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A review of the rise of the us public debt limit: selected theoretical contributions and legislative changes

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Abstract
For the most of its history, the US public debt has neither been a factor that, aside from rare crisis periods, acted as a factor of significant worry, nor was it a topic present in relevant policy debates. A key element often overlooked in the debate regarding the long-term sustainability of the public debt of developed ec onomies is the legal framework that should prevent macroeconomic imbalances. The aim of this paper is to assess, through theoretical argumentation, the historical significance of the public debt in the USA. The pap er concludes that the USA requires a more coherent and precise legal framework that will ensure the long-t erm stability of the American economy.

Table of contents

1. Introduction

The debt-growth nexus has received renewed interest among academics and policy makers alike in the afte rmath of the recent global financial crisis and the subsequent euro area sovereign debt crisis. Cross-country experience shows that some economies have run into debt difficulties and experienced subdued growth at re latively low debt levels, while others have been able to sustain high levels of indebtedness for prolonged pe riods and grow strongly without experiencing debt distress (Chudik *et al*., 2015: 1).

A rather new development is that authors such as Farmer and Schelnast (2013:185) have begun questioning the sustainability of the US public debt. A key element often overlooked in the debate regarding the long-term sustainability of the public debt of developed economies is the legal framework that should prevent macroeconomic imbalances. There is perhaps a key reason why the US is in such a significant position in setting the trend with dealing with macroeconomic imbalances while still not placing in question the validity of the US government bonds or their other external obligations. The US government shutdown and how close the USA came to defaulting its public debt are acts that had very significant consequences. One very significant viewpoint is the following: If the strongest and one of the most developed economies of the world can default on its foreign debt, what is to stop far more heavily indebted countries such as Greece from defaulting on their foreign financial responsibilities? The sustainability of the public debt of several European countries, often referred to as the PIIGS countries, has been questioned by several authors (Robbins, 2015; Connolly, 2012).

As the USA cannot default its public debt or any of its other external obligations without severe and very dire consequences to the international economic system, it continues to interpret its own legislative framework flexibly. The US policy-makers are aware that any kind of default on external obligations will have long-term effects on the entire international economic system.

Therefore, they are left with only two options – both unpopular, yet one significantly more efficient and with far less public backlash. One consists of various measures that would increase budget revenue such as increasing investments or raising taxes. The second of these is especially unpopular and there is therefore a far simpler solution to the problem – raising the public debt limit.

The public debt limit in the USA is simply defined by the aggregate amount the public debt may reach, not considering even the ratio of public debt-to-GDP or the primary budget deficit as the Maastricht criteria do. The history of the US policy-making in that regard can be summarized as choosing to constantly raise the public debt net limit. This paper aims to theoretically consider the previously mentioned hypothesis and signify the long-term dangers of such an approach.

2. A theoretical approach to understanding the relevance of the public debt

In the long-lasting debate regarding austerity policy perhaps one of the most perceived indicators is the public debt-to-GDP ratio. The start of such a view is perhaps in the aftermath of the Maastricht Treaty, but a new surge of “threshold” economics was caused by the findings of Reinhart and Rogoff (2010a, b). The concept that an arbitrarily chosen percentage of public debt- to-GDP ratios may be associated with significant economic disturbances is especially welcome to pro-austerity policy-makers. That concept is perhaps intuitively even more easily understandable in member-states of the EU where based upon the Maastricht criteria of fiscal convergence there are several such thresholds. While the concept of threshold economics is intuitively understandable from a political or layman point of view, it firmly depends upon key entirely economic concepts.

Most notably, as Reinhart and Rogoff have themselves confirmed they believe that there is a causal bivariate relationship between the public debt-to-GDP ratio and GDP growth (Reinhart and Rogoff, 2013). While using arbitrary targets may be a useful practice in the sphere of politics where it is difficult to obtain consensus, such an approach, without adequate evidence, may provide unwanted results. It should also be noted that Reinhart and Rogoff (2013) distanced themselves from conservative politicians that portrayed the 90% threshold as the “magic threshold that transforms outcomes”.

The most comprehensive critic of Reinhart and Rogoff's hypothesis was conducted by Hernon *et al*., (2013) where they replicated the study conducted by Reinhart and Rogoff (2010b) and concluded that there is no significant difference between the growth rates with countries that have an economic debt higher than 90% and countries that have smaller debt-to-GDP ratios. They concluded that the calculations made by Reinhart and Rogoff (2010b) are influenced by coding errors, selective exclusion of available data and unconventional weighting of summary statistics (Hernon *et al*., 2013: 2-3). Perhaps most importantly, Hernon *et al*., (2013: 3-4) note that many pro-austerity politicians have begun referring to the Reinhart-Rogoff (2010b) hypothesis as an irrefutable fact.

There are significant difficulties in understanding the relevance of the public debt to economic growth in such conditions. What is significantly more understandable from an economic viewpoint is considering a wide range of macroeconomic variables when detecting macroeconomic imbalances, as is the case with the Maastricht criteria of fiscal convergence, rather than considering a singular threshold. All of these criteria help promote a more stable fiscal policy in the member states of the European Union, while panic from the 90% threshold and the use of austerity measures to avoid this threshold by any means necessary may have a negative impact on the economy. It should also be noted that, although the European Commission has formally started the Excessive Imbalance Procedure in several of its member-states that failed to conform to one or several goals of the Maastricht criteria of fiscal convergence, they have not used the strictest measures of financial sanctions which they have the legal right to enforce (European Commission, 2016). In a state where compliance with the criteria is more flexible, the criteria of fiscal convergence may present more of a suggested framework of good policies or targets which all member states should strive towards rather than a completely formal system where all of the criteria are adhered to at all times. The USA would definitely benefit from having such a framework that also might help refocus the attention of the public on the issue of macroeconomic imbalances.

> **For a large, developed economy such as the economy of the USA, the problem lies not in the public debt itself. The current debt of the USA, despite its historically high levels, is serviceable.**

With the adequate governance, the USA can be able to sustain such a high level of debt in the short-term while focusing on a policy of sustainable growth to combat the rising debt in the middle and long term. The question therefore shifts to what mechanisms of transfer from the public debt or other elements that provide evidence of macroeconomic imbalances transfer to economic growth. Checherita-Westphal and Rother (2012:1401-1402) have identified that the public debt negatively affects private saving and investment, public investment and total factor productivity in the twelve-euro area countries they observed.

Regarding this issue, there are competing theoretical interpretations of the impact of public debt on economic growth. As emphasized by Dornbusch and Draghi (1990), the first approach is called the Ricardian Equivalence view and the basic hypothesis of such a view is that assets and liabilities cancel each other across time and generations, which means that the level of public debt does not impact the net worth of households nor does it impact aggregate spending. The simple approach of D. Ricardo suggests that, in theory, the government can fund itself through either funding or taxes.

This view suggests that borrowing money in order to decrease the fiscal burdens of the populace do not have any consequences for future generations. Barro (1974) initially provided views that mostly conform with the Ricardian view, yet after Buchanan’s (1974) critique of the lack of a comparative analysis between the effects of taxation and the public debt, Barro (1980:941) ultimately modified his theory in a manner to consider the “Ricardian invariance as a valid first- order proposition”, yet he introduced “second order considerations involving the excess burden of taxation to obtain a determinate (optimal) amount of debt creation”.

A differing approach is considered by Keynesian economics, where one of the central ideas is that fiscal policy can be used in order to actively influence aggregate demand. Both of these views have been considered by economists who have attempted to prove several key aspects of these hypotheses. Motley (1987) claims that it is especially difficult to quantify certain aspects of the Ricardian hypothesis, thus making it difficult to make a conclusive recommendation, although his conclusion is that there are some empirical elements that suggest that an increase in the government debt does not stimulate private consumption, thus meaning that households recognize that debt interest payments must be financed out of future taxes. Taylor *et al.*, (2012) especially emphasize the return of Keynesian style of thinking in the aftermath of the 2008-9 Crisis and ultimately concluding that there is a positive effect on growth from a higher primary deficit. A number of empiric papers have further expanded such a view, especially combating the Reinhart-Rogoff (2010a, b) hypothesis. This is especially reflected in the work of Panizza and Presbitero (2014:38), where they focus on the fact that there is no empiric evidence that the public debt constrains growth in developed economies. However, high levels of debt may cause contractionary policies which in accordance with their research are ill-advised in times of a recession.

Fincke and Greiner (2015) point out the neoclassical point of view that there is a possibility of high levels of public debt crowding out investments, especially in emerging markets. This view is especially interesting when contrasting it to that of Panizza and Presbitero (2014), as it displays the full scope of disagreement amongst authors on the actual impact of the public debt – economic growth nexus. One of the aims of this paper will be to theoretically asses, through qualitative analysis of the relevant documents, the state of the American legislature regarding macroeconomic imbalances. On the other hand, as is further explained in the data and methodology section, this paper empirically focuses, by using several relevant methods of time series analysis, on determining whether the Reinhart-Rogoff (2013) bivariate causality hypothesis has any merit. The key contribution of this paper is not only advancing the understanding of the widely discussed causality issue (Reinhart and Rogoff, 2010a, b; Lainà, 2011; Cherif and Hasanov, 2012; Panizza and Presbitero, 2014), but also advancing the understanding of the legal framework in context of the policy debate of containing macroeconomic imbalances. Such an interdisciplinary approach will allow us to consider both the econometric issue of causality, while also addressing the possible strengths and weaknesses of the US legal framework, with providing objective policy recommendations.

3. Selected empirical studies of the influence of the us public debt on gdp

Dar and Amirkhalkhali (2014) conducted a study on a sample of 23 OECD economies in the period of 1996-2007 and in most cases failed to find any evidence of statistically significant negative impact of public debt on economic growth. Ahlborn and Schweickert (2016) conduct an empirical analysis of three country clusters with different economic systems; these clusters are Liberal (Anglo-Saxon), Continental (Core EU) and Nordic (Scandinavian). The authors conclude that there is a statistically significant difference between the country clusters and that in less developed countries the effect of public debt on GDP is negative, while in more developed states it is neutral or positive (Ahlborn and Schweickert, 2016).

Chudik *et al*., (2015) specified a heterogeneous dynamic panel-threshold model and provide a formal statistical analysis of debt-threshold effects on output growth, in a relatively large panel of 40 countries, divided into advanced and developing economies, over the period 1965-2010. We study whether there is a common threshold for government debt ratios above which long-term growth rates drop off significantly, especially if the country is on an upward debt trajectory. The authors did not find a universally applicable threshold effect in the relationship between debt and growth, for the full sample, when accounted for error cross-sectional dependencies.

Eberhardt and Presbitero (2015) analysed the empirics of the debt–growth nexus within a standard neoclassical growth model. Using the total public debt data from 118 developing, emerging and advanced economies over the period 1960 to 2012 the authors have found that long- run debt coefficients differ across countries and provide some evidence that countries with higher average debt-to-GDP ratios are more likely to see a negative effect on their long-run growth performance. This result is consistent with higher debt ratios being associated, on average, with lower GDP growth rates (Reinhart and Rogoff, 2010a, b).

Mercinger *et al*., (2015) concluded that there is a statistically significant difference between the impact of public debt on economic growth in the EU member-states that have acceded before 2004 and the new EU member states. Most significantly they note that the threshold effect where there is a more negative impact of public debt on economic growth is lower in the new EU member states (Mercinger *et al*., 2015). Gómez-Puig and Sosvilla-Rivero (2015) conducted Granger causality tests on the EMU countries and concluded that there is no negative causality in the period from 1980-2009, but they find evidence of negative causality between public debt and economic growth in the period of 2009-2013.

Cecchetti *et al*. (2010) indicated that since the 2008 economic crisis there has been a very significant rise in the public debt-to-GDP ratio and they further conclude that if the public debt levels are not curbed, these debts will become unsustainable. Hall and Sargent (2015) analysed the public debt and its historic values since 1939. Their primary conclusion is that the majority of changes between 1950 and 1983 were nominal adjustments used to account for inflation, but they believe that the changes that happened after 1983 the real debt increase outpaces the inflation rate, and that hence there is a real growth of the public debt (Hall and Sargent, 2015:42). A similar historic study was conducted by Edwards *et al*., (2015), where they analysed the unilateral restructuring of the US public and private debt by the Congress in June 1933. They have concluded that the decision to unilaterally restructure their debt, conflicting with the majority of existing modern economic theory, did not have a significant impact on the ability of the US Treasury to issue new securities (Edwards *et al*., 2015:23). Gallagher and Collins (2015) analysed the effect of the crises of 2011 and 2013 and conclude that in both these instances there was a case of “flight- to-liquidity”, marked by significant outflows from money market funds.

Lainà (2011) conducted an analysis of the relevance of the public debt on GDP for the USA in the period 1959-2010 and concluded based upon the results of the Granger causality test and Impulse Response Functions that it is difficult to achieve economic growth while also reducing the total level of debt. Cherif and Hasanov (2012) implemented a VAR analysis of impulse response functions for the USA, considering the change in GDP and public debt-to-GDP ratio and concluded that the safest policy to deal with excessive debt is stimulating economic growth. Based upon the conducted literature review it is possible to determine that there is no consensus regarding the direction of causality of the relationship between economic growth and the public debt. There is also a noted literature void, as very few studies regarding the US focus on a longer time period, such as the one observed here.

4. The US legislation regarding macroeconomic imbalances

> **The US public debt is regulated by a series of laws that are implemented and ultimately modified by the Congress. There are several relevant actors in the development of American fiscal policy.**

This is due to the fact that the President and his cabinet, as representatives of the executive branch, propose the budget that the Congress must then approve with a majority of its votes. The President of the USA cannot pass a budget using executive actions or any other kind of unilateral measure. Executive actions are the only *de facto* legislative capacity of the President and they have a significantly limited legal capacity in comparison to laws implemented by the Congress. The question of executive actions that go directly against the wishes of Congress are also usually done considered a cost-benefit analysis of both public opinion and the political downsides to such acts (Christenson and Kriner, 2015).
While executive actions have had a significant effect in regards to crucial military decisions in the history of the USA, no executive actions have attempted to usurp the role of the Congress as the key policy-maker regarding fiscal policy. A rare example may be found during the presidency of Bill Clinton, when he implemented an executive action regarding collecting delinquent child support (Bureau of the Fiscal Service, 2016). Such a question had limited political value, but did not in any way attempt to significantly challenge the authority of the Congress. The key law in the maintenance of macroeconomic imbalances in the USA is the Federal Claims Collection Act of 1966. There has been previous legislation regarding the public debt limit, but this is perhaps the first relevant legislative document that has not significantly been altered to this day. The main difference between the times this document was voted into law and today is the constant rise of the public debt limit. Since 1966 Subchapter 3101, which regulates the public debt maximum total amount, has been amended 18 times (Bureau of the Fiscal Service, 2016).

It is possible to conclude that the changes are far too often and sometimes do not consider the long-term perspective. The practice that is slowly being implemented in the EU, starting with the adoption of the Maastricht criteria of fiscal convergence, present a far more significant indicator rather than the aggregate amount of the public debt. The data clearly suggests that the debt ceiling was raised multiple times during the post-1973 Oil crisis and the post-2008 Global economic recession. From the start of 2008 to the end of 2010 the public debt ceiling was modified five times, from 10 trillion to more than 14 trillion dollars (Federal Claims Collection Act, 2011). If Subchapter 3101 is purely an administrative figure that can be changed at any time it further decreases the value of the US legal framework regarding macroeconomic imbalances.

The fact that the USA was in serious damage of defaulting its foreign obligations has become a matter of increasing concern regarding both investors and other interested parties.

Ostro (2014) has emphasized that there is a strong need for long-term legislation, as the current situation where the public debt ceiling is part of day-to-day politics may present a danger to the credibility of the USA and decrease the investors' trust. As the current solution was unsustainable and realistically lead to the possibility that the USA might default its foreign obligations, a new solution was proposed. The President and the Secretary of the Treasury could, when necessary, increase the public debt ceiling (Budget Control Act, 2011). This *ad hoc* solution indicates a strange precedent in which the key legislative body of the USA is delegating its legislative authority to other key actors. A possible explanation is the complex dynamic between the Republican and Democratic Party, as well as there being no consensus within the general public on how to balance the federal budget (Blendon and Benson, 2012:21). These and multiple other elements are the primary causes of why this highly significant question will probably have to be dealt with by the next administration.

5. Conclusions

The public debt of the US cannot be compared to the cases of less developed countries or in countries where there are extreme cases of macroeconomic imbalances, such as the case of the "PIIGS" countries in Europe. It is important to note that lack of regulation sometimes enables certain sectors of the US economy to advance their agenda so that they aim for the short-term economic growth while ignoring possibly dangerous long-term consequences on the entire economy. An example that perhaps best reflects this behaviour is the 2008 Global Economic Crisis where lack of regulation of the banking sector and manipulation of the actual value and sustainability of mortgage bonds paved the path to a global crisis (Whalen, 2008). Crotty (2009) noted that the direct cause of the 2008 Crisis was the deregulation process started in the 1970s.

The current high level of the US public debt is far from damaging as it is to the European economies for several reasons. Perhaps most importantly, investors know that the US public debt, even at a level where it has surpassed 100% of its GDP, is sustainable and as it can be seen from our empirical analysis there is currently no short-term or long-term causality going from the public debt towards economic growth which indicates rejection of Reinhart and Rogoff's (2013) claim of bivariate causality. It is also not accompanied by the high unemployment, especially youth unemployment rates present in parts of Europe that prevent the recovery of economic growth (FRED, 2016). Agreeing on and implementing a more comprehensive legal framework would be a significant step in ensuring that the high levels of public debt do not cause long-term structural imbalances in the US economy and are not left insufficiently regulated such as the banking sector at the start of the 20th century, which expands on Ostro's (2014) call for a more comprehensive long-term legal framework.

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