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Mr. Chairman and members of the Committee: It is a pleasure for me to be back at the House Budget Committee. I am especially gratified to follow my former colleague, Douglas Elmendorf, as he makes the first of many appearances before this Committee as Director of the Congressional Budget Office.

I will say a few words about the uncertainties of the economic outlook and then turn to the question of how to deal with the immediate and longer-run challenges of fiscal policy. The challenge of budget-making has never been greater. Indeed, I believe that the future viability of the United States economy depends very heavily on budget policy-makers' ability to focus on two seemingly contradictory imperatives at the same time:

- The immediate need to take actions which will mitigate the impact of the recession and help the economy recover—actions that necessarily require big increases in the budget deficit
- The equally urgent need to take actions that will restore fiscal responsibility and reassure our creditors that we are getting our fiscal house in order—actions to bring future deficits down.

I stress two sets of actions because I do not believe it will be sufficient to pay lip service to the long run challenge, while acting only on deficit-increasing responses to the current financial and economic crisis. Congress and the Administration must work together on actual solutions to both problems at the same time.

* The views expressed in this testimony are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution or Georgetown University.

The Economic Outlook

We meet at a time of extraordinary uncertainty about how deep the recession will be and how long it will last. Forecasters all admit that they have little confidence in their ability to predict how consumers, producers, and investors at home and abroad will react to the cataclysmic economic events that have occurred. But people in the forecasting business still have to produce forecasts, so they do the best they can. The Congressional Budget Office (CBO) forecasts that the recession will "last well into 2009" and that the economy will begin to recover, albeit slowly, in 2010. CBO expects unemployment to peak at about 9 percent. The CBO is a bit more pessimistic than the Blue Chip average of commercial forecasters, because the rules of CBO forecasting do not allow them to take account of likely congressional actions to stimulate the economy and enhance recovery.

Right now I think we should be skeptical of all forecasts and especially conscious of the risk that things may continue to go worse than expected. The current CBO forecast is much more pessimistic than the one released just last September, and the Blue Chip consensus has been going steadily south for many months. Additional revelations of weakness in the financial services sector could further impede credit flows and produce a continued slide in all forecasters' expectations.

Indeed, uncertainty about the health of the financial sector compromises all current forecasting efforts. The economic models used by forecasters are based on the experience of the post World War II period, especially the last several decades. Not since the 1930's, however, have we experienced a downturn caused by crisis in the financial sector. Despite aggressive efforts of the Treasury and the Federal Reserve to stabilize the financial sector, credit is not flowing normally, even to credit-worthy borrowers. Continued instability in the financial sector and credit tightness could deepen the recession and delay recovery.

Also adding to the uncertainty and increasing the chance that recovery will be unusually slow is the fact that returning to the pre-crisis economy is not desirable. Before the current crisis Americans were consuming and borrowing too much, while saving too little. We had become an over-mortgaged, over-leveraged society dependent on the inflow of foreign credit. If recovery from this recession is to be solid and sustainable, we must stop living beyond our means. We must transform ourselves into a society that consumes less, saves more and finances a larger fraction of its investment with domestic saving, rather than foreign borrowing. This transformation is necessary, but it will put recovery on a slower track.

Indeed, not since we were a developing country have we been so dependent on foreign creditors. We are lucky that, even though this world-wide financial crisis started in the United States, the response of world investors has been to flock to the safety of U.S. Treasuries, which makes it possible for our government to borrow short-term at astonishingly low rates. But we cannot count on these favorable borrowing conditions continuing forever. Especially if we fail to take serious steps to bring down future budget deficits, the United States Government could lose the confidence of its foreign creditors and be forced to pay much higher interest rates on to finance both public debt and private debt. Rapid increases in interest rates and a plummeting dollar could deepen the recession and slow recovery.

An "Anti-Recession Package" and Investment in Future Growth

Despite the uncertainty of forecasts it is already clear that this recession is bad and that worse is yet to come. Recessions always increase budget deficits as revenues drop and recession-related spending increases. These automatic deficits help stabilize the economy. In addition, since an unusually severe downturn in the economy is threatening, the government should act quickly to mitigate the downslide with spending increases and revenue cuts that will stimulate consumer and investor spending, create jobs and protect the most vulnerable from the ravages of recession.

What we used to call “stimulus” (temporary spending or tax relief designed to jump-start the economy) has been merged into a broader concept of “recovery” and investment in future growth. However, I believe an important distinction should be made between a short-term “anti-recession package” (aka “stimulus”) and a more permanent shift of resources into public investment in future growth. We need both. The first priority is an “anti-recession package” that can be both enacted and spent quickly, will create and preserve jobs in the near-term, and not add significantly to long run deficits. It should include temporary aid to states in the form of an increased Medicaid match and block grants for education and other purposes. Aiding states will prevent them from taking actions to balance their budgets--cutting spending and raising taxes--that will make the recession worse. The package should also include temporary funding for state and local governments to enable them to move ahead quickly with genuinely “shovel ready” infrastructure projects (including repairs) that will employ workers soon and improve public facilities. Another important element of the anti-recession package should be substantial transfers to lower and middle income people, because they need the money and will spend it quickly. This objective would be served by increasing the Supplemental Nutrition Assistance Program (SNAP), unemployment compensation, and the Earned Income Tax Credit. Helping people who lose their jobs to keep their health insurance and aiding distressed homeowners also belong in this “anti-recession” package. On the tax side, my favorite vehicle would be a payroll tax holiday, because payroll tax is paid by all workers and is far more significant than the income tax for people in the lower half of the income distribution. Moreover, a payroll tax holiday would be relatively easy to reverse when tax relief was no longer appropriate. This anti-recession package should move forward quickly. Because its components would be temporary, there would be little reason for concern about its impact on the deficit three or four years down the road.

The anti recession package should be distinguished from longer-run investments needed to enhance the future growth and productivity of the economy. The distinction is not that these longer-run investments are less needed or less urgent. We have neglected our public infrastructure for far too long and invested too little in the skills of the future workforce. If our economy is to grow sustainably in the future we need to modernize our transportation system to make it more efficient and less reliant on fossil fuels. We need to assure access to modern communications across the country and invest in the information technology and data analysis needed to make medical care delivery more efficient and effective. We need a well thought-out program of investment in workforce skills, early childhood education, post-secondary education, science and technology. Such a long-term investment program should not be put together hastily and lumped in with the anti-recession package. The elements of the investment program must be carefully planned and will not create many jobs right away.

Since a sustained program of public investment in productivity-enhancing skills and infrastructure will add to federal spending for many years, it must be paid for and not simply added to already huge projected long-term deficits. That means either shifting spending from less productive uses or finding more revenue. Overtime, Congress could reduce commitments to defense programs and weapons systems that reflect outmoded thinking about threats to U.S. security, reduce agricultural subsidies, and eliminate many small programs that have outlived their original priorities. Reform of the tax system--including making the income tax simpler and fairer or increasing reliance on consumer taxation—could produce more revenue with less drag on economic growth. None of these policies would be easy, but the resources to pay for large permanent increases in federal spending must be shifted from somewhere else as the economy returns to full employment. Congress will only be able to accomplish this reallocation of resources if it reinstates some form of long run (say, ten year) PAYGO and caps on discretionary spending.

I understand the reasons for lumping together the anti-recession and investment packages into one big bill that can pass quickly in this emergency. A large combined package will get attention and help restore confidence that the federal government is taking action—even if part the money spends out slowly. But there are two kinds of risks in combining the two objectives. One is that money will be wasted because the investment elements were not carefully crafted. The other is that it will be harder to return to fiscal discipline as the economy recovers if the longer run spending is not offset by reductions or new revenues.

Immediate Action to Bring Down Future Deficits

As this Committee knows well, projections of the federal budget show rapidly rising spending over the next several decades attributable to three major entitlement programs; namely, Medicare, Medicaid and Social Security. Under current rules, Social Security spending will rise rapidly over the next two decades, but level off after the Baby Boom generation passes through the system. The health care entitlements are expected to rise even faster. Moreover, they are expected to keep on rising because they are dominated by continued increases in the spending for health care in both the public and private sectors. If policies are not changed Medicare and Medicaid—and to a lesser extent Social Security—will drive federal spending up considerably faster than the rate at which the economy is likely to grow. Unless Americans consent to tax burdens that rise as fast as spending, a widening gap will open up. We will not be able to finance these continuously growing deficits.

Because rapidly rising debt threaten our credibility as sound fiscal managers, we do not have the luxury of waiting until the economy recovers before taking actions to bring down projected future deficits. Congress and the Administration should take actual steps this year to reduce those deficits in order to demonstrate clearly that we are capable of putting our fiscal house in order. This can be done without endangering economic recovery.

The crisis may have made Social Security less of a political “third rail” and provided an opportunity to put the system on a sound fiscal basis for the foreseeable future. Fixing Social Security is a relatively easy technical problem. It will take some combination of several much-discussed marginal changes: raising the retirement age gradually in the future (and then indexing it to longevity), raising the cap on the payroll tax, fixing the COLA, and modifying the indexing of initial benefits so they grow more slowly for more affluent people. In view of the collapse of market values, no one is likely to argue seriously for diverting existing revenues to private accounts, so the opportunity to craft a compromise is much greater than it was a few years ago. Fixing Social Security would be a confidence building achievement for bi-partisan cooperation and would enhance our reputation for fiscal prudence.

Vigorous action should also be taken to make Medicare more cost effective and slow the rate of growth of Medicare spending, which contributes so much to projected deficits. While restraining health spending growth should be a major feature of comprehensive health reform, Medicare is an ideal place to start the effort. Medicare is the largest payer for health services and should play a leadership role in collecting information on the cost and effectiveness of alternative treatments and ways of delivering services, and designing reimbursement incentives to reward effectiveness and discourage waste. Congress has a history of allowing pressure from providers and suppliers (for example, suppliers of durable medical equipment or pharmaceutical companies) to thwart efforts to contain Medicare costs. The government has also not been adequately attentive to punishing and preventing Medicare fraud. The United States will not stand a chance of restoring fiscal responsibility at the federal level unless Congress develops the political will to hold health providers accountable—whether in the context of existing federal programs or comprehensive health reform--for delivering more cost effective care. A good place to start is Medicare.

Process Reform

This Committee does not need to be convinced that deficits matter and that the deficits looming in the federal budget--exacerbated by the rapid increases in debt associated with recession and financial bailout—must be dealt with sooner rather than later. You know that procrastination will make the hard choices harder and make us increasingly dependent on our foreign creditors and exposed to their policy priorities. The question is: should you take actual steps now to reduce future deficits or design process reforms that will force you to confront viable options and make choices in the future? My answer is: do both.

Fixing Social Security and taking aggressive steps to control the growth of Medicare costs would be visible evidence that Congress and the new Administration have the courage to rein in future deficits. But the Congress also needs to restore discipline to the budget process—not use recession or the financial meltdown as excuses for throwing fiscal responsibility to the winds just when we are going to need it more than ever. A large temporary anti-recession package is the right fiscal policy in the face of severe recession and should not be subject to offsets—that would defeat the purpose. But more permanent investments in future growth—also good policy—should be paid for and not allowed to add to future deficits. Caps on discretionary spending and PAYGO for revenues and mandatory spending should be reinstated and seriously enforced.

Moreover, PAYGO is not enough, because it only guarantees that congressional actions with respect to entitlements and revenues will not make projected deficits worse than they would be under current policies. But, we all know that deficits projected under current policy will rise at unsustainable rates. Spending required by Medicare, Medicaid and Social Security will rise substantially faster than revenues at any feasible set of tax rates. We will not be able to borrow that much money—even if we thought it desirable to do so.

The current budget process subjects a declining—discretionary spending—to annual scrutiny by leaves entitlement programs and revenues on automatic pilot outside the budget process. Fiscal responsibility requires that all long-term spending commitments be subject to periodic review along with taxes and tax expenditures. There is no compelling logic for applying caps and intense annual scrutiny to discretionary spending, while leaving huge spending commitments, such as Medicare or the home mortgage deduction entirely outside the budget process and not subject to review on a regular basis. I am a member of a bipartisan group called the Fiscal Seminar (sponsored by The Brookings Institution and the Heritage Foundation) that addressed this problem in a paper entitled, Taking back our Fiscal Future, in 2008. We may not have come up with the right solution, but we certainly identified a serious problem that stands in the way of getting the federal budget on a sustainable long run track.

Not a Partisan Matter

The challenges that face this Committee—mitigating the recession, enhancing future growth, restoring sustainable fiscal responsibility—cannot be solved by one political party, but require non partisan analysis and bipartisan cooperation. Many budget analysts with quite disparate views on particular policies share the conviction that Congress and the Administration must meet the double challenge of reviving the economy and restoring fiscal responsibility at the same time. I attach a memo to President Obama signed by twelve experienced budget analysts (including myself) that emphasizes these points.

Thank you, Mr. Chairman and members of the Committee.

Attachment

To: President Obama
From: Bob Bixby, William Galston, Ron Haskins, Julia Isaacs, Maya MacGuineas, Will Marshall, Pietro Nivola, Rudy Penner, Robert Reischauer, Alice Rivlin, Isabel Sawhill, Eugene Steuerle

Subject: A Budget We Can Believe In

January 22, 2009

Your first budget will be a defining document. It will cast the basic mold of your administration, highlight your key priorities, and specify how you are going to deliver on your most important campaign promises or modify them in light of new developments. The decisions you make in shaping this budget will be among the most consequential of your tenure.

In our view, the overriding imperative for your first budget is to strike a judicious balance between America's short-term and long-term economic needs. To accomplish this, that budget must be strategic as well as tactical. The steps you take to address our short-term problems must not make it harder to achieve our long-term goals. Indeed, they should set the stage both for steady economic growth and a sustainable fiscal future. To be a truly transformative president, you must not allow the urgency of the short-term to crowd out concern for the country's long-term wellbeing.

As you have noted, the key short-term challenges are:

- stabilizing America's financial markets to ensure an ample and affordable supply of credit, which is the lifeblood of our economy; and

- reducing the severity and duration of the current recession and getting Americans back to work.

At the same time, your budget must set in motion measures that deal with two critical long-term challenges to America's economic health:

- controlling the growth of health costs and putting Social Security on a financially sustainable path.

- reforming America's tax system to make it more efficient, fairer and simpler and to raise adequate revenue while maintaining economic growth.

These short- and long-term economic imperatives are inextricably linked. The costs of stabilizing the financial markets and stimulating economic growth will generate a large increase in our national debt. We will have to borrow money in domestic and international capital markets to finance this debt, and without a serious commitment to long-term fiscal restraint, lenders will eventually question the nation's fiscal credibility. They may respond by reducing the share of their portfolios devoted to U.S. government debt or by charging higher interest rates. In the extreme, the reluctance to buy U. S. debt could cause a crisis in international capital markets. No one can describe the risks precisely, but Wall Street's recent troubles demonstrate that the perils of over reliance on debt can come swiftly and in unpredictable ways. What is predictable is that if the long-term problem is not confronted, interest costs will absorb a growing proportion of our budgetary resources and, together with growing health costs and Social Security, will threaten to crowd out spending on programs for the poor, children, and improving the nation's infrastructure. Moreover, our dependence on foreign creditors and the resulting mortgage on future national incomes will diminish American standards of living for generations to come.

We understand full well the myriad considerations that will shape your fiscal proposals for the next fiscal year. We suggest, however, two criteria that a future-oriented budget for fiscal 2010 should meet.

- First, you have pledged repeatedly to scrub every line item in the current budget with an eye to finding items that are either ineffective or outdated. We do not believe that this effort will be credible unless it produces significant savings from both programs and tax expenditures.

- Second, the stimulus package should not worsen the long-term fiscal outlook. To the extent that it includes items that increase the long-term budget deficit, offsetting long-term spending cuts or revenue streams should be proposed.

We believe, moreover, that Congress must re-impose caps on discretionary spending as soon as the economy begins to recover from the recession. The budget documents you submit to Congress should make it clear that you will support such a move.

The long-term budget challenge can be stated succinctly. Three large programs – Social Security, Medicare, and Medicaid – now constitute almost one-half of non-interest federal spending and are growing faster than tax revenues because of soaring health costs and the aging of the population. If we fail to reform these spending programs and insist on maintaining the tax burden where it is has been over the past 50 years (about 18 percent of GDP), deficits will soar, and the public debt is likely to exceed 100 percent of the GDP within 25 years. That compares to 37 percent at the end of fiscal 2007.

It's entirely understandable that public concern over the long-term budget problem has now been swamped by the financial crisis and accompanying recession. But as President you can't afford to lose sight of these inconvenient truths. The budget deficit for fiscal 2009 is estimated at $1.2 trillion by CBO, and this excludes any new spending as part of a stimulus bill. The federal debt owed to the public may increase by considerably more than 50 percent over the next two years. Although large debt increases occurred in the early 1980s, they did not occur as quickly. Moreover, there are two important differences from that era. First, we are now more dependent on foreign private and government investors to buy our debt. Second, relative to the size of the economy (GDP), Social Security, Medicare, and Medicaid are much larger now than they were then, and they are expected to grow more rapidly as the oldest baby boomers begin to retire. Consequently, the budget deficit will contract more slowly than usual as the economy recovers.

Although we are rightly absorbed by our short-term problems, the long-term budget situation ultimately poses graver challenges to the success of your presidency. Social Security, Medicare, and Medicaid are expected to constitute 1.8 percent more of the GDP in 2016 than they did in 2008. That may not sound like much, but if the growth were to be financed entirely with tax increases, it would imply an overall tax increase of almost 10 percent above historical levels – and that would only be the first of many tax increases to follow. If it were financed by cutting all other non-interest programs including defense, the across-the-board reduction would have to be more than 20 percent compared to baseline levels. Even if a number of inefficient and low priority programs are eliminated, it would not be possible to fulfill your election promises – to expand health insurance coverage or to increase public investment in education, infrastructure, and research on alternative energy sources, among many others – without digging our long-term fiscal hole even deeper.

Your budget should make it very clear that you take the long-term budget problem seriously. It must quantify the cost of our long-term promises and explicitly state the goal of achieving fiscal sustainability. As a first step, we should stabilize the ratio of debt to GDP while creating an atmosphere conducive to economic growth. The budget could, for illustrative purposes, specify two or three combinations of target revenue and spending paths that would achieve this initial goal.

We believe you should do more than express your concern about the danger of escalating future deficits. You should move quickly to reduce them without endangering near-term economic recovery. First, you should give high priority to putting Social Security on a sound fiscal basis to reduce future deficits and show our creditors that we are taking serious steps to manage our national finances. Second, you should take quick action to reduce the growth of Medicare by shifting to payment systems that reward effective treatments and discourage wasteful spending.

The long-term fiscal problem is complicated by the fact that it is difficult to contemplate increased revenues being part of the solution so long as the public rightly remains highly distrustful of our inequitable and economically inefficient tax system. Tax reform is always difficult, but it will be necessary to achieve a rational solution to our long-term problems. Hundreds of billions of dollars worth of tax expenditures in the federal code must be evaluated and eliminated where they inhibit economic growth, are inefficient, have undesirable distributional consequences, or are difficult to administer.

Throughout your campaign, you pioneered new ways of involving the American people in our nation's political life, and you have signaled your determination to continue that commitment as president. Our long-term economic and fiscal future is an issue that cries out for just such public engagement. Congress is unlikely to cooperate in undertaking such painful reforms so long as the general public remains unaware of the magnitude and urgency of the long-term fiscal challenge. Therefore, we recommend that you launch an intensive public education campaign. This could include a series of town hall meetings across the country or fireside chats to explain the problem and lay out options for solving it to the American public. Although you could send surrogates around the country, you should personally take part in some of these meetings to underscore their vital importance, as President Clinton did a decade ago. If Americans grasp how essential budget reform is for the wellbeing of their children and grandchildren, they will be more likely to accept the sacrifices necessary to get the budget under control.

One additional (and crucial) point: it makes no sense to undertake a challenge of such magnitude unless it yields structural changes that are enduring. To that end, we recommend two key shifts in our budget procedures.

- Once an agreement for tax and long-term spending reform is in place, it must be enforced by pay-as-you-go rules that require that all tax cuts or entitlement increases be financed by some combination of tax increases and entitlement cuts. Without such rules, a painfully negotiated agreement is likely to erode over time.

- In addition, targets for entitlement spending and tax expenditures should be budgeted for the long run, say, 30 years. If unexpected events push spending or tax expenditures above targets, automatic triggers could be used to slow spending growth, increase revenues, or some combination of the two.

We have outlined a formidable task. It may be possible to muddle through another eight years without facing the long-term challenge. To evade it, however, would be to squander an historic opportunity to set our economy and governing institutions on a sound and sustainable course. To be remembered as a truly transformative president, you must boldly confront – and master – the toughest problems of your time.

The signatories to this memo are all members of a group that has been meeting together for several years at the Brookings Institution under the auspices of Brookings and the Heritage Foundation. The views expressed are those of the individuals involved and should not be interpreted as representing the views of their respective institutions.