Testimony on:

"The Debt Outlook and its Implications for Policy"

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Mr. Chairman, Ranking Member Gregg and members of the Committee, I thank you for the privilege of appearing today to discuss the important issue of the federal debt. I would like to make three main points:

- Federal debt outstanding is a reflection of economic policy choices, especially the decision to enact and expand spending programs.

- The recent sharp rise in federal debt – and the likely further increase due to fiscal policies under consideration – is far from costless. This rise:

    - Reduces federal budgetary flexibility in the future,
    - Imposes lower standards of living on future workers and hinders U.S. competitiveness, and
    - Will likely prove an impediment to fundamental reforms of the tax code and entitlement spending programs.

- Any necessary sharp, near-term rise in federal debt should be paired with an explicit strategy to address the underlying forces driving up federal spending, thereby stabilizing and reducing the debt outstanding.

<u>Determinants of Federal Debt</u>

The Congressional Budget Office reports that at the conclusion of fiscal year 2008, federal debt in the hands of the public exceeded $5.8 trillion dollars, up from $4.8 trillion as recently as 2006. As a matter of accounting, federal debt outstanding is the cumulative amount by which federal outlays exceed federal revenues – generating annual budget deficits – and the interest costs on past debt. Thus, the rise in the federal debt outstanding *per se* is not a policy issue. Instead, debt outstanding is a <u>reflection</u> of underlying policies:

- The decision to <u>spend</u>, and
- The decision on <u>when</u> to tax.

The most important decision is the decision to enact spending programs. Federal spending programs consume and transfer economic resources. Once government decides to undertake $1 of federal spending, it must necessarily acquire control of $1 to finance that spending. For this reason, federal spending is a straightforward and reasonable measure of the burden of the federal government.

Recent spending developments are illustrative. In 2008, federal spending totaled roughly $3 trillion dollars, or 20.9 percent of Gross Domestic Product (GDP). The Congressional Budget Office projects that without full funding of the costs of military operations overseas or new legislation, spending will rise to $3.5 trillion in 2009. At the same time, the federal debt in the hands of the public is projected to rise by $5.8 trillion to $7.2 trillion, or from 40.8 to 50.5 percent of GDP.

These recent spikes in new outlays are layered upon an already-bleak long-term outlook for federal spending. As documented in a series of *Long-Term Budget Outlook* reports by the CBO, if current demographic trends, health care spending growth, and federal mandatory program rules for Social Security, Medicare, and Medicaid are left unchanged, spending is projected to raise explosively in the future, and the federal debt accordingly to spiral beyond control.

Of course, federal debt need not necessarily rise with new spending programs. Again, that outcome is the result of decisions with respect to spending and tax policy. Lawmakers could choose to shift resources – reducing spending in other areas to accommodate new spending. There is little in the history of the federal budget that shows this strategy at play on a significant scale – overall spending rises even as new policy initiatives ranging from military operations to Medicare benefit enhancements to financial market stabilization are undertaken.

Finally, policymakers could prevent a rise in the debt by raising taxes, using the tax code to take command of the necessary resources to meet the spending needs. But the decision to borrow the necessary funds simply means that the taxes are deferred, not avoided. As interest costs accrue and principal payments come due, taxes will have to rise to meet these obligations.[1]

In sum, rising federal debt has its roots in decisions to increase federal spending without offsetting reductions in other outlays and to defer the imposition of taxes to a later date. Fundamental changes to the outlook for federal debt cannot be achieved without fundamental changes to the foundations of budget policy.

The impact on financial markets is an important element of using debt to finance federal policies. In particular, the sale of Treasury instruments competes in a global marketplace with an enormous array of household, corporate, quasi-governmental, sub-federal government, and sovereign financial instruments. The availability of alternatives imposes a discipline on federal debt management – offerings must offer a sufficiently competitive combination of risk and return to attract the needed funds.

Investors assess such offerings by evaluating the risks of asset price declines or outright defaults. In both instances, the primary concern is that future new issuances of debt will be so large as to dramatically drive down prices or actually exceed the ability of the government to honor the debt contracts. Mechanically, investors can arrive at this conclusion only if they anticipate ever-rising spending beyond the ability or willingness of a government to impose the taxes to finance it.

A good metric for evaluating the risks is the ratio of federal debt in the hands of the public to GDP. Debt in the hands of the public measures the need by the Treasury to attract resources for spending not financed by taxes.[2] GDP is a broad measure of the capacity of the U.S. economy to generate income, and thus the pool of resources available to be taxed and either service or retire the debt.

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[1] Of course, spending could be cut to make room in the budget to pay interest or principal obligations.

[2] In contrast, the gross debt includes Treasury securities held by entities within the government.

Notice that tax cuts or spending increases – other things held constant – increase the debt and raise the ratio. However, to the extent that these policy changes are pro-growth, they also will increase GDP in the denominator. That is, the ratio captures both the benefits and the costs of debt-inducing policy changes.

Concern about the outlook for U.S. federal debt centers on the projected rise in federal spending over the next several decades. For example, the most recent CBO long-term outlook projects a rise of 15 percentage points in the debt-to-GDP ratio between 2009 and 2050.[3] This occurs despite the fact that taxes are assumed to be raised from 18.7 to an unprecedented 23.5 percent of GDP, and the anti-growth impacts of this 25 percent expansion of the tax share are excluded from the analysis. In contrast, with different revenue assumptions – taxes held to a more modest rise to 19.4 percent – debt explodes by 256 percentage points over this horizon.

At what point do participants in global capital markets suffer an erosion of their confidence in the future viability of U.S. securities? Unfortunately, there is no magic "bright line" numerical cutoff for the debt-to-GDP ratio that signals a safe harbor below or threat above. Instead, the fundamental evaluation is whether global capital markets believe in the fundamental rough balance of the future of budgetary policies.

Costs of Federal Debt

As noted earlier, spending measures the basic burden of the federal government.[4] Federal debt shifts the financing of that burden from the present to the future. In doing so, it imposes additional costs.

[3] This analysis pre-dates, and thus does not incorporate, the recent sharp receipts decline, spending increase, and rise in federal debt.
[4] A more extensive discussion of this is contained in CBO Director Douglas Holtz-Eakin, "The Economic Costs of Long-Term Federal Obligations," Committee on the Budget United States Senate February 16, 2005.

To begin, larger outstanding federal debt necessarily means that the federal budget will carry with it larger interest costs. These mandatory outlays will cut into the ability of the Congress to manage the composition of overall spending, reduce flexibility, and impair the ability of future Congresses to address unexpected budgetary challenges.

Because debt shifts financing of outlays from the present to the future, it also shifts the distortions of taxation to the future as well. With higher taxes inevitably come interference with decisions on schooling and skills acquisition, occupation, work, hours, entrepreneurship, saving, portfolio allocations, and the many other aspects of economic life. If debt serves to keep taxes lower on average by shifting the burden of taxes to offset a temporary spike in spending, average efficiency is improved. In contrast, if debt defers taxes on permanently high or rising spending, the damage to the economy is higher on average and focused on the younger generations.

On average, federal borrowing lowers national saving, and thus cuts into the national wealth accumulation that finances a higher standard of living for the future. In this way, a debt is burden on capital accumulation, productivity growth, and the real compensation of workers in the future. In a global economy, these effects also diminish the ability of the United States to compete effectively on open, world markets and directly expose our firms to greater import and export competition.

Finally, a large, outstanding public debt likely raises a hurdle against much-needed fundamental reforms in the United States. Over the past decade, discussions of fundamental tax reform, Social Security reform, and health care reform have often foundered over the transition costs – necessarily financed by public borrowing – of reform proposals. To the extent that this remains true, higher near-term borrowing acts as a barrier to much-needed reforms in the U.S..

Principles for Debt Management in The Current Economic Climate

The fairly straightforward discussion of policy options for addressing the federal debt is clouded by the policy imperatives of responding to dramatic financial market distress and a sharp economic downturn. It is imperative that the federal budgetary response to these events be developed in the context of a strategy of budget process and policy changes to address the fundamental, long-run spending growth that feeds explosive debt. President-elect Obama is to be applauded for his recognition of this facet of challenge, and I implore the Congress to place this at the center of its deliberations.

How does "stimulus" fit into the debt discussion? In principle, stimulus represents a one-time increase in the debt as taxes are cut and/or spending is increased temporarily. In the current context, discussions center around a stimulus effort that would raise the debt-to-GDP ratio by about 10 percentage points. If stimulus works well – again, in principle – GDP would rise more (or fall less) than otherwise, muting the increase in the debt-to-GDP burden. Finally, when the temporary stimulus is withdrawn, further rises in debt abate.

What are the consequences of this exercise? Assuming that the basic growth rate of the economy is roughly 2.5 percent, a one-time rise in the debt-to-GDP ratio of 10 percent can be offset over five years of average growth. Put differently, one price of the stimulus exercise is that fundamental changes to the level of spending and taxes (unless paired) have to be put on hold for five years.

Clearly, in addition to a large financial and borrowing cost, stimulus carries with it a potentially large costs in terms of restrictions on future policies. In light of this, it seems sensible to evaluate stimulus in these terms – in addition to the obvious need to help an economy that is clearly struggling and workers who are facing tough times and have lost jobs.

A first principle, then, is that the stimulus effort should avoid new policies that creating new spending programs. From a debt perspective, these types of programs would exacerbate the underlying spending growth that is feeding unsustainable debt projections. From a political-economy perspective, bringing to a stimulus exercise new programs about which there is little consensus likely would (and should) prolong debate and slow implementation.

Finally, from an economic growth perspective, to the extent that there are productivity-enhancing investments that will provide economic returns in excess of their financing costs, then these are the types of activities that the federal government should undertake regardless of current economic conditions. The empirical regularity that the large majority of these kinds of federal spending proposals do not make the grade outside of times of economic duress casts doubt on their claim to pro-growth status. Moreover, it would make sense to find budgetary resources for these investments by reducing spending elsewhere. To make the point starkly: if infrastructure investments will help the economy, in general, and the blue-collar, middle class, in particular, why should these not be financed by reductions in the entitlement benefits of the affluent?

A corollary to avoiding permanent new spending is that spending increases should be concentrated in fortifying the "automatic stabilizers." Programs like unemployment insurance benefits, food stamps (Supplemental Nutrition Assistance Program) and so forth automatically increase in scale during economic duress as more Americans qualify for benefits. These kinds of programs offer two advantages. First, they expand upon need, are tuned to the economic conditions on the ground, and minimize the traditional risk of arriving too late to be effective. Second, they automatically shrink as conditions improve – guaranteeing their temporary nature. Neither of these advantages are present with new spending programs, even seemingly-modest "down payments" on future programs.

A second principle is that the focus should be on tax reductions. Moreover, because temporary tax reductions are largely saved, any tax relief should be as long-term as possible, reduce taxes on pro-growth activities, and eliminate uncertainty about the future of tax policy. To the extent that these tax changes are steps toward a fundamental reform, the additional debt would implicitly finance these transition costs as well. For example, the U.S. code continues to impose a double tax on dividend income, the corporation income tax rate places U.S. firms at a competitive disadvantage, and the year-to-year uncertainty of the research and experimentation tax credit undermines its economic intent. Each could be rectified in the near-term as steps toward a more integrated and efficient tax code. Similarly, the payroll tax is widely recognized as imposing a burden on workers and interferes with labor market incentives at a time when getting people to work is a priority. Reducing the payroll tax would raise issues regarding the structure and finance of retirement programs, but these issues must be resolved in any event.

A third principle is that the effort should provide clear signals to financial markets. This should occur in three ways. First, the programs should be transparent and document the economic impacts. I favor the notion that earmarks should be banned from such legislation, and that the legislation itself should be available electronically for public scrutiny for a substantial period prior to vote. The market could easily assess, then, the economic character of the policies.

Second, markets should be able to assess what is being gained for such a significant commitment of federal funds, and its economic impact. I applaud the recent publication by Jared Bernstein and Christina Romer of their analysis of a prototype stimulus. One may or may not agree with the numbers, but it shows the path of the economy without stimulus, the path with stimulus, and the benefits of stimulus. It has the ingredients needed to assess the net benefits.

Thirdly, I believe that it is important that the effort convey to markets a clear path to stabilizing and reducing the debt burden. It would be useful if any stimulus legislation itself contained provisions that ensured a reduction in future debt as the economy improved. Moreover, if the effort is nested between timely completion of FY 2009 appropriations and imposition of improved spending controls, the market may reward a strengthening of overall budgetary integrity.

Thank you again for the opportunity to appear today. I look forward to your questions.