The Economic Outlook and Risks for the Federal Budget and Debt

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Chairman Conrad, Ranking Member Gregg, and Members of the Committee, thank you for inviting me to appear today to discuss our economic and fiscal challenges.

As this Committee is well aware, our nation is on an unsustainable fiscal path. If current policies continue, we will run trillion-dollar deficits in the years ahead—even after the economy recovers—and the public debt will rise faster than our ability to pay it. Persistent deficits and rising debt will undermine American prosperity, threaten beneficial social programs, and weaken our position in the world.

Those threats deserve immediate attention but, as this Committee is also well aware, our economy remains fragile. Payroll employment has fallen by 8.4 million jobs since the start of the recession, and long-term unemployment is at record levels. Recent data have provided some glimmers of hope: the economy grew at a 5.7% pace in the last three months of 2009 (a figure that many observers expect to be revised up), and the unemployment rate fell to 9.7% in January, down from 10.0% a month earlier. Those improvements are welcome, but our economy has a very long way to go.

Policymakers thus face a difficult challenge of balancing concern about current economic conditions with a meaningful response to our looming fiscal crisis. In thinking about that balance, I would like to make five main points:

1. Most analysts believe that the recession is behind us and that an economic recovery is underway. Where analysts differ is in their assessment of how strong the recovery will be. As always, there is much uncertainty about the outlook, but my best guess is that near-term growth will be moderate, not rapid.

2. Uncertainty discourages investment and hiring and therefore undermines growth. Economic uncertainty has declined over the past year, creating an environment more conducive to growth. Policy uncertainties are enormous, however, and are likely discouraging some employers from hiring and investing. Lawmakers should look for opportunities to reduce unnecessary policy uncertainty.

3. Persistent deficits and rising debts pose a serious risk to long-term economic growth. Concerns about the near-term economic outlook should not deter Congress from

taking steps to strengthen our fiscal position over the next decade. Although major steps toward fiscal consolidation should not take effect in 2010 and 2011, Congress should begin to plan now for deficit reduction and debt stabilization in later years. That plan should include clear goals (e.g., a target trajectory for the debt-to-GDP ratio) and credible means for achieving them.

4. A credible plan to reduce future deficits would help keep long-term interest rates low, thus strengthening the current recovery.

5. In the long-term, bringing our deficits under control will require both spending restraint and increased revenues. Spending restraint should receive greater emphasis both because spending is the primary driver of our long-run budget imbalances and because higher government spending may slow economic growth. Given the government's existing commitments, however, it is unlikely that spending restraint alone can put our nation on a sustainable fiscal trajectory. As policymakers consider how to finance a larger government, they should therefore give special attention to relying on more efficient forms of taxation.

I elaborate each of these points below.

The economic outlook

Most analysts believe that the recession is behind us and that the United States will grow at a moderate pace over the next few years. The *Blue Chip* consensus of private forecasters sees 2.9% real GDP growth in 2010 and 3.1% growth in 2011, for example, while the Administration sees somewhat stronger growth of 3.0% and 4.3%. On the other hand, the Congressional Budget Office projects somewhat slower growth (2.1% and 2.4% in 2010 and 2011, respectively). These forecasts differ in their underlying assumptions—CBO's is based on current law, for example, while the Administration's is based on its policy proposals—but they reflect a general consensus that the economy is once again growing.

Some analysts believe that these forecasts are too pessimistic and that growth will pick up sharply in the next year or two. The primary basis for this view is the observation that sharp downturns have often been followed by sharp recoveries. That is certainly true, but I believe such optimism should be tempered for at least two reasons.

First, as Carmen Reinhart and Kenneth Rogoff have documented in detail, economies tend to rebound slowly from financial crises.[1] It takes time for the financial system to heal and for economies to make necessary structural adjustments (in our case, creating new jobs for workers who previously worked in housing construction and finance). As a result, this recovery is likely to be weaker than those that have followed purely cyclical downturns.

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[1] Carmen M. Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

Second, both households and financial institutions are only partway through the painful process of recognizing losses and deleveraging. According to some recent estimates, 11 million households—accounting for more than 20% of borrowers—are underwater on their mortgages. Unless house prices rebound sharply (highly unlikely) many of those homeowners will default, adding to the stock of foreclosed properties and eating away at the thin capital cushions of many banks. In addition, financial institutions will realize substantial losses as borrowers continue to default on commercial mortgages and leveraged loans. Although the worst of the financial crisis is behind us, there is still much pain to be recognized.

Uncertainty impedes growth

As Nobel Laureate Nils Bohr[2] once said, "Prediction is difficult, particularly if it's about the future." Businesses face that challenge every time they consider whether to invest in new equipment, develop new products, or move into new markets.

In making such decisions, businesses try to predict the uncertain, future returns on those efforts and compare them to their upfront investment costs. With that information in hand, they then have three options: to go ahead with the project, to kill it permanently, or to wait for further information before deciding.

The third option—waiting—is particularly attractive when a business faces significant uncertainty. An investment may be profitable under some future conditions, but unprofitable under others. Even if the firm thinks the investment might be profitable, it may make sense to wait to learn more about future conditions before incurring upfront investment costs. As a result, uncertainty discourages investment.

The same logic applies to hiring as well. Firms face significant fixed costs (e.g., training) when they bring a new employee on board. In other words, hiring a new employee is an investment. And, again, when uncertainty is high, firms have an incentive to delay hiring until they can be more confident that a new employee will generate enough value to cover the costs of hiring.[3]

The degree of uncertainty is thus an important consideration in thinking about the economic outlook. The good news is that economic uncertainty has fallen sharply over the past year. Great Depression 2.0 scenarios appear to be off the table and debate now focuses on the strength or weakness of the nascent recovery.

The bad news is that policy uncertainty remains high, for at least three reasons:

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[2] Not, as often thought, Yogi Berra.

[3] For a rigorous analysis of how uncertainty discourages investment and hiring, see Nicholas Bloom, "The Impact of Uncertainty Shocks," *Econometrica 77:* 3: 623-685, May 2009.

1. Our obsession with temporary tax provisions. Over the past decade, policymakers have enacted a series of temporary tax reductions, almost all of which are scheduled to expire in the next year or two. These include the individual income tax reductions enacted in 2001 and 2003, the "patch" on the alternative minimum tax, the Making Work Pay tax credit, the first-time homebuyer tax credit, the research and experimentation tax credit, expanded net operating loss carrybacks for firms, partial expensing of equipment investment, tax credits for ethanol-blended motor fuels, various preferences for international income, and on and on. And don't forget the estate tax, which blinked out of existence on January 1, but is scheduled to return in full force next year.[4]

   CBO estimates that the revenue impact of these provisions will amount to 2.7% of GDP in 2012; if all of them expired (as CBO assumes in its baseline) overall tax revenues would thus be boosted by about 17%. Of course, no one believes that all these provisions will expire. But businesses and individuals can't be sure which ones will continue and which not. Some allegedly permanent provisions may actually expire, while some allegedly temporary provisions may get extended.

   That violates almost every principle of good tax policy. And the resulting uncertainty encourages firms to wait-and-see before committing to investments (including new hires) whose economic viability could depend on future taxes.

2. The prominent exercise of government discretion during the financial crisis. The private sector does best when there are clear, well-enforced rules for it to follow. During the depths of the financial crisis, those rules were often superseded (or were perceived as superseded) by policymaker discretion. As a result, firms (primarily but not exclusively in the financial sector) now feel less certain about the rules-of-the-road in such crucial areas as the treatment of creditors in bankruptcy and government-mediated bankruptcy alternatives and the structure of compensation packages.

3. New policy initiatives. Congress has taken up an ambitious agenda over the past year, including proposed legislation to reform health insurance, address climate change, and modernize our system of financial regulation. These efforts would affect every business and family in America, sometimes substantially. But their outcomes remain highly uncertain.

Having worked at both ends of Pennsylvania Avenue through much of this period, I understand the economic and political circumstances that create such policy uncertainties. And I am certainly not suggesting that concerns about temporary uncertainty are a reason

[4] For a helpful overview of these expiring provisions see Box 4-1 (pp. 82-83) of Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010-2020, January 26, 2010.

for Congress to avoid important issues. (Indeed, if you take my advice, you would add one more item—serious deficit reduction—to your already-crowded agenda.)

Instead, my point is simpler: Policy uncertainty is a drag on the economy, and therefore there is value is eliminating unnecessary uncertainty wherever possible. As the financial crisis recedes, for example, policymakers should strive to reestablish clear rules-of-the-road so that companies can get on with their business without unnecessary doubts about how creditors will be treated or how employees can be compensated.

Similarly, when policymakers have reached agreement on particular policies, there is value in enacting them on a permanent basis. Doing so would eliminate needless, growth-reducing uncertainty and maximize the incentives created by the policy.

Unfortunately, our process often favors temporary policies, with all of their downsides. Consider, for example, the research and experimentation tax credit that the Congress extends every couple of years. This is absurd. If the tax credit is good policy, it should be enacted permanently, thus maximizing the incentive for innovation. If it is bad policy, then it should be killed permanently. Either way, firms that undertake research will face less uncertainty developing their plans, lobbyists can move onto other matters, and legislators can spend their time on more pressing issues.

Addressing our rising debt

Persistent deficits and rising debts pose a number of dangers to American prosperity including reduced economic growth, concerns about inflation, increased reliance on foreign creditors, and reduced flexibility for dealing with future crises.

For all those reasons (and more), it is essential that we place our nation on a sustainable fiscal path. In his recent budget, President Obama takes some steps in that direction, but his specific budget proposals fall far short of that goal. Under the President's budget, deficits would total more than $10 trillion over the next eleven years and would never fall below 3.6% of GDP. The publicly-held debt would more than double, rising from $7.5 trillion at the end of 2009 to $18.6 trillion at the end of 2020, and the debt-to-GDP ratio would rise to more than 77%.

Under the President's budget, the debt will grow faster than the economy in every year of the budget window. In my view, that would pose unnecessary risks to the U.S. economy.

To his credit, the President acknowledges this problem and makes a recommendation for how to deal with it: the creation of a fiscal commission. According to the budget, the fiscal commission would be tasked with:[5]

[5] See Table S-1, p. 146, Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011*, February 1, 2010.

> "[B]alancing the budget excluding interest payments on the debt by 2015. The result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers."

In addition, the commission would also be tasked with examining:

> "[P]olicies to meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government."

Despite the good intentions of many individual Members, Congress as a whole appears incapable of dealing realistically with our budget problems through its usual procedures. To make headway on this problem, policymakers should therefore consider special, *ad hoc* institutional structures—such as a fiscal commission—that may overcome the political impediments to action.

My preference would be for a statutory commission, passed by the Congress and signed into law by the President. Such a commission would have the greatest political legitimacy, and its recommendations could be guaranteed expedited attention in Congress.

If that proves impossible, a commission created by executive order, as the President suggests, may be a reasonable fallback. For it to have any hope of being effective, however, both the President and Congressional leaders should strive to ensure that (a) the membership is truly bipartisan (the best way to make difficult choices is to have both parties step off the cliff together), (b) every aspect of the budget is on the table, and (c) the commission's recommendations will get fair and expedited attention in Congress.

It remains to be seen whether the President's proposal will satisfy these procedural criteria. My primary concern with the proposal, however, is substantive: I believe that the commission should be tasked with more aggressive deficit and debt goals.

Under the President's proposal, the only specific target is primary budget balance in 2015 and beyond. In other words, incoming revenues would cover all spending except interest payments beginning in 2015. Under the President's budget assumptions, this would have the practical effect of capping the publicly-held debt at around 71-72% of GDP.

That's a step in the right direction, but it isn't enough. I would recommend that the commission also be tasked with lowering the debt-to-GDP ratio to a specific target by the end of the budget window. The Pew-Peterson Commission on Budget Reform recently recommended that lawmakers aim to lower the debt to 60% of GDP.[6] The Commission proposed that level as a target for 2018, but given the latest budget information, 2020

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[6] Peterson-Pew Commission on Budget Reform, *Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt*, December 2009.

would be reasonable. As the Commission notes, the 60% level has often been used by international organizations to determine whether nations have their finances under control. The Growth and Stability Pact of the European Union stipulates, for example, that member nations should keep their public debts below 60% of GDP. Many European nations have breached that threshold during the recession, but will try to regain it once their economies strengthen.

The near-term benefits of credible fiscal policy

As policymakers consider such steps to rein in long-term deficits, they should keep in mind that some of the economic benefits will begin much earlier. World financial markets would certainly welcome signs that the United States recognizes its budgetary challenges and is willing to take hard steps to address them. As result, those markets would reward the United States with lower long-term interest rates. In addition, some recent research suggests that near-term stimulus efforts will be more successful if they are paired with credible commitments to later fiscal restraint.[7]

Addressing spending and revenues

Given the magnitude of the commitments that we have made, it is unlikely that the government will be able to stabilize the debt purely through spending reductions (relative to their baselines). Revenue increases will almost certainly be required as well.

Nevertheless, spending reductions do deserve particular emphasis. Driven by an aging population and rising health-care costs, the government's biggest long-term financial obligations—Medicare, Medicaid, and Social Security—grow faster than the economy each year. As a result, they tend to worsen our future budget challenges. For that reason alone, these spending programs deserve special attention in efforts to get our fiscal house in order.

In addition, experience suggests that spending reductions tend to be more successful than tax increases in achieving sustained budget improvements. In a study of attempts at fiscal consolidation in developed economies from 1970 to 2007, for example, Alberto Alesina and Silvia Ardagna found that fiscal adjustments based on spending reductions were much more likely to result in sustained declines in deficits and debt-to-GDP ratios than were efforts based on tax increases.[8]

Finally, increased government spending will, all else equal, lead to slower economic growth.

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[7] Giancarlo Corsetti, Andre Meier, and Gernot Muller, "Fiscal Stimulus with Spending Reversals," International Monetary Fund Working Paper, May 2009.

[8] Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," October 2009.

The key to that final statement, of course, is the phrase "all else equal." Looking across nations, some researchers have found that countries with larger governments do not, in fact, suffer from weaker economic growth. As Peter Lindert has documented, the explanation of that seeming paradox is that countries with large amounts of government spending adopt other policies that minimize the extent to which government actions weaken the economy.[9] Most importantly, high-budget nations tend to adopt more efficient tax systems—with flatter rates and greater reliance on consumption taxes—than do countries with lower budgets.

If the United States decides to become a higher-budget country, policymakers should take heed of Lindert's findings. Our existing tax system is notoriously inefficient and will not scale well to higher revenue demands. Any efforts to increase tax revenues beyond their historical range should therefore be informed by three principles:

1. Taxes on income are usually worse for the economy than taxes on consumption. That is why one finds a rising chorus of economists recommending the introduction of a value-added tax, rather than higher income taxes, if our nation decides it wants to support substantially higher government spending.

2. High tax rates are worse for the economy than low rates; policymakers should therefore favor reforms that eliminate special exemptions and deductions, thus broadening the tax base and allowing for lower rates.

3. It is better to tax behaviors we want to discourage rather than those we want to encourage. Where appropriate, taxes on pollution, for instance, should thus be preferred over taxes on working, saving, or investing.

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

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[9] Peter H. Lindert, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century, Volume 1: The Story*, Cambridge University Press, 2004.