Testimony of Jacob J. Lew
Senate Budget Committee
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Thank you for inviting me to testify this morning. As Director and Deputy Director of the Office of Management and Budget, I appeared before this committee many times, but today I appear for the first time as a private citizen, and the views I express are accordingly my own. It is also the first time I have prepared testimony for this Committee without the able assistance of the OMB career staff, which only heightens my appreciation for their outstanding service.

It is important to remember that deliberate policy choices were necessary to produce a surplus and begin to pay down the public debt. Similarly, deliberate policy choices in the budget presented this week chart a path in a very different direction.

Budget projections changed dramatically from the beginning to the end of the Clinton Administration. At the end of fiscal year 1992, the annual deficit was $290 billion and it was projected to rise to $390 billion in fiscal year 1998 and $639 billion in fiscal year 2003. Fiscal discipline, starting with the Budget Enforcement Act of 1990 and continuing with deficit reduction legislation in 1993 and the Balanced Budget Act of 1997, reversed twenty years of ballooning deficits. Markets responded with low interest rates which helped drive strong economic growth and accelerated the accumulation of a surplus. As a result, during my three years as Director of the Office of Management and Budget we were able to pay off $363 billion in debt, an accomplishment that would have been called impossible if predicted in 1992. We were on a path towards eliminating the publicly held debt.

Last January I appeared here on the last full day of the Clinton Administration to present our final baseline budget projections. At that time, the Office of Management and Budget and the Congressional Budget Office both projected a ten-year surplus of $5.6 trillion. The debate was whether it would be possible to eliminate the entire debt held by the public within ten years or whether even with a surplus some debt could simply not be paid off. There was broad consensus that the projected surplus would both accommodate substantial new policy initiatives and provide a cushion against potential unexpected shocks. The budget presented this week includes a simple table that shows in black and white how quickly a surplus can be dissipated. According to Administration estimates, the baseline surplus has dropped to $2.2 trillion and the proposed budget would reduce it further to only $665 billion over the same period.

Much has changed over the past year: the recession was deeper than expected; terrorist attacks on the World Trade Center and the Pentagon required a substantial commitment of new resources for defense and domestic security; and policy changes, in particular a significant tax cut, were enacted into law. To understand the change that has taken place and chart a path back to fiscal discipline, it is crucial to differentiate the impact of economic conditions, attacks that could not be predicted and policy changes that were deliberate decisions.

The trend from last year through this year must be distinguished from the longer term trend. In 2002, instead of posting a surplus of $277 billion, there was actually a deficit of $106 billion. In fiscal year 2003, instead of a surplus of $307 billion, as projected last year, the current baseline shows a surplus of $51 billion. If the Administration's proposals are enacted, the 2003 deficit will be $80 billion.

This is a dramatic swing, and one could question whether additional economic stimulus is likely to have a positive effect before a recovery is already underway, particularly if the stimulus is not targeted well. Nonetheless, in the context of an economic downturn along with significant military and emergency expenses, a deficit in these years does not indicate a radical departure from fiscal discipline. In fact, the key argument against a constitutional amendment to balance the budget has always been the need to respond to unexpected and unpredictable events such as war and economic recession.

Far more troubling is the forecast of a steady drift away from fiscal discipline, well beyond the economic recovery, which the budget presented this week only accelerates. While Administration projections show the baseline surplus over ten years shrinking to $2.2 trillion, the Congressional Budget Office is even more pessimistic, forecasting a baseline surplus of only $1.6 trillion. One difference between the two forecasts that jumps out is Medicare spending, where CBO assumes over $300 billion of additional spending under current law. If CBO is correct, the Administration estimate of $665 billion remaining surplus over ten years would be almost completely erased.

Neither the economic downturn nor the military and domestic response to the September 11 attacks on the World Trade Center and the Pentagon are sufficient to explain this longer term trend. In fact, the single largest cause of the ten-year decline in the surplus is last year's tax bill. From 2002 through 2011 the tax bill will cost $1.5 trillion, including higher interest costs due to the larger national debt resulting from the tax cut. In the current budget, the Administration proposes additional tax cuts, including an extension of provisions that were set to expire under last year's tax bill, adding over $600 billion in additional cost. This brings the cost of the tax bill to more than $2 trillion between 2002 and 2012. In contrast, the proposed increase for defense and homeland security from 2003 through 2012 is $627 billion.

The change in fiscal condition is even more dramatic when Social Security is separated from the rest of the budget. CBO projects that the unified budget, including Social Security, will return to surplus in 2004, but only because of the implicit assumption that the Social Security surplus will be used to finance non-social security tax and spending policies. The CBO baseline projects that the non-social security budget remains in deficit until 2009 and over ten years projects a non-social security deficit of $742 billion. The Administration budget proposals would further reduce revenue and increase spending at the same time, driving the non-social security deficit to $1.7 trillion between 2002 and 2012.

In fact, under the Administration budget the non-social security budget remains in deficit for the entire period. In 2008, the year when the baby boom begins to retire, the non-social security budget will continue to draw $143 billion in financing from the Social

Security trust fund. At the end of the forecast period, the annual non-social security deficit would still be $75 billion. Cumulatively, shifting from a policy of saving the Social Security surplus and using it to pay down debt means that the publicly held debt will remain quite high, around $3 trillion throughout this period. Administration projections show that the publicly held debt will not fall below $3 trillion until 2010. Consequently, interest payments instead of falling to near zero, will remain in the range of $150 billion a year even at the end of the ten years.

Dependence on the Social Security surplus to finance non-social security expenses is a dangerous but familiar pattern. It is the path that from 1981 through the early 1990s led to high interest rates and constrained growth. It is also the path that led citizens to worry about the ability of the federal government to make payments for Social Security and other entitlements when the baby boom retires. Stubbornly high long-term interest rates today suggest that the financial community expects federal borrowing to remain heavy for some time to come.

We enjoyed a virtuous cycle in the late 1990s, as declining deficits permitted the repayment of debt and a further decline in interest costs. The non-social security budget no longer depended on Social Security financing to run a surplus and federal outlays for interest payments were rapidly shrinking.

When the baby boom begins to retire in 2008, it will no longer be possible to finance the non-social security deficit from the trust fund. Starting in 2016, only eight years later, in order to pay current benefits the Social Security trust fund will first spend the interest and eventually the principal it is owed for past financing of general government expenses. This will only be possible if the non-social security budget can be balanced and eventually run a surplus. Unfortunately, the Administration budget takes a path which makes a distant memory the goal of saving the Social Security surplus to pay down the debt and protect Social Security.

In a number of areas, this budget understates the true extent of the problem. For example, it assumes non-defense-spending cuts that appear unrealistic. After accounting for increases in homeland security, all other discretionary spending will be reduced by more than $200 billion over ten years compared to the baseline, which keeps pace with inflation. Moreover, if specific proposals to reduce spending are rejected, such as the proposal to reduce spending from the highway trust fund, the cut to all other discretionary spending will only get deeper. With broad bipartisan support for education funding, biomedical research and other important domestic priorities, it is difficult to see how such deep reductions can or should be achieved. Yet if savings fail to materialize, the fiscal problem will only get more severe.

On the tax side, the budget does not address issues that are likely to become increasingly troubling. For example, it does not recognize the fact that the individual alternative minimum tax, through a form of bracket creep, will cover tens of millions of middle income taxpayers over the coming years. In fact, the cost of the Administration's own tax cuts is reduced because of the assumption that the AMT will force more and more middle income taxpayers to give up some of their rate cuts through this back door.

Tax experts agree that the individual AMT should be modified, but this budget does not leave room for the cost associated with such a change.

As noted above, the budget forecasts a rate of Medicare spending which may be $300 billion too low if CBO is correct in its projections. Moreover, the Medicare proposals appear to count on continued savings from provisions that tightly limit reimbursement to physicians and teaching hospitals. In recent years, Congress has demonstrated on a bipartisan basis that these limits were too tight. At a minimum, funding for prescription drug coverage appears to be dependent on continuing these savings.

There is also a distressing trend towards triggers that make spending and tax cuts appear to go away. As we see in this budget, policies that are assumed to disappear have a way of coming back.

There appears to be broad support for a number of important policies, including increased defense spending and prescription drug coverage under Medicare. There should be sufficient surplus available to finance these investments without going back to deficit spending. Unfortunately, the Administration's tax policy leaves virtually no room to fund other priorities. The choices are actually pretty straightforward: domestic priorities can be severely reduced; the Social Security trust fund, contrary to promises made, can be used to finance these activities; or provisions of the tax bill that have not yet taken effect can be deferred or reconsidered.

At a time when there is increased understanding of the importance of clear financial presentations, the integrity of a budget requires more than simple arithmetic. A budget must accurately detail demand for government services and likely sources of revenue. While this budget paints a grim fiscal picture, it understates the true extent of the problem. It also misstates the cause, which is not war but a tax policy that we cannot afford without turning away from the goal of protecting the Social Security surplus and paying down the debt.