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HANDBOOK ON AFFORDABILITY

2. Fiscal Policy

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Persistent and large federal deficits increase long-run inflation risks when they raise doubts about how the government will finance its obligations. When debt grows faster than the economy, investors begin to anticipate one of three outcomes: higher future taxes, spending cuts, or inflation that erodes the value of government debt. Absent congressional actions to stabilize the debt by reducing spending or raising taxes, inflation becomes the inevitable option.

Even with an independent Federal Reserve, large and rising debt can undermine the central bank's core focus on keeping inflation low. If interest costs spiral and threaten financial stability, the Fed will face pressure from officeholders, the Treasury Department, and the markets to lower government borrowing costs, perhaps by keeping interest rates lower than would otherwise be consistent with hitting its inflation target.

In the short term, high deficits can worsen inflation. Take the 2022 inflation surge. Supply disruptions certainly contributed to inflation at times. But overwhelmingly, it was the effects of unprecedented deficit-financed spending coupled with loose monetary policy that drove the sharp surge in consumer demand that increased prices.

When fiscal policy injects large amounts of borrowed money into the economy while monetary policy remains accommodative, inflationary pressures can build quickly. Sustained deficits increase the risk of higher and longer-lasting inflation, requiring higher interest rates for longer to bring inflation back under control. For instance, the Fed had to raise interest rates sharply in the late 1970s and early 1980s to restore price stability after inflation expectations had become entrenched. Rebuilding fiscal and monetary credibility is far more costly than maintaining it in the first place.

There are several channels through which persistent and large deficits raise inflation and interest rate risks:

Higher inflation expectations: If investors and households believe future deficits may be financed through money creation, long-term inflation expectations rise.

Higher borrowing costs: Investors demand higher yields to compensate for inflation and fiscal uncertainty. As debt grows faster than the economy, this puts upward pressure on Treasury rates, which flow through to higher borrowing costs on mortgages, business loans, and credit card balances.

Interest cost feedback loop: As debt rises and interest rates increase, federal interest payments grow, further worsening deficits and increasing fiscal pressure.

Demand pressures: Persistent and large deficit spending can contribute to pushing consumer demand beyond what the economy can supply, particularly when production is constrained and monetary policy remains loose.

Risk to central bank independence: High and rising debt increases the risk that monetary policy becomes subservient to fiscal considerations—so-called fiscal dominance—where concerns about debt-service costs and financial stability make it harder to prioritize low inflation.

On the flipside, sound fiscal policy supports price stability. When Congress credibly commits to stabilizing and reducing the debt, it helps keep inflation expectations stable and lowers the interest costs investors demand to compensate for fiscal uncertainty. Lower long-term rates reduce borrowing costs for families and businesses and slow the growth of federal interest payments, freeing up resources for capital investments that grow the economy.

Congress should reduce deficits immediately and reform unsustainable health care and retirement programs that are the main drivers of growing debt levels.

FEDERAL POLICIES TO AVOID HIGH INFLATION AND INTEREST RATES

- **Adopt credible fiscal rules.** Putting America on a sustainable budget path starts with adopting clear and enforceable fiscal targets to reduce budget deficits. Stabilizing the publicly held debt as a percentage of gross domestic product (GDP), achieving primary budget balance (balanced budgets excluding interest costs), or limiting deficit spending as a share of GDP all have their own merits. What matters most is that Congress adopt a realistic, clear, and binding budget target, ideally anchored in a constitutional amendment, that is backed by specific policies to reduce budget deficits.
- **Establish an independent fiscal commission.** A fiscal commission modeled after the Base Realignment and Closure (BRAC) process could provide Congress with the political cover needed to implement difficult but necessary reforms to unsustainable entitlement programs, especially Social Security and Medicare. Such a commission should be composed of independent experts tasked with clear fiscal goals, such as stabilizing the public debt or reducing the federal deficit to 3 percent of GDP. Commission members would be empowered to make recommendations that take effect unless Congress passes a joint resolution of disapproval.
- **Rein in emergency spending.** Over the past three decades, Congress has increasingly used emergency designations to bypass well-intentioned fiscal rules and expand the size and scope of government spending. Congress should reform emergency powers and require full offsets for any new emergency spending. This would deter vast borrowing during crises, which—as the recent pandemic experience has shown—can worsen inflationary pressures and undermine price stability.
- **Reform Social Security to lower the path of spending.** Social Security is the largest federal spending program and on an unsustainable

trajectory, with \$28 trillion in unfunded obligations. Congress, or an independent fiscal commission acting on behalf of Congress, should consider transitioning Social Security toward a predictable flat benefit focused on preventing senior poverty rather than replacing pre-retirement income. Congress should also consider automatic stabilizers that align program spending with available revenues based on economic and demographic developments, such as indexing eligibility ages to rise with improvements in longevity and reducing the generosity of future benefit increases as the worker-to-retiree ratio shrinks. Finally, Congress should also consider universal savings accounts, which would allow individuals to save after-tax income and withdraw the principal and gains tax-free at any time for any purpose, without restrictions.

- **Limit spending growth in Medicare.** Medicare spending is projected to grow faster than GDP indefinitely. Congress should cut baseline spending and cap spending growth, ideally converting Medicare into a Social Security–style cash-transfer program that sends risk- and income-adjusted payments directly to enrollees.
- **Convert Medicaid to smaller, fixed block grants.** Medicaid’s matching-grant structure encourages states to overspend, ignore fraud, and shift costs to federal taxpayers. Congress should cut Medicaid spending and convert the program to a fixed block grant, ending the scams that have contributed to wasteful and fraudulent Medicaid spending.
- **Reduce federal aid to states.** Many federal programs overlap with state responsibilities, driving up costs by imposing bureaucratic requirements while also reducing accountability by obscuring which level of government is responsible for program outcomes. States should fund their own K–12 education, housing, community development, and transit programs, among others, to tailor policies to local conditions and compete to deliver better results at lower cost.