fiscal rules for the public deficit ratio or debt ratio in the US. Although the country's nominal debt is subject to a maximum limit, Congress can raise this ceiling at any time and at present this threshold is even suspended. Nevertheless, the USA has experienced several phases during which the public deficits have been successfully reduced. Currently, this has been the case since 2010. Unlike in earlier periods, the focus this time has been on spending cuts. This has meant further cuts in what was already comparatively weak public investment, possibly with an adverse impact on the potential for overall economic growth.

Public finances in the USA have been viewed critically for some time now, even before the 2008/09 financial and economic crisis. Occasionally the US government's budgetary policy is portrayed as being relatively lax and deficit-oriented and it is argued that this has led to a high debt level. After all, unlike Germany, the USA has scarcely any fiscal rules.¹ Germany not only has to meet the Maastricht fiscal criteria, but also comply with the (more stringent) debt brake.

While it is the case that, unlike in the years preceding the crisis (Fig.1), general government² debt in the USA has, as a proportion of GDP, soared following the onset of the financial and economic crisis and is now higher than the debt ratios in Europe and Germany, it is nonetheless equally true that the USA has undergone periods of budget consolidation in which public finances have improved.

Figure 1: General government debt ratios



Budget consolidation in the USA – different this time round

In the past, the USA has by all means succeeded in maintaining the balance between the dynamics of public expenditure and revenues (Fig 2). Since 1970, both revenues and expenditure have risen by an average of just below 7% per year. It was however the financial and economic crisis that finally led to budgetary development in the USA being thrown off course. The general government deficit peaked at almost 13% of GDP (2009) and the debt ratio subsequently rose significantly.

There were two reasons for this rapid increase; one was resolute fiscal intervention in the wake of the crisis as attempts were made to combat the then recession. The US federal government used public demand to compensate for a lack of private demand, itself a result of unemployment and the repayment of loans in the heavily indebted private sector. The other reason was that more public money was devoted to the recapitalisation of the banks. Consequently, the USA is now growing faster than

Germany or the Eurozone, the banking sector is better capitalised, private debt has decreased considerably and the US automotive sector, which hit rock bottom just a few years ago, is now back on its feet.

In other industrialised countries, deficits did not fall as sharply, despite fiscal stimulus measures (Figure 3)³: Since the introduction of the euro, the deficit criterion of maximum 3% of GDP has been fulfilled, at least on average, both in Germany and the Eurozone as a whole.

After the 2008/09 recession and the associated widening of the deficit, the USA went through a phase of consolidation. This took the form of a tangible

Figure 2: Public revenues, expenditure and net lending / net borrowing in the USA (general government)

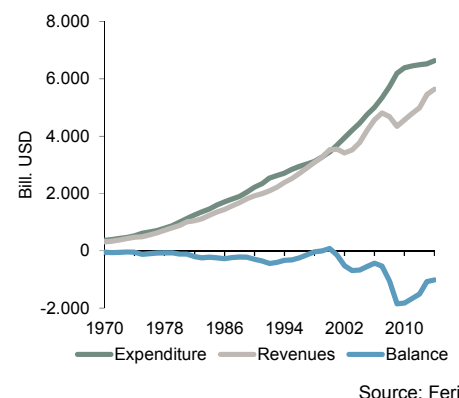


Figure 3: Average annual net lending / net borrowing of general government

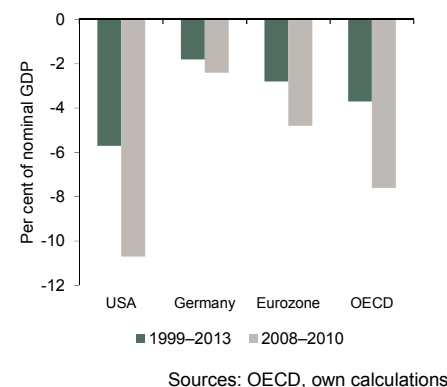
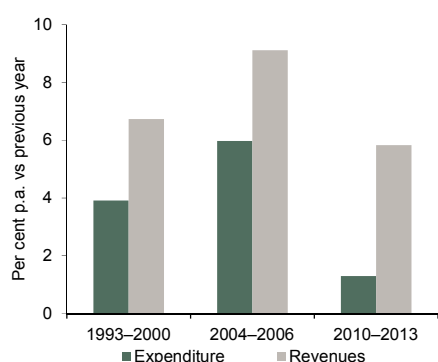


Figure 4: Expenditure and revenue dynamics in the USA*



* of the general government

Source: Feri, own calculations

consolidation of expenditure. Although overall spending did not fall, it rose only very slightly (Fig. 4). This had the desired effect on the budgets. Within four years, general government net lending / net borrowing improved by a total of approx. 6½ percentage points. This contrasts with the two previous consolidation phases (1993 to 2000 and 2004 to 2006) when revenue dynamics were the key to cutting the deficit (Fig. 4). In both cases, revenues gained momentum, particularly in the 2004 to 2006 consolidation phase. On the other hand, no noticeable loss of momentum or even a reduction in expenditure can be identified. The latest consolidation phase therefore stands out: Public revenue has been less dynamic and spending discipline greater than in the earlier consolidation phases.

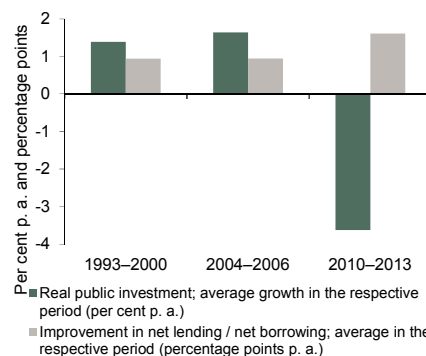
New adjustment path involves costs

However, the downside to the spending discipline after 2009 is namely possibly high but still unknown macroeconomic costs, as the cuts were chiefly made to capital expenditure that was intended to have an impact on the future (Figs. 5 and 6). Ultimately, government capital expenditure has fallen by an average of 3½% p.a. in real terms since 2010, which has contributed to the economic recovery after 2010 being one of the weakest to ever follow a post-war recession in the USA.⁴ Furthermore, this reluctance to spend is gradually bringing about a loss of substance in public infrastructure. Public net investment, i.e. excluding depreciation, is lower than ever before in GDP terms and is now just half a percentage point above the zero

line (Fig. 7). That cannot be a sensible route to take in the long run, especially since the population of the USA, unlike that of say Germany, is still growing. After all, the health of the public infrastructure is also an important input for private investment and production processes and thus for the potential growth of the economy overall.

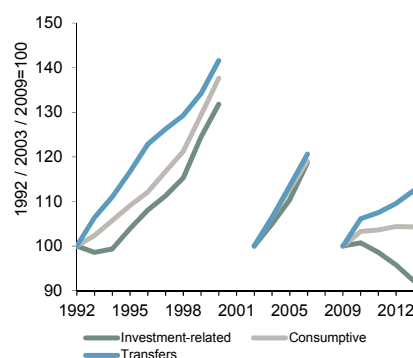
However, the successful consolidation after 2009 is not just a consequence of spending cuts but also of the repayment of assistance provided to companies, e.g. as part of the TARP programme, which had originally driven up the deficit. As already indicated above, both the high deficit resulting from the financial crisis and the relatively sharp decrease in the deficit after 2009 have to be qualified in this context.

Figure 5: Public investment and net lending / net borrowing in the USA



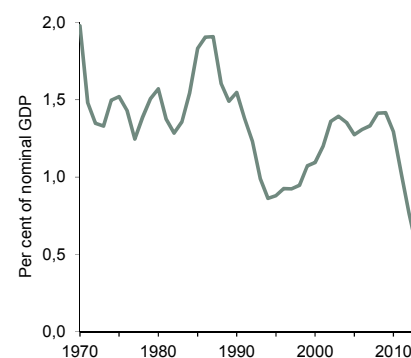
Source: Feri, BEA, own calculations

Figure 6: Expenditure development by type in the consolidation phases



Source: BEA, own calculations.

Figure 7: Public net investment



Source: Feri, BEA, own calculations

Why not risk debt-financed investment?

The current weakness of public capital expenditure, not only in the US, is often perceived as a dilemma. The importance of public investment and therefore of public infrastructure is undisputed, but public consumption and transfer spending are often able to be cut even less (because collective agreements or legal requirements force this spending). Likewise, however, the debt-financed expansion of public capital expenditure is also dismissed because of the resultant failure to consolidate and the already high debt ratios.

Against this backdrop, an expansion of public capital expenditure may be best achieved when revenues increase faster than at present. In this context, the recovery of the employment market and the future development of real wages and salaries have to play an even bigger role if the USA is to move towards long-term higher growth. The option of a debt-financed expansion of capital expenditure should also play a role, as it does not necessarily lead to a worsening of the debt ratio. The opposite may be the case. To put in in simple terms, if the public investment multiplier is greater than one, the debt momentum is lower than growth and the debt ratio decreases, despite new indebtedness. At the same time, the multiplier effect benefits all the more from any increase in the efficiency of investment activity.⁵ The following scenario calculations offer an example of this. In the **baseline scenario** in Fig. 8 there is no additional fiscal stimulus. The public revenue ratio declines only slightly over the scenario horizon (until 2020), with the spending

ratio decreasing rather more sharply (IMF assumptions). As a consequence, the primary deficit also falls, albeit it not to zero (Table 1). If the assumption is made that interest rates will rise only moderately over the coming one to two years and growth continues to recover (KfW forecast for 2015: approx. 3%), then the debt to GDP ratio will initially fall a little, primarily due to GDP growth (Fig. 8). Starting from 2018, however, it will then again increase considerably because the interest-rate increase process will remain intact (new indebtedness will become more expensive), but growth will stabilise at an assumed potential rate of 2%.

A public investment initiative may be one way to improve the prospects for the debt situation in the US. As already indicated above, the starting point is public infrastructure. **Alternative scenario 1** thus assumes a one-off increase in public capital expenditure of 1% of GDP in 2015.⁶ Economic growth in the same year is therefore two percentage points higher than in the baseline scenario. As a result, even though this relatively high growth cannot be maintained, the adjustment path ends with higher potential growth. This adjustment is justifiable if the investment campaign leads to an improvement in key infrastructure that improves the underlying economic conditions long term. In the case of the US, examples might be local public transport or the power grid, which is vulnerable to weather conditions.

In comparison to scenario 1, **alternative scenario 2** makes similar but weaker assumptions: the initial multiplier effect (1.5 vs. 2 percentage points) and the potential growth (2.5% vs. 3.0%) are lower.⁷ The adjustment path alters accordingly.

Generally speaking, the development of the debt to GDP ratio responds strongly to the supposedly small changes in the initial conditions, in particular the induced growth. To put it another way, the growth push can be very effective means for rapidly lowering the debt ratio, even if the effect is not a lasting one, and based on the assumption that the investments are selected intelligently and can be implemented relatively quickly and efficiently.

Table 1: Scenario assumptions (in each case from 2015 to 2020 if not otherwise stated)

Scenarios	Primary deficit ratio	Real GDP growth	Average interest rates on total public debt (5 years)
Base	from 2.2 to 1.2% (until 2019 IMF forecast, then projected for 1 year)	from 3.0 to 2.2%	from 1.5 to 3.9%
Alternative 1	+1 PP 2015, otherwise as base	from 5.0 to 3.0%	from 1.5 to 4.2%
Alternative 2		from 4.5 to 2.5%	from 1.5 to 4.1%
Alternative 3	from 3.2 to 0%	Like alternative scenario 1	

It goes without saying that, ultimately, net lending / net borrowing also plays a part in determining the long-term success of a consolidation strategy. As a primary deficit remains in both alternative scenarios and it is assumed that current interest rates will align to nominal growth, the debt to GDP ratios also increase again after 2019 (or after 2018 respectively) in these scenarios.

To consequently stabilise the debt to GDP ratio in the long term, one route for the USA would be to also endeavour to balance the primary budget. The effect of this can be seen in **alternative scenario 3**, which is largely identical to alternative scenario 1 but differs in that it assumes a balancing of the primary budget by 2020. The USA would have the scope to repay the primary deficit by increasing the revenue ratio.⁸ At around 33%, it is the second lowest among the OECD countries (after that of South Korea).⁹

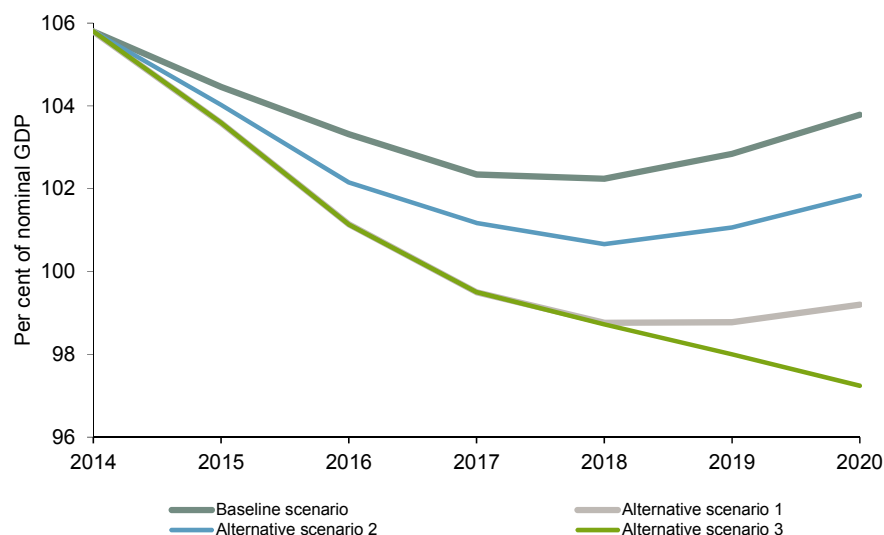
Conclusion

The question of how to deal with public deficits and rising debts and of how "bad" public deficits and debts in fact are is a source of endless discussion and debate in academia, the political sphere and among the broader public.

It may be that former experience in the USA provides an answer. This shows that it may ultimately be of benefit to approach public deficits calmly and not necessarily attempt to achieve consolidation by means of an excessive tightening of expenditure. While the latter may lead to the desired effects on net lending / net borrowing, it has unwanted ramifications for the economy as a whole. Unfortunately, the USA also experienced this in the course of its budget consolidation after 2009.

The energy invested in consolidating the budget is possibly better spent on im-

Figure 8: Simulation of debt to GDP ratios



Source: Feri, IMF, own calculations

plementing public investments with a strong multiplier effect. A moderate increase in the revenue ratio, when the investment multiplier has taken effect, could further reduce the debt to GDP ratio. ■

¹ In the USA, there is a nominal debt ceiling that must not be exceeded (which, however, in contrast to the customary international conventions, is not a ratio of nominal GDP but is expressed as an absolute sum). This debt limit has currently been suspended until March 2015.

² "General government" is used here in connection with deficits and debts at all levels of the state – national government, federal states, municipalities and social security. This should be borne in mind, particularly for the USA, where the deficit ratio and debt ratio are normally only analysed and discussed on a federal level, which is not the case with Germany and Europe.

³ In other countries, however, the need for fiscal intervention arising from the financial crisis was nowhere near as high as in the US. Like the US, those countries that were hugely impacted by the crisis had to accept high deficits, e.g. Ireland with a ratio of over 30 % to nominal GDP (2010).

⁴ There can be no doubt that this below-average recovery may be partly attributed to the financial market crisis that caused the preceding recession. Recessions in connection with financial market crises are regarded as being particularly severe and therefore harder to overcome than "normal recessions".

⁵ Cf. IMF, *Is It Time for an Infrastructure Push? The Macroeconomic Effects of Public Investment: World Economic Outlook: Legacies, Clouds, Uncertainties*, October 2014, p. 83. The USA is among the countries with the highest degree of investment efficiency, cf. Deutsche Bank Research, *Standpunkt Deutschland, Mehr Infrastrukturinvestitionen – trotz fragwürdiger „Lückenanalyse“*, December 2014, p. 4.

⁶ The extent of accumulated public infrastructure investment in the USA is vast. According to data from the American Society of Civil Engineers (ASCE), a total of USD 2.2 billion would be needed to thoroughly redevelop US infrastructure. It would be illusory to assume that this amount would be allocated as a realistic fiscal stimulus in the area of infrastructure. Nevertheless, this high demand in relation to infrastructure makes it clear that a public investment programme involving 1 % of GDP (equivalent to about USD 170 billion, measured in terms of nominal GDP 2013) is by no means overambitious.

⁷ Moreover, the alternative scenarios differ in their assumptions regarding interest rates. In both alternative scenarios the rise in interest rates is more dramatic than in the baseline scenario but is again far more pronounced in alternative scenario 1 (up to 5.0 % in 2020) than in alternative scenario 2 (up to 4.5 %). For the entire interest burden, the decisive average interest rate for existing public debt does not, of course, increase to the same extent, meaning that the impact on the average interest rate in both scenarios is almost identical (up to 4.2 % in 2020 in alternative scenario 1 and to 4.1 % (likewise 2020) in alternative 2, see also Table 1 in the text).

⁸ The increase in the revenue ratio cushions the multiplier effect of the public investment stimulus. This is not taken into consideration in alternative scenario 3. However, as alternative scenario 1 (like alternative scenario 2 and the baseline scenario) in any case includes an improvement in the primary balance, the increase in the revenue ratio in scenario 3 would only have to commence when the primary deficit in the other scenarios stops falling any further. In the present simulation, this would be the case in 2018. The public investment offensive will then have achieved most of its impact and the revenue consolidation can "take over". This works better than just revenue consolidation from the outset (without an increase in public capital expenditure).

⁹ The chances of this becoming reality are, however, slim. The Republican Party, which has held the majority in both Houses of Congress since January 2015, even hopes to push through tax cuts.