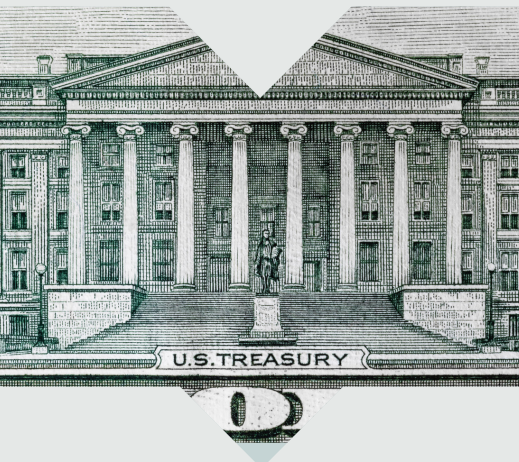


APR 2020

POLICY BRIEF



Summary

- The United States is facing a massive debt crisis.
- As America accumulates more debt, the greatest risk for the nation is economic stagnation.
- Swiss-style fiscal rules, which would ideally be included in an amendment to the U.S. Constitution, could resolve the United States' long-term fiscal problems and help spur sustained economic growth.
- Regardless of whether a constitutional amendment is passed, the federal government should immediately adopt Swiss-style fiscal rules to avert economic disaster.

How to Solve America's Debt Crisis in the Wake of the Coronavirus Pandemic

By John Merrifield and Barry Poulson

Introduction

The Trump administration and Congress recently passed the Coronavirus Aid, Relief, and Economic Security Act. Under the terms of the \$2 trillion rescue package, the federal government will make direct payments to households, businesses, and state and local governments.

President Donald Trump proposes that the next phase of economic relief from the pandemic should include an additional \$2 trillion of debt-financed infrastructure spending, as well as allocating \$500 billion from the Treasury to the Federal Reserve to bolster credit markets.

The cost of this multi-trillion-dollar rescue package will drive up the federal budget's already substantial trillion-dollar deficit, so it's safe to conclude that the magnitude of this fiscal stimulus far surpasses the legislation enacted in response to the 2008 financial crisis.

* This study was conducted as part of the Friedman Project, a research project funded by a grant from the Koch Foundation. For more information on this research, see Merrifield, J., and B. Poulson, 2017b, *Restoring America's Fiscal Constitution*, (New York, NY: Lexington Books).

While the phase one fiscal plan in response to the coronavirus is now in place, there has been little discussion of phase two. There are essentially two views of what a post-coronavirus fiscal plan should look like. The non-orthodox fiscal view is to double down on fiscal stimulus. In this view, orthodox fiscal policy is dead, and the real danger is that fiscal stimulus in phase two will be insufficient to restore full employment. The assumption is that money-printing governments can incur deficits and accumulate debt without ever becoming insolvent.

We should not underestimate the damaging impact the coronavirus pandemic has had on the economy. Just as in wartime, the response should be massive spending and market intervention required to stabilize the economy. But the coronavirus has not negated orthodox fiscal policy, as some economists and commentators argue. Just as the government adjusted to a post-World War II economy, the government must design a phase two fiscal plan for a post-coronavirus pandemic economy. This phase two fiscal policy should address the debt crisis by balancing the budget and using surplus revenue to reduce debt burdens.

A few years ago, the national debt was considered one of our country's most

pressing problems. Today, it is treated by many politicians in the U.S. Congress as a taboo topic. Some economists even suggest we need not worry about the debt. They claim our grandchildren will figure it out, or even that debt and deficits don't matter. But what these irresponsible policymakers and economists

really mean is that adult Americans should stick their children and grandchildren with a hefty tax bill.

In this study, we propose a phase two plan for addressing the long-term impact of deficits and

debt on the U.S. economy. Over the past half-century, the federal government has accumulated debt at an unsustainable rate, and the debt incurred in response to the coronavirus pandemic will exacerbate this debt crisis.

Understanding the Debt Crisis

The vast majority of Americans are baffled about the actual state of the U.S. national debt, and there are a number of reasons why the public remains confused about this important problem.

First, the magnitude of the debt is mind-boggling. Even before the coronavirus pandemic, the Congressional Budget Office (CBO) projected that under

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current law, over the next three decades the national debt will grow from \$24 trillion to \$100 trillion. CBO also projected that at the end of this forecast period, the federal government will pay interest on the debt equal to \$4 trillion per year, exceeding all discretionary spending.¹

To pay off the national debt today, every U.S. citizen would need to contribute about \$72,000. Thirty years from now, our grandchildren will each owe more than \$250,000. What does it mean to owe a quarter of a million dollars? Just to pay the interest on that debt, each of our grandchildren would have to pay more than \$5,000 in taxes each year, and that assumes that interest rates remain at the current levels, which are at an all-time low.²

This study is a common-sense guide to addressing the national debt. The debt crisis we are experiencing in the United States has been experienced in virtually every other country in the world over the past half-century. Some countries have responded to their debt debacles by enacting new fiscal rules designed to balance their budgets and reduce debt to sustainable levels. Other countries, including the United States, have failed to

do so. This study explores why these different responses to unsustainable debt levels have occurred, and whether the United States can finally follow the lead of countries that are solving their debt emergencies.

Of all the nations that have enacted fiscal rules to address out-of-control debt, Switzerland is arguably the most successful. It's no wonder that the Swiss debt brake has been copied in other countries, in the Organization for Economic Co-operation and Development, and the European Union. In fact, any European Union member that fails to meet the targets set in these

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fiscal rules faces sanctions designed to correct its misguided fiscal policies while bringing debt down to sustainable levels.

The United States is not part of an economic union. Therefore, America does not face sanctions for incurring unsustainable deficits and debt. However, it is clear the fiscal policies pursued under current law are failing.

In this study, we explore why elected officials continue to pursue fiscal policies that incur and accumulate debt at an

¹ Congressional Budget Office, *Long Term Budget Outlook*, 2019.

² *Ibid.*

unsustainable pace. We further explain why these fiscal policies are not sustainable, and why it is important to enact new fiscal rules to constrain the tax and expenditure decisions of elected officials, limiting their ability to pursue such destructive discretionary fiscal policies.

Additionally, we'll explore the impact that Swiss-style fiscal rules would have on the U.S. federal budget and economy. Simulation analyses reveal Swiss-style fiscal rules could constrain fiscal policies and reduce debt to sustainable levels in America, just as they have in European countries. Enacting the new fiscal rules in the United States is feasible, but would require some fundamental institutional reforms in both the public and private sectors, which will be a daunting challenge.

The Great Divide in the Debt Crisis

Over the past half-century, the debt crisis has emerged as a global phenomenon. During this period, virtually every country has at some point experienced unsustainable levels of debt growth. Policymakers and analysts can better

understand the great divide in debt by contrasting the experience of the United States with that of Switzerland.

The best measure of the debt burden is the ratio of total debt to national income. At the end of the twentieth century, the debt burden in the United States was comparable to the burden in Switzerland. In both countries, the ratio of total debt to national income was about 30 percent. In the years leading up to the financial crisis in 2008, Switzerland was able to stabilize debt at that level. And over the past decade, Switzerland has significantly reduced its debt burden, to about 20 percent of national income.

Conversely, the debt burden in the United States has increased significantly over the past two decades. In the years prior to the financial crisis, the ratio of debt to national income in America doubled, up to 60 percent. During the financial crisis, the U.S. debt burden increased sharply, and it has continued to increase since, to almost 100 percent, as of this writing.³

The explanation for the great divide in the debt crisis can be found in the fiscal rules enacted in each of these countries. The most effective of the fiscal rules was the

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³ Merrifield and Poulson 2016a, 2016b, 2016c, 2017a, 2017b.

“debt brake” enacted in Switzerland. The basic idea of the debt brake is straightforward: If you find yourself in a hole, stop digging. The debt brake mandates that if deficits exceeds an upper limit, the government must reduce spending until the budget is balanced and debt is reduced to a sustainable level.⁴

The Swiss debt brake originated in new fiscal rules enacted at the local level. The debt brake proved to be effective in balancing budgets and reducing debt burdens in a few Swiss cantons. Soon thereafter, it was adopted in all Swiss cantons. At the end of the twentieth century, the debt brake was enacted at the federal level as a constitutional measure through a referendum, with support from an overwhelming majority of Swiss citizens.

Since then, the Swiss debt brake has served as a model for similar fiscal rules created by other European governments, and at the supranational level by the European Union. In short, European Union countries that fail to meet the deficit and debt targets set in these fiscal rules face sanctions designed to correct their fiscal policies and reduce debt burdens to a sustainable level.⁵

⁴ *Ibid.*

⁵ *Ibid.*

⁶ M. Badia, P. Medass, P. Gupta, and Y. Xiang, “Debt is Not Free,” *IMF Working Paper WP/20/1*, International Monetary Fund, 2019.

Over the past two decades, with new fiscal rules in place, some European countries have stabilized and reduced their debt burdens. Germany and other northern European countries enacted refinements in their fiscal rules to make them even more effective. These countries are now better able to use countercyclical fiscal policy in response to a financial crisis without triggering a debt crisis.

However, other European countries were less successful, especially during the 2008 financial crisis. Some of these nations, such as Greece and Italy, became insolvent when they could not meet their obligations. Most countries in southern Europe have not fully recovered from the financial crisis and continue to experience solvency problems.⁶

“THE MOST EFFECTIVE OF THE FISCAL RULES WAS THE ‘DEBT BRAKE’ ENACTED IN SWITZERLAND. THE BASIC IDEA OF THE DEBT BREAK IS STRAIGHTFORWARD: IF YOU FIND YOURSELF IN A HOLE, STOP DIGGING.”

The great divide in the debt crisis is also evident in Japan. Until the late twentieth century, the debt burden in Japan was similar to the United States and other advanced economies. When debt burdens increased, the Japanese government responded with prudent fiscal policies, balancing its budget and reducing debt. But over the past three decades, the Japanese government has allowed

its debt burden to increase continuously, leaving Japan with the highest ratio of debt to national income in the world, at 250 percent.⁷

In 2020, Japanese Prime Minister Shinzo Abe announced yet another fiscal stimulus package of \$120 billion.⁸ Despite decades of deficit spending and debt accumulation, Japan continues to experience economic retardation and stagnation. Japan has not experienced insolvency because the Bank of Japan holds large reserves, and the Japanese yen is a reserve currency. Also, the Japanese debt is largely held by domestic lenders such as Japanese households and banks.

The debt crisis in Japan is especially relevant for the United States. In America, debt is on a similar trajectory as the one experienced in Japan. Like Japan, the United States will probably not experience insolvency. The U.S. dollar is unique as the dominant reserve currency in international financial markets. A significantly larger share of U.S. debt is held by foreign lenders compared to Japan. To date, foreign lenders have been

willing to hold larger dollar reserves, although there is some evidence that this could change if debt burdens continue to rise in the United States.

As the United States accumulates more debt, the greatest risk for the nation is economic stagnation. Like Japan, in recent decades the United States has experienced a slowdown in economic growth. The Congressional Budget Office projects that retardation in economic growth will continue over the next three decades, with annual growth rates falling below 2 percent.⁹

“DESPITE DECADES OF DEFICIT SPENDING AND DEBT ACCUMULATION, JAPAN CONTINUES TO EXPERIENCE ECONOMIC RETARDATION AND STAGNATION.”

Over the next 30 years, the United States will look more like Japan in other ways as well. As the population ages, a smaller share of the labor force in the population means that tax burdens used to support expanding entitlement programs fall on a smaller share of the population.

The magnitude of these transfer payments is just as incredible as the size of the national debt. At the end of the forecast period cited earlier, CBO estimates the government will pay out

⁷ X. Debrun, J. Ostry, T. Williams, and C. Wyplosz, “Public Debt Sustainability,” in *Sovereign Debt: A Guide for Economists and Practitioners*, IMF Conference, 2018, edited by S. Abbas, A. Pienkowski, and K. Rogoff, International Monetary Fund, forthcoming, Oxford University Press.

⁸ M. Fujikawa, “Japan’s Cabinet Approves \$120 billion Stimulus as Economic Clouds Gather,” *Wall Street Journal*, December 5, 2019.

⁹ Congressional Budget Office, *supra* note 1.

each year \$4 trillion in Social Security payments and \$4.5 trillion in Medicare benefits.¹⁰

A slowdown in economic growth would make it difficult, if not impossible, to generate the tax revenues needed to meet these obligations. As the trust funds used to finance Social Security and Medicare are exhausted, it is less likely that these entitlement programs will be viable when our grandchildren retire.

As the debt crisis in the United States worsens, we should expect intergenerational transfers of wealth to be accompanied by generational conflicts and political instability. Slower economic growth means fewer opportunities for young people to find good jobs or pursue entrepreneurial ventures. Younger generations are losing faith in the ability of elected officials to pursue prudent fiscal policies. We should not be surprised that younger people are attracted to a progressive agenda that promises even more ambitious entitlement transfers paid for by taxing the wealthy, a fantasy that only the young could believe.

How the Swiss Debt Brake Solved the Debt Crisis

The Swiss debt brake has proven to be effective in solving Switzerland's debt crisis, both because of the design of the fiscal rule and because of the constitutional framework within which the rule is enforced.

“THE SWISS DEBT BRAKE HAS PROVEN TO BE EFFECTIVE IN SOLVING SWITZERLAND’S DEBT CRISIS, BOTH BECAUSE OF THE DESIGN OF THE FISCAL RULE AND BECAUSE OF THE CONSTITUTIONAL FRAMEWORK WITHIN WHICH THE RULE IS ENFORCED.”

The Swiss debt brake incorporates a unique balanced budget rule in the constitution. The Swiss recognized that an annually balanced budget rule would not work in the long run. The problem with an annually balanced budget rule is that it does not pro-

vide sufficient flexibility to respond to economic shocks and other emergencies. In a recession, an annually balanced budget rule is pro-cyclical. As income declines in a recession, revenue decreases more rapidly than the fall in income, and expenditures for unemployment and welfare benefits increase automatically. An annually balanced budget rule would require an increase in taxes, which would exacerbate the recession.¹¹

The Swiss debt brake solves this problem by balancing the budget over the business cycle. In periods of recession, the rule allows for deficits. However, the

¹⁰ *Ibid.*

¹¹ Merrifield and Poulson 2016b and 2017a.

deficits must be offset by surpluses in periods of economic expansion.

When elected officials are given the discretion to pursue such fiscal policies on their own, they find it easier to incur deficits in periods of recession, but they fail to offset the deficits with surplus revenue in periods of expansion. The result of discretionary fiscal policies is a ratcheting up of deficits and debt from one business cycle to the next.

The Swiss rule solves this deficit-bias issue by providing guardrails against deficit spending during prosperous periods. A target ceiling for the ratio of deficits to national income is set at 3 percent. When deficits exceed this ceiling, the rule mandates a reduction in spending. An extraordinary budget is created that functions as a budget stabilization or rainy-day fund. Any deficit in the rainy-day fund must be offset by transfers of revenue from the ordinary budget to eliminate the deficit in the near term.¹²

The Swiss debt brake also provides for growth in government spending in line with the growth of the economy in the long run. But this long-term growth in spending is not left to the discretion of elected officials. The long-run growth of spending is linked to a measure of the

trend of growth in the economy. For two decades, the Swiss have constrained the growth of government spending in line with the growth of the economy. They have also balanced the budget over the business cycle and reduced debt burdens significantly.

“FOR TWO DECADES, THE SWISS HAVE CONSTRAINED THE GROWTH OF GOVERNMENT SPENDING IN LINE WITH THE GROWTH OF THE ECONOMY.”

During the 2008 financial crisis, the Swiss were able to pursue countercyclical fiscal policy without accumulating more debt. It is not surprising, then, that the Swiss debt

brake has served as the model for similar fiscal rules enacted in other countries.

Could Swiss-Style Fiscal Rules Solve the U.S. Debt Crisis?

Americans are now asking important questions: How did we get into this debt crisis? And how do we solve the crisis?

The simple explanation for the U.S. debt crisis is that for decades, elected officials made fiscal decisions incurring deficits and accumulating debt because it is in their self-interest to do so. Elected officials are motivated to get elected and stay in office, which means they often act to appease special interests and their constituents even when doing so is not fiscally sound.

¹² *Ibid.*

Special-interest groups are often better organized, better funded, and more effective at lobbying for certain legislation than average Americans with similar policy interests. This special-interest effect results in a deficit bias in every democratic society.

The lesson learned over the past half-century is that we cannot rely on the electoral process alone to solve the debt crisis, at least not while the United States operates under its current monetary system. In the electoral process, the voting record of elected officials is subject to scrutiny by the electorate. It is these reputational considerations that incentivize elected officials to pursue fiscal policies consistent with the preferences of their constituents. Clearly, in the United States, reputational effects alone have failed to limit the deficit bias, allowing elected officials to impose larger debt burdens on citizens in the long run.

The countries that have been successful in solving or avoiding their debt crises have done so by enacting fiscal rules that constrain the decisions made by elected officials. The experience with fiscal rules in Switzerland and other European countries is that when effective fiscal rules are incorporated into a nation's

constitution, they are more likely to be enforced. When fiscal rules are statutory rather than constitutional, it is too easy for elected officials to circumvent or suspend the rules. That has proven to be the case in the United States.

Over the past five decades, Congress has enacted many statutory fiscal rules designed to balance the budget and reduce debt burdens. These fiscal rules have typically been effective in the short run, but in the long run, they have failed to balance the budget and halt the accumulation of debt. The federal government, unlike state governments, has no constitutional provision requiring a balanced budget or limiting debt.¹³

“THE COUNTRIES THAT HAVE BEEN SUCCESSFUL IN SOLVING OR AVOIDING THEIR DEBT CRISES HAVE DONE SO BY ENACTING FISCAL RULES THAT CONSTRAIN THE DECISIONS MADE BY ELECTED OFFICIALS.”

The real question is: Would Swiss-style fiscal rules work in the United States? To answer this question, we designed Swiss-style fiscal rules for the United States and estimated the impact they would have on the budget and economy. The estimates are based on a dynamic simulation model that captures the unique characteristics of the U.S. economy and fiscal policies. We first simulated this model over a historical period covering the past three decades. The empirical results from this simulation are encouraging.

¹³ Merrifield and Poulson 2016a, 2016c, and 2017b.

With these rules in place, the United States would have balanced the budget over the business cycle and reduced debt significantly, with a modest reduction in the rate of growth in federal spending. The government would have been able to stabilize spending during the 2008 financial crisis without a massive increase in debt.¹⁴

“ON THE POSITIVE SIDE, ENACTING SWISS-STYLE FISCAL RULES WOULD GIVE A SIGNIFICANT BOOST TO ECONOMIC GROWTH OVER THE FORECAST PERIOD.”

We also simulated the model over the next three decades, using data from CBO’s long-term forecast, which does not include the present economic crisis related to the coronavirus pandemic. Solving the debt crisis by enacting Swiss-style fiscal rules will be very challenging. That should not be surprising given the magnitude of debt projected over these years under current law. With these fiscal rules in place, by the end of the 30-year period, the government could balance the budget over the business cycle and close the fiscal gap maintaining the ratio of debt to national income at current levels. However, this would require a significant reduction in the growth of federal spending and downsizing of the federal government.¹⁵

On the positive side, enacting Swiss-style fiscal rules would give a significant boost to economic growth over the fore-

cast period. The combination of downsizing of the federal government and low tax rates would increase economic growth. Fewer dollars would be spent in the public sector on entitlement programs and on interest payments, and more dollars would remain in the private sector, where they are used more productively.¹⁶

What Are the Prospects for Solving the U.S. Debt Crisis?

As the magnitude of debt increases each year, the window of opportunity for solving the debt crisis is closing. Indeed, we are like the football team that is behind with seconds left on the clock. Sometimes, the only hope is a desperate heave into the end zone.

One option is to rely on Congress to enact effective fiscal rules to solve the debt crisis. Over the past half-century, Congress has enacted many statutory fiscal rules that have proven ineffective in limiting debt over the long run. It is too easy for Congress to circumvent and suspend the statutory rules they enact.

Recognizing the flaws in these statutory

¹⁴ Merrifield, J., and B. Poulson, *Perspectives on the Federal Debt Crisis*, Cato Institute, forthcoming in 2020.

¹⁵ *Ibid.*

¹⁶ *Ibid.*

fiscal rules, legislators have introduced many resolutions calling for a balanced budget amendment and other fiscal rules as amendments to the Constitution. However, these proposals are flawed because they promise that a silver bullet will solve the debt crisis. They propose simple solutions, such as an annually balanced budget, which, as we noted earlier, we believe will fail over an extended period. They often set a simple target, such as a debt target or a level of federal spending as a share of national income, without any provisions showing how to achieve these goals.

“IF ELECTED OFFICIALS CONTINUE TO MUDDLE ALONG, INCURRING DEFICITS AND ACCUMULATING DEBT AT AN UNSUSTAINABLE RATE, CITIZENS MAY HAVE TO TAKE MATTERS INTO THEIR OWN HANDS BY ENACTING SWISS-STYLE FISCAL RULES AS AN AMENDMENT TO THE CONSTITUTION.”

Citizens should be especially wary of any proposal that promises to balance the budget or reduce debt in the near term. We must be honest and recognize that our elected officials have dug a deep hole and are still digging; solving the debt crisis will be a long and difficult slog that will take many decades.¹⁷

President Trump surprised many folks by proposing new fiscal rules in his fiscal year 2021 budget.¹⁸ The proposal is not just to restore the statutory fiscal rules that Congress suspended in recent years. Trump proposed new fiscal rules,

like those enacted in European countries in recent years, to constrain the growth in spending, balance the budget, and reduce debt over many years. Further, he proposed reforms in a wide range of entitlement programs, as well as discretionary spending programs, to achieve these goals.

As expected, Democrats dismissed these proposals as aspirational goals that would be dead on arrival in Congress. But Trump should be given credit for recognizing that the budget process in Congress is broken and that new fiscal rules are needed to solve the debt crisis.

Trump’s budget proposal has been criticized by Republicans as well as Democrats for projecting higher rates of economic growth. But our research suggests that the combination of government downsizing and low tax rates in the president’s budget proposal would generate significantly higher rates of economic growth in the coming decades.

If elected officials continue to muddle along, incurring deficits and accumulating debt at an unsustainable rate, citizens may have to take matters into their

¹⁷ Merrifield and Poulson, *supra* note 11.

¹⁸ Office of Management and Budget, “President’s Fiscal Year (FY) 2021 Budget,” 2020.

own hands by enacting Swiss-style fiscal rules as an amendment to the Constitution.

Although the U.S. Constitution does not provide the same options for amendments as provided in the Swiss Constitution via initiative and referendum; it does provide an option through an Article V amendment convention. The inability of Congress to successfully address a major issue, such as the debt crisis, is precisely why the Founding Fathers incorporated Article V into the Constitution. Although many resolutions calling

for an Article V amendment convention have been introduced over the years, none have received the requisite approval from two-thirds of the state legislatures.

Recently, several private organizations have been successful in enacting new resolutions in state legislatures calling for an Article V amendment convention to incorporate fiscal rules in the U.S. Constitution. This may seem like a last-minute, desperate heave, but it might be the only option left for citizens to solve the debt crisis.¹⁹

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¹⁹ Keeney 2019a and 2019b.

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About the Authors

John Merrifield is professor emeritus of economics at the University of Texas at San Antonio, where he served as a faculty member for 32 years.

Merrifield the editor of the *School System Reform Journal*, and he previously served as the editor of the *Journal of School Choice*. He is the author of *School System Reform: Why and How is a Price-less Tale*, *Can the Debt Growth be Stopped*, *The School Choice Wars*, *School Choices*, *Parental Choice as an Education Reform Catalyst: Global Lessons*, *Basic Economic Tools*.

Merrifield has also been an author or co-author of 55 peer-reviewed journal articles and several chapters in edited books in his primary teaching and research fields of education economics, public finance, urban and regional economics, and environmental and natural resource economics.

Dr. Merrifield earned a B.S. in Natural Resource Management from Cal Poly San Luis Obispo in 1977, an M.A. in Economic Geography from the University of Illinois in 1979, and a Ph.D. in Economics from the University of Wyoming in 1984.

He resides in San Antonio, Texas with his wife Gayla and their adopted human children, Christopher and Joshua, and their four-legged children, canines Ted, Lindsay, and DeLorean.

Barry W. Poulson is emeritus professor of economics at the University of Colorado. Throughout his long career, he has been a visiting professor at several universities, including the Universidad Autonoma de Guadalajara in Mexico, University of North Carolina, Cambridge University, Konan University in Kobe Japan, and the Universidad Carlos Tercera in Madrid, Spain.

He is the author of numerous books and articles in the fields of economic development and economic history. His current research focuses on fiscal policies and fiscal constitutions.

He has served on the Colorado Tax Commission and as vice chair of the Colorado State Treasurer's Advisory Group on Constitutional Amendments in Colorado.

Dr. Poulson is also the past president of the North American Economics and Finance Association, and he serves as an advisor to the American Legislative Exchange Council's Task Force on Tax and Fiscal Policy. Additionally, Poulson is a fiscal policy and constitutional consultant for a number of state and national think tanks.

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