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Mr. Chairman and members of the Committee: I am very pleased that you are holding this hearing on the short- and long-run fiscal challenges. I strongly share the Committee's perception that the future viability of the United States economy depends on 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 <u>actions</u> 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.

I will say a few words about the economy and then turn to the question of how to deal with the immediate and longer-run challenges of fiscal policy.

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 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 is the fact that 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 a lot more for borrowed money. 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 efforts should also be made 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.

Moreover, entitlements, which dominate future spending, cannot remain 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, <u>Taking back our Fiscal Future,</u> 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. In my opinion they require action on two fronts at once, including a strong antirecession package and immediate steps to reduce the contributions to future deficits of Social Security and

Medicare. They also require agreement on reforms of the budget process that will force the Congress to confront long-run spending and revenue choices.

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