In Praise of Debt Limit ‘Chicken’

By John B. Taylor

Top economic officials in Washington continue to argue that Congress should vote to increase the debt limit without any commitment to reduce spending growth—in other words, a "clean debt limit hike." They compare linking the debt limit and spending reductions to playing a game of chicken. Federal Reserve Chairman Ben Bernanke argues that "using the debt limit as a bargaining chip is quite risky," while Treasury Secretary Timothy Geithner and Council of Economic Advisers Chairman Austan Goolsbee elaborated on the alleged risks to the financial markets and U.S. creditworthiness.

Yesterday 150 economists released a statement saying a higher debt ceiling should be tied to spending reform now.

Yet these arguments do not consider the enormous benefits to the economy from linking the debt limit to spending reductions. Such a link is good economics in theory and in practice. It is essential to a credible return to sound fiscal policy and an end to the ongoing debt explosion. Such credibility is needed to bolster the weak recovery and reduce unemployment as government spending levels are adjusted. A statement released yesterday that I signed with 150 economists—including former Treasury Secretary George Shultz and Nobel Prize winner Robert Mundell—says "Increasing the debt ceiling without significant spending cuts and budget reforms ... will bring further harm to private-sector job growth in America."

Here's why. In the current political and economic environment—where more people than ever in the United States and around the world are aware of the country's debt problem—the decision about the debt limit will be precedent-setting. They also know that government spending has increased rapidly in recent years, rising to over 24% of GDP today from 18.2% in 2000. If Washington does not change the budget game now, people will sensibly reason, it will never change the game.

If politicians just increase the debt limit now without simultaneously correcting that rapid spending growth, then they will be expected to do so in the future. In contrast, if they tie any increase in the debt limit to a halt in the explosion of spending, then people will give them better odds that they will control spending in the future. Linking the debt limit vote to spending thus establishes a precedent and valuable credibility.

Another way to see the value of the link is to compare it with the debt-failsafe mechanism that President Obama has proposed. Under the debt-failsafe plan, if spending grows too rapidly in the future (after 2015) relative to forecast, and the debt thereby rises more than budgeted for, then there would be an automatic reduction in spending. In other words, debt increases and spending reductions are linked in the future. But if there is no link in the present, as in a case of a clean debt-limit increase, how can people expect one to be followed in the future? How can today's politicians expect future politicians to adhere to such a policy if they can't do so today?

This is a common problem in economics, called the time inconsistency problem, where taking actions today that are inconsistent with good policy in the future leads to very poor economic outcomes. Economists Edward Prescott and Finn Kydland were awarded the Nobel Prize in 2004 for explaining the problem and proposing a solution. In this context, the solution is to link the debt limit increase and the spending reductions.

The principle of linking the debt increase and spending reductions—put forth by the House Republicans in the White House meeting yesterday—-is therefore an important goal worth trying to achieve. Yes, there are risks as we approach the Aug. 2 deadline, but those risks are far smaller than the risks caused by the continued debt explosion that is so likely if the link is severed. Rather than calling for a clean debt limit increase, Washington economic officials should be calling for a package linking the debt limit hike to spending reductions.

Such a deal could come from splitting the difference between the two major budget proposals on the negotiating table. One proposal is the budget President Obama outlined in his speech on April 13, after he discarded his original budget for 2012. Although details need to be provided, it reduces spending growth by about $2 trillion over the next 10 years. The other budget is the House Budget Resolution, which reduces spending growth by about $6 trillion over 10 years. Hence, a bipartisan deal to reduce spending would naturally fit between the $2 trillion proposal and the $6 trillion proposal. Simply splitting the...