Testimony of Douglas Holtz-Eakin
United States Senate Committee on the Budget
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Chairman Conrad, Ranking Member Gregg, and distinguished Members of the Committee thank you for the privilege of appearing before the Committee today. The federal government faces daunting fiscal challenges, as the budgetary outlook is a threat to the very foundations of the U.S. economy and the tradition of leaving to the next generation a promise of prosperity that is greater then that which was inherited. In these circumstances, one can only hope that the business of this hearing – a discussion of "Bipartisan Process Proposals for Long-Term Fiscal Stability" – would translate quickly into actual legislation, Congressional passage, and a reversal of the trajectory upon which federal government finds itself.

The Problem

The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's *Long-Term Budget Outlook*. In broad terms, over the next 30 years, the inexorable dynamics of current law will raise federal outlays from about 20 percent of Gross Domestic Product (GDP) to anywhere from 30 to 40 percent of GDP. Any attempt to keep taxes at their post-war norm of 18 percent of GDP will generate an unmanageable federal debt spiral. In contrast, a strategy of ratcheting up taxes to match the federal spending appetite would be self-defeating and result in a crushing blow to economic growth.

The policy problem is that spending rises above any reasonable metric of taxation for the indefinite future. Period. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of large mandatory spending programs and the appetite for federal outlays, in general.

Just as some would mistakenly believe that we can easily "tax our way out" of this budgetary box there is an equally misguided notion in other quarters that we can "grow our way out." The pace of spending growth simply must be reduced.

This depiction of the federal budgetary future has been unchanged for a decade or more. The diagnosis and prescription have remained unchanged. The only thing missing has been action; well, at least action in the right direction.

Those were the good old days. Now the problem is dramatically worse and happens more quickly. The federal government ran a 2009 deficit of $1.4 trillion – the highest since World War II – as spending reached nearly 25 percent of GDP and receipts fell below 15 percent of GDP. In each case, the results are unlike those experienced in over 50 years.

Going forward, there is no relief in sight. Each year the federal budget is projected to be in enormous deficit. By 2019, according to the CBO's analysis of the President's budget, the deficit will be 5.7 percent of GDP, even though the economy will have long-since been projected to reach full employment and revenues will rise above the norm to reach 19 percent of GDP. The deficit will be roughly $1 trillion, of which about $800 billion will be devoted to servicing debt on previous borrowing.

In 2019, debt in the hands of the public will have doubled from its 2008 level to 82 percent of GDP and will be on an upward trajectory. Measured in nominal dollars, by 2008 our Republic had amassed a debt of $5.8 trillion. The debt is expected to double in three years and then relentlessly expand. In 10 years, it will be $17.1 trillion – over $50,000 per American.

In short, what used to be a problem that would take 30 years to mature is now upon us in the next decade. The diagnosis is the same – too much spending and too much debt – and the prescription is the same. But there is less time to waste.

The Risks

Deficits have economic consequences that impact both fairness and growth. At the most basic level, they force our children and grandchildren to pay the bill for our over-consumption. Often it is argued that it is "fair" to do so because the debt-financed spending confers a corresponding benefit to those generations, but the debts contemplated in the near future cannot pass any reasonable test of equity.

Federal deficits can crowd out domestic investment in physical capital, human capital, and technologies that increase potential GDP and the standard of living. Financing deficits may require net capital inflows that crowd out exports and harm our international competitiveness. We should worry about large borrowing from competitors like China limiting the United States' range of economic and diplomatic options.

In addition to these continued, corrosive effects of budget deficits, analysts have long worried about more dramatic fallout from the budgetary outlook. At what point do rating agencies downgrade the United States? When do lenders price additional risk and charge higher interest rates to federal borrowing, leading to a damaging spike in interest rates? How quickly will international investors flee the dollar for a new reserve currency? If so, how will the resulting higher interest rates, diminished dollar, higher inflation, and economic distress manifest itself? How quickly could such a tsunami of debt-related economic weakness arise? And when could it happen?

Since the basic outlook has been around for a quite some time, one explanation of why such events have yet to transpire is that the same financial market analysts who understand the weak state of the U.S. books also believe that they will be rectified before serious distress arrives. That is, they are counting on the U.S. to put its house in order.

If so, the marked deterioration in the next 10 years raises the urgency of action. Put bluntly, the U.S. is relying on the faith of others in its ability to undertake serious budgetary reforms, and time is getting short.

Viewed from this perspective, the policy uncertainties underlying the budget outlook increase in importance. The President's budget outlook for example, relies on over $600 billion in cap-and-trade auction revenues for which Congress has displayed little appetite. Similarly, it embeds $200 billion in new corporation tax receipts that media reports suggest are no longer a policy initiative. Finally, it pretends that spending and tax credits (Make Work Pay, etc.) that are already on the books from the stimulus package will sunset in two years. In each case, there are policy risks are toward bigger deficits that send the message to financial markets that deficits are not going to be dealt with; they are going to get bigger.

Perhaps the most vivid example of running the risk of sending the wrong message to international capital markets is the health reform legislation before Congress. As I wrote this testimony, the House passed its version of health care reform. This is a bad bill. While one might be tempted to write it off to a triumph of good intentions over good legislation, the House bill has too many transparent flaws to be defensible.

> (1) It does not bend the cost curve downward. As noted by the Congressional Budget Office, it does not reduce the pace of health care spending growth. Even worse, Administration actuary Richard Foster concludes that it bends the cost curve the opposite way; increasing the pace of national health care spending. In this way, the bill betrays the basic promise of health care reform: providing quality care at lower cost. No legislation should pass the Congress that does not meet this test.
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> (2) It is budgetarily dangerous. The bill sets up a new entitlement spending program that grows at 8 percent annually as far as the eye can see – faster than the economy will grow, faster than tax revenues will grow, and just as fast as the already-broken Medicare and Medicaid programs. It also creates a second new entitlement program – the CLASS Act.

> (3) It is budgetarily dishonest and uses every budget gimmick and trick in the book: leave out inconvenient spending, back-load spending to disguise the true scale, front-load taxes, let inflation push up tax revenues, promise spending cuts that have never materialized, ……. the list goes on.

If there really are savings to be found in the Medicare area, those savings should be dedicated to deficit reduction and making the trust fund solvent, not to financing huge new entitlement programs. Getting long-term budgets under control is hard enough now – the job will be near impossible with a slew of new entitlements in place.

For these reasons, the House-passed legislation is economically dangerous, and invites the acceleration of the risk of a debt crisis. It is a dramatic statement to financial markets that the Federal government does not understand that it must get its fiscal house in order. It is a statement that it is content to make things worse. For the Senate to echo this action would be a risky move at a dangerous time.

The obvious problem is that movement in the other direction is hard – lower spending and higher taxes – and requires sacrifice. Will it be worth it? There is no way to know for certain. However, if Congress *does* take action and it turns out that there was never a risk of being punished by international capital markets or otherwise suffering economic disruption, then all that will happen is that national saving will be higher, productivity and wages will grow, international competitiveness will be enhanced, and the federal budget will have maneuvering room in the event of a future crisis. If, on the other hand, it *does not* and these threats are real the Nation will be demonstrably weakened.

In thinking about these risks, it is useful to note that we are in an era unlike the past. While there have been nations whose debt approached or exceeded U.S. levels, it has never been in a situation in which nearly every part of the developed world faces a debt problem comparable (or worse) to that of the United States.

We simply have no experience with massive debt management on this global scale, raising the risks associated with inaction.

Options for Congressional Action

The most obvious option for addressing these actions has been for Congress in regular order to take up and pass legislation to reform Social Security, Medicare and Medicaid so as to slow their damaging outlay growth. Similarly, Congress could pass a comprehensive reform of our income and payroll tax systems that would generate revenue sufficient to fund its spending desires in a pro-growth and fair fashion.

I have long been an advocate for precisely this course, but have reluctantly concluded that I was wrong. There simply is not enough evidence that Congress has the incentives to undertake this crucial task, and the odds of success get lower as the stakes have gotten higher.

An alternative would be for an Administration to present plans of this sort to Congress. Putting aside the problem of getting a Congress to then act, I am equally reluctantly convinced that the most likely incentives lead in the other direction.

As a matter of elimination, then, I am led to structures that supplement the regular Administration and Congressional budget cycles with proposals from commission-like structures or task forces and expedited and restricted rules for consideration of their recommendations.

Aspects of Structuring a Task Force or Commission

There are many aspects of structuring such an approach. I will touch only upon a few that I consider to be the most important.

The first is membership, in particular experts versus Members of Congress. The Commission should be composed of Members. I believe this important in a representative democracy. Using alternative procedures should not replace the fundamental obligation of our elected officials to carry out the duty of their offices. Nor should it permit the unelected to carry undue weight in the formulation of the laws of the United States.

Some will argue for the importance of having experts on the commission. Congress has no lack of access to experts, and neither would a commission. It could have expert staff, hearings, and research reports. But experts simply do not carry the weight of responsibility, experience, or electoral approval of Members.

Similarly, some will argue that the Administration should be represented in the membership of a commission. This is a tougher call, but on balance I think that it should be restricted to Congress. A commission is in effect an alternative set of procedures for the development, consideration, and passage of legislation. That is the role of Congress. An Administration will doubtless advise and advocate as part of shaping the outcome, but it need not be a member of the commission to do so. Of course, the President can always veto any commission-produced legislation.

The second key aspect is that the commission and its rules of deliberation must be bipartisan. In order to be successful, the public has to perceive the commission as bipartisan and fair. This principle should apply to both comprehensive membership decisions and the rules governing approval of recommendations. There will likely be dissenters from whatever proposals a commission ultimately reports. But there should be a sufficient number – a majority of both the majority and minority – of supporters from both sides so that the recommendations themselves are perceived as bipartisan.

The third consideration is the scope of any such commission. Here I perceive a fundamental tradeoff. The broader the scope of such a commission (Social Security, Medicare and Medicaid, and tax reform) the greater the ability to really solve the policy problem and incorporate the broad set of tradeoffs among interest groups, programs, and timing. However, the greater the scope, the more it substitutes for Congress instead of providing a supplementary set of legislative procedures. For this reason, it is more likely that the Congress as a whole will seek to modify the proposals (if permitted, see below) or turn them down.

In contrast, having one or more targeted commissions provides more manageable recommendations but makes it more difficult to coordinate their activities to produce a coherent solution. My instinct suggests that more targeted efforts are preferable as less-coordinated action is preferable to stasis, but the argument is far from clear-cut.

The final aspect concerns the rules for consideration of commission recommendations. I believe that the recommendations themselves should take the form of legislative language so as to avoid any confusion regarding what the commission is recommending. I also believe that these recommendations should be given expedited consideration for an up-or-down vote in the House and Senate by simple majority. The goal should be to improve the odds of action and diminish the opportunity for procedural legerdemain by any interest to trump a bipartisan proposal of the commission.

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