The Nation's Fiscal and Economic Health

Chairman Baucus, Ranking Member Hatch, members of the Committee, thank you for inviting me to testify today on our nation's fiscal and economic health.

In the past few weeks your jobs have been consumed by the twin tasks of addressing the unsustainable long term budget position of the nation while allowing the legally allowable debt level for Federal debt to increase. While media attention has focused on the latter goal of raising the debt ceiling, in the long term getting control of the fiscal situation is actually more important. At this point, it appears to me that Congress and the Administration have not taken this latter goal as seriously as they should and I believe that the bond market will exact a price for this inaction.

In fact, while much has been made about the risks of a credit downgrade from the rating agencies for failing to raise the debt ceiling, surprisingly little attention has been paid to what the rating agencies said about the failure to cut long term spending and deficits. When S&P warned that it might downgrade U.S. debt back on July 15th, their main justification was NOT the debt ceiling but, "if we conclude that Congress and the Administration have not achieved a credible solution to the rising U.S. government debt burden and are not likely to achieve one in the foreseeable future."

Let me clear. Passing a so-called "clean" debt ceiling increase is not and never has been a means to preserve our credit rating over the long term; nor is simply passing some short term spending cuts or simply raising taxes. The American budget is burdened with long term structural problems in our entitlement programs causing them to perpetually grow faster than

GDP. This is not just a political problem, it is a mathematical problem which must be addressed if we are to put America on a sound fiscal footing.

My concern about the failure to take this opportunity to significantly cut long term government spending is amplified by a belief that official deficit projections are far too optimistic. First, these deficit projections are predicated on an overly optimistic expectation for economic growth. For example, the President's budget projected growth of 3.1 percent this year, 4 percent in 2012, 4.5 percent in 2013, and 4.2 percent in 2014. We know that growth in the first half of the year was roughly 1 ½ percentage points less than what the President's budget projected. Moreover, there is an academic consensus that growth after a financial crisis tends to be at trend, not well in excess of trend.

The budgetary consequences of overestimating growth are dramatic. The President's own budget estimates that missing growth by one point in one year increases the ten-year deficit by $750 billion. Thus, just the six month shortfall that has already occurred during the first half of this year means an increase in the 10-year deficit of a bit over $500 billion. If the economy rebounds to a trend rate of growth of 2 ½ percent starting in the current quarter, the cumulative shortfall in GDP through the end of 2014 would be 5 ½ percentage points implying a ten-year increase in the national debt that would be more than $4 trillion higher than what is now projected. In short, even the budgetary gains that would have resulted from the so-called "Grand Bargain" being discussed would be eliminated by having the economy growing at trend rather than what was projected.

Second, federal borrowing costs are now well below historic norms. In the last 20 years these costs have averaged 5.7 percent. Currently they are just 2.5 percent. This means that a mere normalization of borrowing costs would mean an extra $700 billion per year by the end of the current decade, and even a gradual ramp up to normalized rates would add $4.9 trillion to the Treasury's interest costs over the next decade relative to maintaining current rates. I might add that the CBO does have a more modest ramp-up in rates that accounts for about half of this in its long term projections.

But the real concern here should not be a gradual normalization of rates. The recent lessons from Europe or the many lessons of history from previous sovereign debt crises indicate that government bond markets function smoothly for a long period of time and then suddenly crash. This has two implications for the budgetary risks we face: (1) rates might ultimately move well beyond the "normalized" average of the last two decades; and (2) that move is likely to happen much sooner and much more quickly than either we or the CBO now project.

The two risks just mentioned, which I would call the growth risk and the interest rate risk, place tremendous constraints on the prudent conduct of fiscal policy. It is urgent that we undertake significant long term deficit reduction and it is equally urgent that we do so in a way that minimizes any adverse consequences for economic growth. But these constraints also provide clear guideposts for what Congress should do.

First, the focus should be primarily on long term expenditure reductions not short run cuts. There is a demand-side element to growth which must be respected. This doesn't mean no cuts in current expenditures, but near-term spending cuts should probably be limited to perhaps half-a-percent of GDP in the next fiscal year with much larger spending cuts to follow. T his is precisely why long term reform to entitlement spending that sharply reduces total spending over many decades is so crucial. It has little or no long term impact on growth, and by freeing up resources over the long term probably enhances our long term growth prospects. Gradually increasing the age of eligibility for entitlement programs, gradually adjusting benefit formulas, and increasing the flexibility states have to control costs in programs like Medicaid will all significantly improve the balance sheet of the Federal Government with little or no impact on economic growth. It is this improvement in the balance sheet that will encourage bond investors that they will be repaid the principal they invest in government securities.

Second, the focus of both budgetary and regulatory actions should be on cost-benefit analysis. There has been a lot of talk about government "investment". The key is not whether one can rhetorically call a spending action an "investment" but whether the action taken produces a positive rate of return for the economy. Consider high-speed rail. I regularly ride the Acela between New York and Washington and therefore am a beneficiary of the government's subsidies of Amtrak. But Amtrak barely makes money on its Northeast Corridor routes, which is the most economically promising market for rail transportation in the country. Money spent on extending high-speed rail to 80 percent of the nation's population will produce a negative rate of return, making it as much of an investment as putting one's money in Bernie Madoff's hedge fund. Congress must use its oversight powers to force spending to be cost-effective and to force the various regulatory agencies to enact only those regulations that support economic growth and provide a positive rate of return for the economy.

Third, this analysis can be extended to the tax side of the budget. Fiscal sustainability is much more difficult to achieve with tax increases than with long term expenditure cuts because, as a general rule, the private sector allocates resources in a manner that yields a higher return than does the public sector. If the private sector does not allocate money that produces a positive return the firm or individual who makes that investment loses their own money. This not only tends to concentrate the mind, it also reduces the resources available to those firms that make poor economic decisions. By contrast, the political process does not have economic maximization as its objective, but getting a majority of votes.

This does not necessarily mean that higher revenues should not be part of the equation. But the key point to make is that the phrase should be "revenues" not "rates". Some revenue increases can actually improve economic allocation by removing subsidies to inefficient activities. But tax rates work in the opposite direction; higher rates muffle market signals and reduce economic efficiency. This fact was recognized by the President's Debt Commission which *reduced* rates while still increasing revenue.

In sum, Mr. Chairman, the need for long term deficit reduction is urgent and has been neglected. We are taking enormous risks with our country's future as a consequence. Such reduction must focus on the long term expenditure side of the equation, particularly entitlements. And while both discretionary spending and extra revenue might be part of the solution, decisions on these issues must face a rigorous cost benefit test. Thank you, and I would be happy to answer your questions.