Senate Democratic Policy Committee Hearing

"Do Deficits Matter?
The Impact of Long-Term Deficits on Economic Growth and Job Creation"

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Mr. Chairman, members of the Committee, thank you for this opportunity to present the views of the Committee for Economic Development on the federal budget deficit, its potential impact on the nation's economic future, and the possible impact on the private sector.

CED was founded in 1942 by a group of business leaders and academics who were concerned about the postwar economy. Our founding Trustees were deeply worried about the ability of the U.S. economy to evolve from a wartime to a peacetime footing without experiencing another major recession or depression. They were also concerned about the strength of various postwar international institutions and began galvanizing business community support for what became the Bretton Woods system, the International Monetary Fund, the World Bank, and the Marshall Plan. One of our founders, Paul Hoffman, then the CEO of Studebaker, became the first administrator of the Marshall Plan.

For more than 60 years, CED has been the voice of the American business community in supporting sound economic and fiscal policy. We now have some 200 Trustees – Democrats, Republicans, and Independents – on our board. Most of them are senior corporate executives and presidents of some of this country's greatest colleges and universities. Our policy work, which ranges from campaign finance reform and education reform to global trade and macroeconomic policy, is strictly nonpartisan. We begin each of our projects with no ideological axe to grind and no political leanings. Each year our Trustees decide the issues we study, and it is the CED Trustees who actually determine our findings and recommendations.

Our mission has been to propose policies that ensure steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all. In short, I think of CED as representing the best of business thinking in the nation's interest.

It was with that background that several of our Trustees became increasingly worried in late 2002 by the reemergence of what appeared to be a serious, long-term structural federal budget deficit. Throughout CED's history, our Trustees have consistently believed that the U.S. economy will be strongest if, over the long run, it enjoys a modest budget surplus. A surplus will help ensure the necessary capital to fund investment that is essential to both economic productivity and growth. While budget deficits are not inherently a problem if they are employed to generate a short-term macroeconomic stimulus, they will undermine economic growth and productivity if they become too large and last too long.

The United States entered the 21st century with a substantial budget surplus for the first time in many years. As recently as three years ago, the projected budget surplus was $5.6 trillion between 2002 and 2011. By late 2002, the surplus had vanished – all of it. Instead, we were suddenly facing major federal budget deficits during that same period of roughly $500 billion per year for a total of $4.4 trillion. This was a remarkable and unprecedented turnaround of some $10 trillion – in less than 32 months.

In late 2002, CED's Trustees decided to establish a "Subcommittee on the Budget, Demographics and Economic Growth," and in March 2003, CED released the subcommittee's report which was entitled Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America. We released this report at the National Press Club with participation from the Concord Coalition.[1] At that press conference, former Commerce Secretary Pete Peterson, the founder of the Concord Coalition and CED's longest-serving Trustee, said that "[w]hat we are objecting to are not temporary deficits, but, rather, long-term or permanent deficits, which we are now confronting." While our report noted that the recession explained much of the immediate deterioration in the federal budget deficit (i.e., the collapse of revenues from the "bubble economy" of the 1990s), the emerging structural deficit also reflected more recent decisions by the President and the Congress concerning taxation and spending policies. We updated the March 2003 report in September 2003 at a joint event with the Center on Budget and Policy Priorities and the Concord Coalition.

We were deeply concerned that these new deficits – unlike those which emerged in the early 1980s – posed an even greater economic threat to the country because of the nation's current demographic profile: the aging of the U.S. population vastly compounds the problem. The "baby boom" generation is now but one presidential election cycle away from retirement. We also have a relatively low fertility rate which will mean an economy with many more retirees and proportionately far fewer workers. The growing demands of our aging population for health services will therefore expand dramatically and entail escalating costs, and the result will be less public and private national saving and fewer resources available for economic growth.

As CED warned last March, we face a situation eventually where, for the first time in our history, Americans may be less well off than their predecessors.

Our March 2003 report listed five principles that, in our view, should guide federal budget policy and ten policy recommendations.

The principles were:

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[1] See David Broder, "The CEOs' Dim View of Deficits," The Washington Post, March 5, 2003, at A21, Col. 1.

1. Any tenable budget program must address the budget deficit on every front, including both comprehensive spending reductions and alternative or additional revenues.

2. Do no harm.

3. Make long-term budgetary balance and economic growth explicit policy goals.

4. Give pro-growth policies higher priority.

5. Distribute the costs of pro-growth policies equitably.

The policy recommendations were:

1. CED strongly opposes any short-term stimulus program that is not combined with a plan to restore longer-term budget balance.

2. CED believes it is urgent to implement a disciplined budget process that can address the long-term fiscal issues that face us.

3. CED calls on the President and Congress to establish a goal of balancing the budget (or producing a surplus) excluding the “off-budget” Social Security accounts over a rolling five-year horizon.

4. CED reiterates its proposal to restructure Social Security into a two-tier system.

5. CED reiterates its earlier recommendation that the federal government restructure the Medicare program along the lines of the Federal Employee Health Benefit Program.

6. CED believes that, whatever the level of spending, the defense and security budgets must be cost-effective and focused sharply on our new national security situation. We urge the Administration and the Congress to rapidly establish national defense priorities and program reforms to accomplish this.

7. CED recommends that we reduce the growth of non-security discretionary spending below its historical level and far below the 9 percent annual growth of the past three years.

8. CED believes that education reform is too important to be allowed to fail; the federal government, which has mandated a national effort, is obligated to assist the states in making it work.

9. CED once again urges the Administration and Congress to make basic research a high priority in the federal budget.

10. CED believes it is extremely unlikely that the long-term budget problem can be solved without additional revenues. We therefore urge the Administration and Congress to forego at this time any additional tax reductions (including the permanent extension of The Economic Growth and Tax Relief Reconciliation Act) that would further reduce long-term revenues.

My colleagues on the panel today have given you a detailed description of how we arrived at the current structural budget deficit. Since CED is essentially a business-led public policy organization, I would now like to explain the implications for the private sector of these sustained deficits if this situation is not addressed.

One view, of course, is that we should just sit back, relax, and not worry about the federal budget deficit: with continued economic growth exceeding 3 percent annually and perhaps some modest spending restraint or spending cuts, we'll ultimately grow our way out of this problem in a few years. That is unlikely to occur for several reasons. Sustaining such a relatively high growth rate over ten years is unlikely. Moreover, putting entitlement programs, Defense and Homeland Security spending off the table, there simply isn't enough domestic discretionary spending left that can practically be reduced to yield large savings. Finally, we estimated last March that on the basis of a long-term growth model, total factor productivity would have to be 50% higher than projected to balance the budget by 2050 (assuming revenues remain the same share of GDP while other expenditures grow at baseline). Such a scenario is virtually impossible.

The projections of the Center on Budget and Policy Priorities, the Concord Coalition, and CED suggest that with structural deficits running at 3.5 % of gross domestic product annually between now and 2013, in order to balance the budget in 2013, we would have to raise income taxes by 27% or cut everything other than Social Security, Medicare, Defense, and Homeland Security by 40%. Politically and practically this approach is unrealistic.

If we fail to take action on the deficit now, that 3.5% share of GDP rises to 6.2% in 2020; 12.3% in 2030; and to 21.1% in 2040. Today, government debt is 37% of our economy. Again, without action now, that figure reaches 69% in 2020, and 250% in 2040.

For the last few years, we have enjoyed remarkably low interest rates, in large part due to an accommodative policy by the Federal Reserve Board to ensure that the last recession was as short and shallow as possible. Those low interest rates were also made possible by the restoration of sound fiscal management and deficit reduction in the 1990s that led to the first budget surpluses in nearly 30 years. The combined effect of the lowest interest rates in 40 years, the fiscal stimulus of the three Bush tax cuts, and the normal process of cyclical recovery has been to jolt the economy back into activity at unprecedented rates: 8.2% growth in the third quarter of 2003. Employment is still lagging in this recovery – an effect of our extraordinarily rapid and ultimately beneficial productivity growth. But strong economic growth will remedy this situation in due course.

There can be no doubt that as stronger economic growth kicks in, the demand for capital by the private sector will increase, and interest rates will begin to rise. This effect will lead to a "crowding out" phenomenon by which government's need to borrow funds to finance the deficit will compete with private sector needs for capital. The growth of our overall capital stock will be reduced which, in turn, will lower productivity growth. At some point in the future, American workers will experience lower real wages and incomes. Of course, what we saw in the mid-to-late 1990s was the precise reverse: as the prior deficit shrank and a surplus ultimately emerged, the amount of savings available to the private sector grew and was accompanied by a significant drop in interest rates and booming investment.

What are the other practical implications of a structural budget deficit equal to 3.5 percent of GDP?

As we continue with our reckless gamble of lost fiscal discipline, there is also some danger that we will see a negative impact on both consumer and business confidence. To date, that has not occurred, in large part because the economic recovery is young and strong. However, should we continue a situation of annual budget deficits of $500 billion coupled with a record current account trade deficit exceeding 5% of GDP and requiring the annual importation of $500 to $600 billion in foreign capital, we may find both domestic financial markets and international currency markets concluding that our government lacks the political will to restore fiscal discipline and that it might resort to inflation as a way out of the problem. Other consequences could include: a rise in household and corporate borrowing rates, an increase in interest payments on the national debt, a loss in investor confidence, a shift out of dollar-based assets, and a fall in stock prices and national wealth. If this scenario emerges, then higher interest rates are a foregone conclusion, most dangerously as part of a crisis scenario.

The U.S. economy in 2004 is far more subject to globalization than it was during the deficit period of the 1980s. We continue to run a sizeable international trade deficit in addition to the Federal budget deficit, and the U.S. dollar has already lost 14% of its value on a trade-related basis since the start of 2002, not to mention a much steeper decline against the Euro. A loss of confidence in our political leadership or in the U.S. dollar would have an immediate impact on exchange rates. And while it is true that the U.S. dollar functions as an international reserve currency, there may well be limits as to how long foreign countries and foreign investors are willing to accumulate U.S. dollars in their reserves. Moreover, we should not be blind to the possibility that a strengthening Euro or a strengthening Japanese yen could provide, at some point, noticeable competition to the U.S. dollar as a reserve currency. In addition, we will need to service the foreign debt generated by our huge current account trade deficit, which means a reduction in goods and services available to the American people.

There is an additional negative consequence to large Federal budget deficits: they have the effect of crowding out other public expenditures which could have positive benefits for the private sector. Federal government investments in areas such as basic research, transportation, and education -- perhaps even manned space exploration to the Moon or Mars -- are areas where government investment can also be a net plus for the American private sector.

It is estimated that spending on health and retirement entitlements (mainly Social Security, Medicare, and Medicaid) will rise to some 9 percent of GDP in fiscal year 2010, and to almost 18 percent of GDP in fiscal year 2050. These demographic possibilities demand that our political leadership in both parties begin to restore a balanced budget and sound fiscal management. We are simply running out of time to restore fiscal discipline before these demographic realities arrive.

The U.S. government is, to some extent, like an individual or a household: neither can continue indefinitely to have its debt rise at a rate faster than its income growth. Exploding deficits today – particularly during a period when we are about to experience a retirement boom, the likelihood of continuing sharp increases in health care expenditures, and a slow-down in the growth of our workforce which additional immigration cannot reverse – pose a grave risk to our economic well-being in ways that have never been experienced before.

Last fall, Treasury Secretary John Snow at the Conference Board's annual dinner in New York stated that "deficits do matter." As a business leader who has long experience with our market economy, the Secretary knows that the current situation is unsustainable. He also knows that loss of confidence in the government's ability to address this issue coupled with loss of confidence abroad in our currency can raise the dangers of economic crisis.

On this subject, let me commend to you a recent paper by former Treasury Secretary Robert Rubin, Peter Orszag at the Brookings Institution, and Allen Sinai of Decision Economics, Inc. The paper was presented earlier this month at the American Economics Association meeting and is entitled "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray." The authors state at the outset that "[s]ubstantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad." The fact that we have not yet seen a sharp jump in interest rates should provide us little comfort, for such an increase surely awaits us if we fail to get our fiscal house in order.

The authors cite a 1995 paper by Laurence Ball and Gregory Mankiw entitled, "What Do Budget Deficits Do?" Here is what Messrs. Ball and Mankiw said: "We can only guess what level of debt will trigger a shift in investor confidence, and about the nature and severity of the effects. Despite the vagueness of fears about hard landings, these fears may be the most important reason for seeking to reduce budget deficits…as countries increase their debt, they wander into unfamiliar territory in which hard landings may lurk. If policymakers are prudent, they will not take the chance of learning what hard landings in G-7 countries are really like."[2] Mr. Mankiw now serves as the Chairman of President Bush's White House Council of Economic Advisers.

Other economists such as Martin Feldstein have noted that it is essential to look at expected future deficits in studying the connection between deficits and interest rates, and as Messrs. Rubin et al. note, it is possible during economic downturns that financial markets do not focus on long-term fiscal issues. If this is the case, the effect of the fiscal deterioration on long-term interest rates will manifest itself only as the economy recovers and the demand for capital strengthens. Their conclusion is that it is not possible to dismiss the potential effect of deficits on interest rates merely by pointing to current market interest rates. It is essential to take expected future deficits into account in examining the linkages between deficits and interest rates. They note that "[s]tudies that incorporate deficit expectations tend to find significant connections between deficits and interest rates."

Even the Congressional Budget Office acknowledged last year that substantial federal budget deficits could produce an economic crisis in which overseas investors stopped buying our

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[2] Ball, Laurence and N. Gregory Mankiw, 1995. "What Do Budget Deficits Do?" In Budget Deficits and Debt: Issues and Options, Kansas City: Federal Reserve Bank of Kansas City, 95-119, at 117.

equities, the dollar would plummet, and interest rates and consumer prices would spike as part of an overall economic contraction. Additionally, there would be adverse implications for equity values and consumption, and these problems could well extend to the rest of the world.[3]

There are no doubt many people who question whether anybody really cares about deficits. Some skeptics believe that those who worry about long-term structural budget deficits are just budget nags and budget scolds. I would submit to you that the American people know better. A poll taken last fall by *USA Today* and Gallup indicated in the context of 2004 campaign issues that 39 percent of those polled said that the candidates' positions on the Federal budget deficit will be extremely important in influencing the vote for President; 35 percent said they will be very important; and 23 percent said they will be somewhat important. If my numbers are correct, that adds up to 97 percent of people polled who actually care about this issue.

I sincerely hope that the issue of the structural budget deficit, our fiscal priorities, and the related demographic challenges we face as a nation become the centerpiece of the debate in this year's Presidential election. All of the candidates owe the American people explanations as to how they would address the current fiscal imbalance. What mix of spending cuts, revenue increases, and budget-process reforms would they propose to solve this issue to prevent a crisis and the adverse impact it would have on domestic markets and international markets?

I must also say, quite honestly, that our track record in this respect is not terribly promising. Last week, speaking at the Brookings Institution, former Treasury Secretary Rubin recognized the importance of establishing a political coalition or consensus that will support the necessary fiscal discipline. Every Member of Congress shares a responsibility to put national interests ahead of political self-interest and to work to establish such a consensus. Far too often the skeptics win, and by that I mean our leaders look the other way as current adverse trends continue through yet another two-year or four-year election cycle. After all, these are somebody else's problems and some future generation can always pay for it later.

Former OMB Director David Stockman, the first Cabinet Secretary under whom I was privileged to serve in government, referred ironically to this tendency as "the triumph of politics." But it is also the precise opposite: it is the failure of politics, the failure to act and to do what is necessary now to preserve our current economic well-being and to ensure a sound economic future for succeeding generations. You and your colleagues in both Chambers and both parties, together with the Administration, can change this situation and avoid a crisis. This is why you are in Congress, and the American people expect no less from you.

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[3] Congressional Budget Office, 2003b. "The Long-Term Budget Outlook." December at 15.