Addressing the Nation's Contradictory Fiscal Challenges

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Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you the challenges posed by the nation's fiscal situation.

It is well understood that we face two serious problems, the remedies for which are diametrically opposed. First, there is the immediate or short-run problem, which is the economic recession whose roots are to be found in the bursting of the housing bubble, the excesses of mortgage markets, and the implosion of the financial sector related to excessive risk taking. This recession, which is the first to occur since the world's economies have become highly interdependent and digitally connected, could well be the deepest, longest and most widespread since the Great Depression. To combat this serious downturn, we must stabilize housing markets, shore up the balance sheets of financial institutions as their regulatory oversight is strengthened, and stimulate aggregate demand. This will require tax cuts and spending increases of an unprecedented magnitude, which in turn will lead to higher deficits and a significant expansion of the debt held by the public.

Second, there is the long-run fiscal sustainability problem. Even before the current recession

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began, the nation was careening down a fiscally unsustainable path. Promises, primarily those related to entitlement programs in general and health-related entitlements in particular, were projected to push spending up far faster than current-policy revenues. Before the middle of the next decade, deficits relative to GDP were projected to begin rising to levels that we have not experienced in non-recessionary periods of peace. Over the course of the following decade, as the retirement of the baby boom generation got into full swing, the imbalance associated with a continuation of current policy would have raised the risk of economic instability to unacceptable levels. Spending restraint, health care reform and judicious increases in taxes represent the prescription for addressing the long-run fiscal imbalance.

The current economic crisis should serve as a wake up call, reminding us of the risks we run when we seek to live beyond our means and delay the hard choices and reforms that we all know are unavoidable. Unfortunately, the downturn has also shortened the window of time we have to address the long-term imbalance. The Congressional Budget Office has estimated that, even without further legislation, the deficit for the current fiscal year will be about $1.2 trillion or over 8 percent of GDP and the debt to GDP ratio will rise from 40.8 percent to 50.5 percent. With stimulus of the magnitude being discussed by the Administration and Congressional leaders and other high priority initiatives, the FY 2009 deficit could approach $2 trillion or about 14 percent of GDP and the debt to GDP ratio could top 55 percent. When he testified before this Committee, OMB Director Peter Orszag warned that deficits of about 5 percent of GDP could continue for the next five to ten years. Were this to occur, the debt to GDP ratio at the end of FY 2019 could exceed any we have experienced in over half a century. In short, the consequences of the current economic downturn are likely to be equivalent to about five to ten years of policy procrastination in addressing our long-term problems.

There is little debate over the primacy of doing everything possible to forestall a further collapse of the economy and mitigate the hardship imposed by the downturn on families, communities and businesses. Furthermore, there is broad bipartisan acceptance of the need to adopt measures that will put us on a fiscally sustainable path. The debate will be over how these two very different prescriptions should be joined.

Some will argue that we should deal with these problems sequentially—address the short-run problem first and then, when it is well in hand, turn to the sustainability challenge. One reason to follow this approach is that if the economy does not recover it would be both undesirable and counterproductive to take the steps needed to bring spending and revenues into line for the long run. A second argument is that measures needed to put the budget on a more sustainable long-run path could reduce the effectiveness of whatever short-run simulative policies we enact. For example, a higher fraction of any tax cut might be saved in anticipation of tax hikes scheduled in the future. Furthermore, businesses might be reluctant to expand capacity knowing that a period of fiscal restraint lies ahead. What is needed, the argument goes, is a single, clear message from public officials that their full attention and efforts are directed at economic recovery. Thirdly, there is great uncertainty about not only when the economy will be in the midst of a strong recovery but also what the new economy will look like. The housing, automobile, state and local government and financial sectors might look quite different than they did in 2007 and that should affect our views of how fiscal restraint should be meted out.

Strong as these considerations are, I would urge you to take actions to deal with the two problems concurrently. There are at least three good reasons for following this approach. First and foremost, we need to instill confidence in our prospective lenders that we understand that changes must be made in our long run fiscal policy. The credit market turbulence of the past six month should convince every one of the importance of confidence, the suddenness with which it can be lost, and the difficulty in regaining it once lost.

In recent years, we have depended heavily on the willingness of foreigners to buy Treasury securities. In fact, between December 2000 and September 2008, 74 percent of the $2.5 trillion net increase in privately held Treasury securities was purchased by foreign and international interests. Looking forward, we have to ask whether these interests will be both willing and able not just to repeat their recent participation but to double or triple their effort, which the size of our projected deficits suggests will be necessary.

Some of the factors that explain why foreigners have been willing to invest huge sums in dollar denominated assets in the recent past have weakened. For example, with oil closer to $40 a barrel than to $140 a barrel, some oil exporters no longer have large dollar surpluses to invest. The trade surpluses of the Asian exporting nations have diminished as the recession has slashed demand for their products. Furthermore, as their own economies have weakened, they have begun to use more of their available resources for domestic stimulus. Finally, a portion of the huge gains made from trading in financial instruments, real estate and equities sought the security of Treasuries; those profits are no more.

Prospective purchasers of our debt instruments will be looking for some assurance that we will address, in a serious fashion, our long-run fiscal imbalance and that they won't face either excessive inflation or exchange rate risks. It would be best to act to provide such assurance as we are asking for their increased participation so that we can avoid any risk premium on the interest rates we will pay. While Treasury borrowing rates have been at historic lows, this situation will not last. The flight of capital to safety and security, which explains these low rates, will reverse when economies around the world begin to bottom out and turn around.

A second reason to take action now to put the long run budget on a more sustainable path is that it may be more politically viable to enact future restraint at a time when significant amounts of more immediate pleasure is being allocated.

The third reason for acting concurrently to address the short and long run problems is that this appears to be a very rare and propitious moment to seek sacrifice for the common good. In a nation that has elections every two years, there is never a good time to impose restraint. There will always be a reason to delay. The stimulus package and other measures enacted to invigorate the economy are likely to whet the appetites of recipient interests. No matter how temporary we say the new spending or tax relief will be, affected interests will argue, often correctly, that it has met only a fraction of unmet need that has developed over the past decade. They will say that the positive impact of the stimulus will be negated if the spending level is not sustained. The new President's commitment to addressing the long run problem, the public's acceptance of his call to act responsibly and the mood of bipartisan cooperation that may be emerging on Capitol Hill combine to make this one of those very opportunities to tackle the difficult problem of fiscal sustainability.

Concurrently enacting measures that address both of the nation's fiscal challenges does not mean that the restraint needed to put the budget on a more sustainable long-run path should be imposed in the near term. That would be foolhardy given the current state of the economy and the forecasts for the next year or two. Rather, what is called for is the adoption of measures that significantly raise the likelihood that fiscal restraint will occur when the current economic crisis abates.

There exists a wide range of measures that vary in the assurance they provide that could constitute serious effort: At one end of the spectrum are promises, solemn commitments and pledges to submit budgets or pass budget resolutions in the future that will exhibit fiscal discipline. Threats to veto fiscally irresponsible legislation and disembodied deficit targets, such as those promulgated under the Gramm-Rudman-Hollings legislation, fall into this food group as well. We have had many such commitments in the recent past. They tend to be forgotten, evaded, or reinterpreted and, therefore, offer little credible assurance of change.

At a second level are changes in the budget process. I, like many others, endorse proposals to reinstate statutory discretionary spending caps and PAYGO but we must remember that these tools are designed to reinforce spending and tax restraint that has already been enacted. They are designed to keep the fiscal situation from getting worse not to make it better. Biennial budgets and joint budget resolutions are more likely to offer opportunities for delay and conflict than to be vehicles that ensure that tough decisions are made.

Summits, bipartisan task forces, and base closing commission type entities can serve as effective mechanisms for defining politically viable packages of spending cuts and revenue enhancements when the will to act is present or action is unavoidable. To be effective, however, they must be accompanied by strict timetables and iron clad procedural requirements that the Congress vote up or down on the package.

The high degree of assurance that creditors will be looking for that we will deal with our long-run fiscal problem probably can only be provided by substantive legislation that will reduce the growth of spending or raises revenues in the future. Such legislation need not require a large dose of sacrifice at any point in time. Small incremental changes made over long periods of time can have significant impacts on the budget's long-term sustainability and be politically palatable. The poster child for this approach is the increase from 65 to 67 in the age of normal retirement, which was part of the 1983 legislation to strengthen Social Security. It first affected those turning 62 in 2000, 17 years after its enactment, and there was hardly a peep from those whose benefits were reduced. It will be fully phased-in for the 62-year-old cohort in 2022.

If Congress wanted to send a clear signal that it was committed to putting the budget on a more fiscally sustainable path it could enact legislation that called for using a more accurate measure of inflation to index both entitlement benefits and the parameters of the tax code starting several years from now. Additionally, it could index the normal age of retirement in Social Security and the age of Medicare eligibility to increases in adult life expectancy.

Such measures alone would be far from sufficient to solve the long-run budget challenge. Nor are they necessarily the most desirable way to bring our spending more in line with our resources. But they are simple, widespread in impact, and very gradual in effect. Furthermore, they would send a strong message to our creditors about our commitment to long-run fiscal responsibility. While some may want to craft a larger and more appropriate package of measures, that task may prove to be very difficult given the demands that the current economic crisis will place on policymakers. Should such a package emerge from the 111th Congress, it would be easy to reverse the indexing legislation.