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Testimony of Peter R. Orszag, Director of the Office of Management and Budget Before the National Commission on Fiscal Responsibility and Reform

April 27, 2010

Chairman Bowles, Chairman Simpson, and Members of the Commission, thank you for inviting me today to testify about the country's fiscal trajectory. Thank you also for your service on this important Commission.

The President formed the National Commission on Fiscal Responsibility and Reform because he believes that the path to fiscal stability begins with bi-partisan cooperation. If we allow the policy positions that divide us to prevent us from taking action, projected medium- and long-term deficits will threaten the health of our economy and the living standards our people enjoy. Sustained, growing long-term deficits will increase our reliance on creditors from abroad, reduce investment in our labs, factories, and businesses, and weaken confidence in the federal government's creditworthiness. Simply put, it may be easier to ignore long-term problems, but we will pay a severe price if we do. With that in mind, the task before you is critical and considerable, and the Administration looks forward to working with you as the Commission seeks solutions.

As you begin this process, it is important to understand the current fiscal trajectory, and that is the topic of my testimony today.

Short-Term Deficits

At the beginning of 2009, the budget deficit for that fiscal year already stood at 9.2 percent of GDP—higher than in any year since World War II and nearly triple the deficit from the year before.

We also faced a serious recession—one that had the potential to become the second Great Depression. In light of that immediate emergency, the overriding economic priority of the Administration became to boost economic growth to prevent the economy from falling off the proverbial cliff. Doing so meant temporarily sustaining higher budget deficits —bringing them to roughly 10 percent of GDP in 2009 and 2010.

As economists from across the political spectrum have said, when the economy is weak, increases in government spending or reductions in taxes are precisely what one needs to boost economic growth and job creation. During an economic downturn, the key to economic growth is increasing the demand for the goods and services the economy could produce with existing capacity, and these moves do exactly that. Raising taxes or cutting spending to reduce the deficit during a recession would be counterproductive, because they would diminish or eliminate the stimulative effect.

That is why it was necessary to enact the American Recovery and Reinvestment Act (Recovery Act) at the beginning of last year and additional measures since then, to further increase short-term demand for goods and services and encourage job creation. Although there is still more work to be done especially to boost job creation to address the unacceptably high levels of unemployment that will persist for some time, the economy is back from the brink and growing at a healthy pace. And, it is clear from the data that the Recovery Act played a critical role in rescuing the economy and putting it back on track.

Medium- and Long-Term Deficits

As the economy recovers, deficits switch from being beneficial to harmful, and the focus must therefore shift to reducing the projected medium- and long-term deficits. Under current policies, our projected deficits amount to about 5 percent of GDP in the second half of this decade—much higher than would be prudent or sustainable.

Exacerbating the problem are the long-term trends that we face—as the combination of rising health care costs and an aging population will, if historical trends continue, drive up costs in the federal government's three largest entitlement programs: Medicare, Medicaid, and Social Security.

What happens if we fail to address these medium- and long-term deficits?

Large budget deficits will have two effects: First, they will lead to a crowding out of private capital, reducing the funds available to finance domestic investment—and, as a result, elevating interest rates economy-wide. Second, they will require increased borrowing from abroad to finance that domestic investment. Either way, budget deficits reduce future national income—either because the nation does not have as much productivity-enhancing capital in the future or because we owe larger liabilities to foreign creditors.

To put this in more tangible terms, if we take no action, anyone needing access to credit—from entrepreneurs seeking new funds to invest in their businesses to families seeking to finance the purchase of a home—will eventually have to compete with growing demand from the federal government for scarce capital, and the Nation as a whole will end up the poorer for it.

Unsustainable budget deficits could also generate adverse effects on the economy that are both larger and more sudden than a gradual crowding out of private capital and rise in foreign borrowing. Although interest rates on government debt remain historically low, substantial deficits projected far into the future could cause the market to rapidly lose confidence in the government's creditworthiness, producing a spike in interest rates and fundamentally disrupting economic activity more broadly. The best way to minimize the probability of such a crisis is to take action as soon as possible.

Role of the Fiscal Commission

Recognizing the fiscal future that we face, the Administration has taken significant action to address both the medium- and long-term deficits. The President's Budget includes more deficit reduction than proposed by a President in any budget in over a decade; by 2015, it would cut the deficit from 5 percent of GDP if current policies are continued to 4 percent of GDP—or by about $230 billion in that year alone. Furthermore, the comprehensive health insurance reform we have just enacted represents an unprecedented effort to address the forces underlying rising health care costs, and is projected to lower future deficits by more than $100 billion in the first decade and by more than $1 trillion in the next.

In addition to these measures, the President has created this Commission because the only way to solve the remainder of our fiscal challenge is to do so in a bipartisan fashion. The Commission is charged with recommending measures to reduce the deficit to about 3 percent of GDP by 2015. This result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers—a key measure of fiscal sustainability. The Commission is also tasked with proposing policies to meaningfully improve the long-run fiscal outlook.

Achieving both these goals will require significant changes in policy that build on what we have accomplished so far. The options to further reduce the deficit may not be popular, but they are necessary. Success will require a commitment from both parties to engage in constructive and honest dialogue, recognizing that there is no easy way forward except through bi-partisan cooperation.

In that spirit, I look forward to working with you in the weeks and months ahead, and I, again, thank you for your service.