Hearing before the House Budget Committee on

Perspectives on Long-Term Deficits

Thursday, January 21, 2010

Statement of Maya MacGuineas

Chairman Spratt, Congressman Ryan, and Members of the Committee, good morning and thank you for inviting me here today to share my views on bipartisan process proposals for long-term fiscal stability. It is a privilege to appear before this Committee.

I am the President of the bipartisan Committee for a Responsible Federal Budget. Our Co-Chairs are Congressmen Bill Frenzel, Tim Penny and Charlie Stenholm, and the Board is made up of past Directors of the Office of Management and Budget, the Congressional Budget Office, and the Government Accountability Office, as well as Chairmen of the Federal Reserve Board and the Budget Committees, and other budget experts. I am also the Director of the Fiscal Policy Program at the New America Foundation, a non-partisan think tank here in Washington D.C. Today, I am here to discuss the work of the Peterson-Pew Commission on Budget Reform, which, in December, released *Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt*, which proposes a six-step plan to address the growing federal debt.

The main points I would like to emphasize today are:

- What was once a long-term fiscal problem has become a medium-term problem that requires that we take action much sooner than was needed a few years ago.
- It is important to focus on stabilizing the debt, so that it declines to a reasonable level and is no longer growing as a share of the economy.
- Policymakers must balance the need to act quickly to avert a fiscal crisis caused by our growing debt with the need not to destabilize the economic recovery.
- The best approach would be to immediately commit to and develop a credible plan to stabilize the debt, and to start phasing it in gradually once the economy is strong enough—we suggest starting in 2012.
- The policies that will stabilize the debt in the medium-term and close the longer-term fiscal gap are somewhat different—both are needed.
- A credible plan will have to be aggressive enough to reassure credit markets.
- The economic risks of doing nothing are tremendous—likely leading either to a fiscal crisis or an ongoing deterioration in the U.S. standard of living.

That the country faces tremendous long-term budget challenges is not news to anyone on this Committee. It is not the massive trillion-dollar-plus deficit of the past year that is so troubling, but that there is no plan to put the budget on a sustainable path in future years. Under reasonable assumptions, the debt will be growing as a share of the economy indefinitely; at some point this will push up interest rates and interest costs as a share of the budget, requiring more borrowing and creating a vicious debt spiral. If not addressed, this will ultimately lead to a fiscal crisis.

Just last week, Fitch Ratings warned that if the U.S. does not take action, government debt by the second half of this decade could threaten the nation's AAA bond rating. And the increasingly regular warnings—from what we hear from Chinese officials worried about their investments in U.S. bonds, to what we see with over-leveraged nations around the world—provide a steady reminder of the urgency of this problem.

It is within that context that the Peterson-Pew Commission on Budget Reform is calling for Congress and the White House to take immediate action to stem the growing federal debt. Our proposal is crafted both to accommodate the needs of the still-recovering economy and reflect the tremendous risks posed by the large and expanding debt burden. We recognize that fiscal problems of this size cannot be fixed overnight or even in a year. Indeed, rushing the process could harm the economy, choking off the budding recovery. But to buy some breathing room, the United States must show its creditors that it is serious about stabilizing the federal debt over a reasonable timeframe. Both spending cuts and tax increases will be necessary.

We recommend that Congress and the White House follow a six-step plan:

> Step 1: Commit immediately to stabilize the debt at 60 percent of GDP by 2018;
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> Step 2: Develop a specific and credible debt stabilization package in 2010;
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> Step 3: Begin to phase in policy changes in 2012;
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> Step 4: Review progress annually and implement an enforcement regime to stay on track;
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> Step 5: Stabilize the debt by 2018; and
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> Step 6: Continue to reduce the debt as a share of the economy over the longer-term.

1. Commit immediately to stabilize the debt at 60 percent of GDP by 2018.

Congress and the White House should immediately commit to stabilizing the public debt at a reasonable level over a reasonable timeframe: we recommend 60 percent of GDP by 2018. Waiting too long could fail to reassure creditors— one of the primary objectives of acting quickly. The "announcement effect" of such a commitment, if credible, can have positive economic effects by signaling that the United States is serious about reducing its debt. We believe that the 60 percent goal is the most ambitious yet realistic goal that can be achieved in this timeframe. The 60 percent debt threshold is now an international standard—regularly identified by the European Union (EU) and the International Monetary Fund (IMF) as a reasonable debt target. A more ambitious target could easily prove to be such a heavy political lift that lawmakers would not embrace it or it would not be credible. Given the significant risks of high U.S. debt, however, a less aggressive target might be insufficient to reassure markets. While cutting government spending or raising taxes too early could slow or reverse the economic recovery, other countries have shown that a credible commitment to reducing the debt prior to actual policy changes can improve creditors' expectations and diminish the risks of a debt driven crisis.

2. Develop a specific and credible debt stabilization package in 2010.

A glide path for getting from today to 2018 is critical. So are the specific policies. Congress and the White House must agree on the necessary reforms and the timing for implementing them. We do not recommend a specific mix but believe that both spending cuts and tax increases will be necessary. Under the Commission's fiscal baseline, average annual deficits are projected to be about 6 percent of GDP. To meet the proposed goal, the average deficit would need to shrink to about 2 percent. For illustrative purposes, we propose a glide path that starts gradually with a deficit of 5 percent in 2012 and that requires a deficit of less than 1 percent by 2018. We allow seven years for the plan so that the impact of policy changes made in any single year is not drastic and does not stall the recovery of the economy.

The magnitude of deficit reduction needed to reach the 60 percent goal depends on the level of debt when policymakers start. If no new deficit-financed policies were added to the budget and any extensions of expiring policies were paid for, deficits would average around 3 percent of GDP, instead of 6 percent, and would only need to shrink to about 2 percent to meet the Commission's goal—clearly a more manageable scenario.

3. Begin to phase in policy changes in 2012.

Given current economic conditions, we recommend waiting to implement the policy changes until 2012. Clearly, policymakers need to closely monitor economic conditions between now and then, but making aggressive changes any earlier could harm the economic recovery, particularly with unemployment reaching a 25-year high in 2009. However, waiting any longer could undermine the plan's credibility and leave the country reliant on excessively high borrowing for too long with no plan in place to change course. Some policymakers will no doubt try to use the struggling economy as an excuse for delay. Keep in mind however, that not putting a plan in place could derail the economic recovery.

4. Review progress annually and implement an enforcement regime to stay on track.

Once a plan is adopted, it will be critical to have a mechanism to ensure that it stays on track. We suggest a broad-based companion enforcement mechanism, or a "debt trigger." The trigger would take effect if an annual debt target were missed. Any breach of the target would be offset through automatic spending reductions and tax increases. The

Commission recommends that the trigger apply equally to spending and revenue. There would be a broad-based surtax, and all programs, projects, and activities would be subject to this trigger. The trigger should be punitive enough to cause lawmakers to act but realistic enough that it can be pulled as a last resort if policymakers fail to act or select policies that fall short of the goal.

5. Stabilize the debt by 2018.

Reducing the debt to 60 percent of GDP will be no small feat. It will require small changes in the first year from the projected level of 69 percent to 68 percent but, more significantly, will require a dramatic deviation from the current debt path. Preventing that projected path is critical for the United States if it is to avoid the economic risks associated with excessive debt.

But hitting a 60 percent target is, in and of itself, not a sufficient goal. What matters just as much—if not more—is that the debt does not continue to grow as a share of the economy thereafter. This makes deriving a package of revenue increases and spending cuts to bring the debt down to 60 percent even more difficult. It would be easier if policymakers could implement temporary measures, timing shifts, and short-term policies that did not address the major drivers of the budget's growth. This shortsightedness, however, would leave the debt on track to grow again after the medium-term goal was achieved. To be effective over the longer-term, a stabilization package will have to include permanent changes to current policies and must be weighted to control the budget's most problematic areas.

We believe the problem is so large that nearly all areas of the budget will be affected, and certainly both spending and taxes will have to be part of the ultimate package. Reforms in programs that are growing faster than the economy—notably Medicare, Medicaid, Social Security, and certain tax policies—afford the best opportunities for savings and will provide the greatest benefits to longer-term debt stability.

6. Continue to reduce the debt as a share of the economy over the longer-term.

Though preventing the debt from expanding again over the coming decades will be quite challenging given the demographic and health care cost pressures, we believe that policymakers must, over time, bring the debt down beyond the initial 60 percent target to something closer to the U.S. historical fifty-year average of below 40 percent. Fiscally responsible federal policies are necessary so that the government has the fiscal flexibility to respond to crises. Even though the United States had budget deficits when the recent economic and financial crises hit, the relatively low level of debt as a share of the economy gave policymakers the ability to respond quickly and borrow large amounts to respond to those crises without worrying about the federal government's ability to borrow. If the debt level had been at its current level, or where it is projected to grow to, responding to the economic crisis would have been much more challenging.

We know that the policies to achieve any of these fiscal improvements are difficult, involving spending reductions or tax increases, and in all likelihood both. In the absence of a single fiscal goal, though, it is too easy for lawmakers to oppose any set of hard choices others suggest without offering alternatives.

Implementing reforms that slow the growth of government spending, keep revenue apace with spending, and are conducive to economic growth will be critical to bringing down the debt levels further. Ultimately, this task will almost certainly require more than one package of debt reduction. The Commission hopes that Congress and policymakers will monitor the debt to ensure that it stays at a manageable level and does not grow faster than the economy. Ensuring the future fiscal health of the country depends on it.

This year we will publish a detailed companion report with additional recommendations on reforming the budget process. That report will also propose budget process tools to help lawmakers reach and maintain a stable level of debt. We very much hope to work closely with the members of this Committee in developing this plan.

And I would like to take the opportunity to elaborate on a few points I think are particularly important.

Prior to the economic crisis, we, at the Committee for Responsible Federal Budget, were worried about the long-term fiscal problem facing the country, driven primarily by an aging population and growing health care costs. But as a result of 1) running deficits prior to the recession, 2) the lower revenues and higher spending due to the recession, 3) the policy costs of dealing with the recession, and 4) a host of new costs that both the administration and Congress support, the debt has grown dramatically and is on course to reach unacceptably high levels. What used to be a multi-decade problem is now at our doorstep.

Policymakers will have to act quickly to reassure credit markets that the United States will soon shift course to a more sustainable fiscal path. This will require committing to such a change immediately, beginning to phase in changes as soon as the economy will tolerate them, and pursuing a fiscal goal that is sufficiently aggressive to reassure credit markets. There is no single "right" goal, but given that average debt levels over the past 50 years were below 40 percent of GDP, it is quite likely that aiming to stabilize the debt at twice the historical level, for instance, will not be sufficiently credible.

Another risk of a fiscal plan that has a long timeframe is the political risk that once policymakers see signs of progress, rather than sticking to the plan, they will switch course and return to the politically more popular exercise of increasing spending and cutting taxes. Therefore, we believe the timeframe for a plan should not be too long. Annual debt goals combined with an automatic trigger mechanism will also help keep policymakers on track.

The bottom line here is that time is a luxury we no longer have.

It is also likely the policies that will be most palatable to bring the debt to a reasonable level over a reasonable time period are in many cases different than those that will keep the debt from growing again in the longer-term. In the medium-term, we have to look for changes that can be implemented reasonably quickly. History shows that policymakers are more likely to cut discretionary spending and increase taxes to get immediate deficit reduction.

These changes, however, will not keep the debt from growing over the longer-term. In order to stabilize the debt over the long-term, we will have to make changes to the drivers of the debt's growth, those programs that are expanding due to aging and health care costs—including the largest mandatory spending programs, Social Security and Medicare.

A reasonable package will have to include both the policies necessary to reduce the debt as a share of the economy over the medium term and keep it under control over the longer-term. The likely time horizon of policy changes only makes it more important to recognize that all areas of the budget will have to be on the table in order to craft a credible and effective debt stabilization package.

I will stop here. We realize the immense difficulty of the task ahead of policymakers. Our board members have either been in Congress or worked closely with Members throughout their careers and know the political and policy challenges we now face—although frankly many of them are concerned that the challenge we face at this moment is the worst they have seen in their careers. For that reason, as difficult as it will be to develop a plan to put the debt on a sustainable course, there is no other option and that action to set the changes in motion must begin right away.

Once again, thank you for the opportunity to appear here today and I look forward to your questions.