Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

January 21, 2010

TESTIMONY OF ROBERT GREENSTEIN
EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES
before the
HOUSE BUDGET COMMITTEE

Hearing Titled: Perspectives on Long-Term Deficits

Mr. Chairman, Congressman Ryan, and members of the Committee, I appreciate the opportunity to appear here today to discuss the long-term budget problem facing the United States.

Last week, the Center on Budget and Policy Priorities released a new analysis presenting our latest long-term projections of federal spending, revenues, deficits, and debt under current policies and our conclusions about the changes that need to be made in those policies.[1]

It will be no surprise to any of you who have heard us testify before on the long-term budget outlook — or have heard from any number of other experts on this subject in recent years — that we conclude the United States faces a very serious deficit problem if current policies remain unchanged. The problem ultimately will threaten the economic health of the country and compromise the ability of the government to meet crucial national needs.

Let me be clear. I am *not* talking about the large deficits we face this year or in the next few years. We all wish that the economic downturn and near meltdown of the financial system that have driven current deficits to such high levels had not occurred. But, given the circumstances we have been confronting, those deficits not only are acceptable but are the necessary result of those circumstances and the efforts required to shore up the financial system and put the economy back on a sound footing. If we had tried to hold down the deficit over the last year, or if we try to cut deficits before the economy is healthy enough to absorb such action — the Congressional Budget Office has projected that the U.S. gross domestic product (GDP) will not be back to its potential level until 2013 and unemployment will remain above its "natural" rate until 2014 — the country will be worse off.

[1] Kathy Ruffing, Kris Cox, and James Horney, "The Right Target: Stabilize the Federal Debt," Center on Budget and Policy Priorities, January 12, 2010.

The problem I am talking about is what we project will happen to deficits and debt in coming decades under current policies (and assuming the economy is healthy). We project that deficits will rise to more than 20 percent of GDP by 2050 and that debt will soar to the unprecedented level of about 300 percent of GDP by mid-century. (The highest level of debt experienced in the United States was 110 percent of GDP, at the end of World War II.) As the Congressional Budget Office and others have pointed out, over the long run, such high levels of debt would constrain the standard of living of residents of the United States and increase the risk of a financial crisis that could seriously disrupt the economy and the budget.

I believe it is absolutely necessary for policymakers to address this problem, and the sooner the better (with the caveat that tax increases or spending cuts that would threaten the recovery should not be implemented until the economy is back on track). As the founder and Executive Director of an organization that is dedicated to promoting efforts to improve the lives of low- and moderate-income Americans, I want to stress that dealing with the long-term budget problem should not just be the concern of "deficit hawks" or "green-eyeshade" types. If the budget is not put on a sustainable path, it is likely that low- and moderate-income Americans will suffer the most from the inevitable erosion of the average standard of living in this country. And, if rising debt does trigger a financial crisis, programs that are crucial to the well-being of less-well-off Americans are likely to bear the brunt of draconian steps taken in that crisis atmosphere to reduce deficits and debt and reassure financial markets. No one with particular concerns about the well-being of low- and moderate-income Americans can afford to ignore the long-term budget problem.

Putting the Budget on a Sustainable Path

Now let me say more about the nature of the long-term problem and what has to be done to put the budget on a sustainable path. One of the striking things about this is the degree of consensus among budget experts — striking because there is so little consensus about most other budget issues.

In the last eight months, budget projections and analyses of the scope of the fiscal problem over the long term have been issued not only by the Center on Budget and Policy Priorities, but also by CBO, the economists Alan Auerbach of the University of California at Berkeley and William Gale of the Brookings Institution, the Government Accountability Office, a commission supported by the Peter G. Peterson Foundation and the Pew Charitable Trusts, and a committee established under the auspices of the National Academy of Sciences and the National Academy of Public Administration.[2]

These reports — produced by organizations and individuals with varied interests and outlooks — all support the same conclusions on a number of key points:

- That deficits and debt will skyrocket in coming decades if current policies remain unchanged;

[2] Congressional Budget Office, "The Long-Term Budget Outlook," June 2009; Alan J. Auerbach and William G. Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond: An Update," September 2009; Government Accountability Office, "The Federal Government's Long-Term Fiscal Outlook: Fall 2009 Update," October 2009; Peterson-Pew Commission on Budget Reform, "Red Ink Rising: A Call to Stem the Mounting Federal Debt," December 2009; National Research Council and National Academy of Public Administration, "Choosing the Nation's Fiscal Future," January 2010.

- That debt at the levels projected would seriously threaten the budget, the economy, and the well-being of the people of the United States;

- That the continued rapid growth of per-person health care costs is the single biggest reason for the projected long-term increases in deficits and debt (with demographic changes — the aging of the baby-boom population — contributing to a significant but lesser extent to the projected increases);

- That the absolutely necessary goal of policymakers to avoid this outcome is to prevent the debt from perpetually rising as a share of the economy — that is, to stabilize the debt-to-GDP ratio;

- That it is not necessary to balance the budget to achieve this goal — that debt could be stabilized at levels projected for the middle of this decade if deficits are no more than about 3 percent of GDP or a bit less; and;

- That it will almost certainly require a *combination* of increases in revenues and reductions in spending to put the budget on a sustainable path. (The reports do not all say this explicitly, but it would be hard for a thoughtful reader to conclude that any of the reports suggest that solving the problem solely on the revenue or the spending side of the budget is feasible.)

As I noted, this degree of consensus among budget analysts on such an important issue is striking. It is true that there is a great deal of uncertainty about what will happen to the economy and the budget in coming decades. Nevertheless, this consensus among a variety of analysts should give pause to anyone who is tempted to believe that it would be prudent to ignore the problem posed by the current budget path or to assert that we can "grow our way out of it."

Setting a Fiscal Target

Among the three reports that propose a specific fiscal target for lawmakers — the Center's report and the reports by the Pew-Peterson commission and NAS-NAPA committee— there is agreement that the general goal should be to stabilize the debt-to-GDP ratio within the next decade. The Center specifically calls for deficits to be reduced to no more than 3 percent of GDP by 2019, and preferably sooner. Given the need to avoid implementing cuts in the next few years that could undercut the economic recovery and to allow for a gradual phasing in of some cuts once they do begin, we assume that the debt would be stabilized at somewhat over 70 percent of GDP over the course of the decade. The Pew-Peterson commission and the NAS-NAPA commission both propose a goal of stabilizing the debt-to-GDP ratio at a lower level, 60 percent of GDP.

We believe that a goal of ensuring that debt is stabilized at 60 percent of GDP in this decade is both overly ambitious and unnecessary, and as explained below, is likely to be self-defeating. Under current policies, we project that debt will be about 70 percent of GDP at the end of 2012 and that deficits in 2013 through 2018 will average about $1 trillion a year, or 6 percent of GDP. For debt to equal 60 percent of GDP at the end of 2018, the deficits in 2013 through 2018 would have to be cut by an average of *about $800 billion a year* (or 4 percent of GDP a year), including interest savings. This is an extremely ambitious goal. The largest deficit reduction efforts in the last three decades trimmed deficits by about 2 percent of GDP.

More importantly, while it is necessary to stabilize the debt-to-GDP ratio, it is not necessary to adopt a target of 60 percent. There is *no evidence* that a debt-to-GDP ratio of 60 percent represents a threshold above which the potential harm to the economy rises to an unacceptable level, and some evidence that that threshold is somewhat higher. There is little empirical basis for any particular debt-to-GDP target, although an analysis of historical international data by economists Carmen M. Reinhart and Kenneth S. Rogoff suggests that economic growth falters when government debt exceeds 90 percent of GDP.[3] The NAS-NAPA report acknowledges this, stating that "There is no magic number for the ratio of government debt to GDP…"[4]

The Pew-Peterson and NAS-NAPA reports both cite the fact that the Maastricht Treaty set a debt-to-GDP ratio of 60 percent as a criterion for membership in the European Monetary Union. They do not cite evidence or economic analysis that supported the EMU's choice of that target, and they discuss neither the role of European politics in the choice of the target nor the criticism of the target in the economics literature as being arbitrary.[5] Nor do they present any arguments to show why a criterion that was deemed appropriate as a condition for entry into the EMU in 1991 should be applied in the United States in the decades after 2010. The reports also do not address whether, even if that target might have been appropriate in 1991, it would still be appropriate today in light of the dramatic increases in government debt resulting from what has in many ways been the worst financial and economic crisis since the Great Depression.

The two reports correctly note that the International Monetary Fund also has used a 60 percent debt-to-GDP ratio target in its analyses of fiscal sustainability, but IMF staff have been clear that the criterion is arbitrary, noting "On why we picked 60 percent, of course, there [is] no magic number, and that's sort of just an illustrative number….Again, these are not targets. These are not ideal numbers. There's no rule that says that it's only sustainable if it's above or below 60."[6] In fact, IMF staff have recently suggested that in light of recent increases in debt, the date for achieving the target should be relaxed — allowing advanced countries that exceed the target in 2014 to gradually reduce the ratio over 15 years, reaching 60 percent *by 2029*.[7]

We believe Congress and the President should focus on bringing deficits down to about 3 percent of GDP in the years ahead and then keeping average deficits no higher than that level. Under one reasonable path, this would require average deficit reductions of *nearly $400 billion* in years 2013 through 2018. That would achieve the necessary condition for budget sustainability of stabilizing the debt-to-GDP ratio (the debt would be stabilized at modestly above 70 percent). Aiming to go further may actually have the unintended effect of *making it harder to enact needed deficit-*

---

[3] See Reinhart and Rogoff, "Growth in a Time of Debt," available at http://www.aeaweb.org/aea/conference/program/retrieve.php?pdfid=416, forthcoming in *American Economic Review*, Vol. 100 No. 2, May 2010.

[4] *Choosing the Nation's Fiscal Future*, p. 3.

[5] For instance, Willem Buiter has written that "The Maastricht deficit and debt criteria were arbitrary and neither necessary nor sufficient for national fiscal-financial sustainability." In "The 'Sense and Nonsense of Maastricht' revisited: What have we learnt about stabilization in the EMU?" http://www.nber.org/~wbuiter/sense.pdf

[6] See "Transcript of a Conference Call with IMF Senior Staffs on the Launch of *The State of Public Finances: A Cross-Country Fiscal Monitor*," July 30, 2009, in which an IMF staff member responds to a question about the 60 percent criterion. http://www.imf.org/external/np/tr/2009/tr073009a.htm

[7] See IMF, *The State of Public Finances: A Cross-Country Fiscal Monitor*, July 30, 2009, p. 18.

reduction legislation, by making the standard for success one that requires budget cuts and tax increases of such severity that they are unacceptable politically. (It also would increase the likelihood that deficit-reduction efforts — if successful — would seriously undercut programs that provide crucial services and benefits to millions of Americans, in which case the savings likely would not endure.)

History clearly shows that overly ambitious budget goals can be counterproductive. For instance, the overly ambitious Gramm-Rudman-Hollings balanced budget target almost certainly contributed to the decisions of President Reagan and the Congress in the mid- to late-1980s to focus more on rosy economic assumptions that made it appear the targets would be achieved rather than on making real progress in reducing the deficit. The House of Representatives also clearly understood the problem of too-ambitious goals last year when it adopted a statutory pay-as-you-go rule that did not require the extension of middle-class tax cuts and other expiring current policies to be paid for. Adopting a strict rule that required any change in law to be paid for would ensure that the rule would be waived multiple times. That would undercut the rule's effectiveness in constraining any costly proposal with significant political support.

Securing Savings Over the Coming Decade

One of the reasons we believe that the goal of holding debt to no more than 60 percent of GDP by the end of the decade is likely to be politically unfeasible is that very large savings in Social Security, Medicare (beyond the savings in the health reform legislation), and Medicaid will be extremely difficult to achieve over the next decade

Most experts agree that we cannot hold the growth of Medicare and Medicaid costs over time below the growth of private-sector health costs. Since the public and private sectors use the same health providers and the same treatments, holding growth in the public sector to a much lower rate than growth in the private sector would lead either to rationing of health care by income or, more likely, to a substantial shift of costs to the private sector as providers raise prices for privately insured patients to compensate for lower public-sector reimbursements.

Efforts to reduce the growth of health care spending system-wide (both public and private) are the key to reducing Medicare and Medicaid costs in a sensible, compassionate, and sustainable manner. (It is important also to remember that rising health care costs not only raise federal spending directly but also increase deficits by lowering tax revenues below what they otherwise would be. Health insurance benefits provided by employers are exempt from tax, and when health care costs grow faster than the economy, the share of compensation that is exempt from taxation rises and the revenue base consequently shrinks.) Provisions included in the health reform bills passed by the House and Senate — including steps to begin changing Medicare reimbursement policies in ways that could serve as a blueprint for private-sector changes that would improve the efficiency of the health care system as a whole — represent a crucial first step in the effort to slow system-wide cost growth. But, it will take time and further changes in the health system — based on knowledge that we gain in coming years but do not yet possess on how to achieve greater economies in health care without jeopardizing health care quality — to achieve the degree of reduction in the growth of health care costs that we ultimately will need to extract the required savings from Medicare. (I should add that because increases in health care costs are due to a substantial degree to advances in medical technology, many of which improve health and prolong life, it almost certainly will not be possible — or desirable — even in the longer run to slow the growth of health care costs so much that it is no greater than the rate of economic growth.)

Similarly, while there are sensible ways to achieve savings in Social Security, there are limits to how large those savings can be — especially over the next ten years — without undercutting the crucial role of Social Security in reducing poverty and ensuring a decent life for people who are elderly or have disabilities. Social Security benefits under current policies are not as generous as some people assume. Social Security checks now replace about 39 percent of an average worker's pre-retirement wages, less than similar programs in other Western countries. And because of the currently scheduled increase in the "normal retirement age" (which operates as an across-the-board benefit reduction) and the projected growth in Medicare premiums (which are deducted from Social Security checks), that figure will gradually fall from 39 percent to about 32 percent over the next two decades under current law.[8] In addition, recent losses in 401(k) and other retirement plans that supplement Social Security make it all the more important to ensure that Social Security benefits are maintained at an adequate level. Furthermore, the changes in Social Security benefits that can be made without undercutting the goals of the program will need to be phased in gradually — as has been the case with the increase in the normal retirement age that was enacted in 1983 and is still being phased in — so that savings will be small to start with but grow over time.

This means that while the largest share of the savings required *over the long term* will need to come from reductions in health care expenditures, much of the savings needed to stabilize deficits at no more than 3 percent of GDP *by the end of this decade* will have to come from increases in revenues and cuts in a wide array of smaller programs (i.e., programs other than Medicare, Medicaid, and Social Security), each of which can contribute only a small amount to the effort. There is clearly a political limit to what can be achieved in these areas.

It should be noted that CBO's projections for the coming decade, our analyses, and budget data from recent years indicate that expenditures for programs *other than* Medicare, Medicaid, and Social Security — including entitlement programs other than the "big three" — will grow *more slowly* than GDP in the decades ahead. These programs consequently are not contributing to the long-term fiscal problem. For this reason, statements that we face a general "entitlement crisis" are mistaken. This does not mean, however, that programs other than the "big three" should not be scrutinized for potential savings; they clearly should be.

Beyond the Coming Decade

If deficits are stabilized in the coming decade, Congress and the President can then consider next steps — whether the benefits of further reducing the debt-to-GDP ratio to 60 percent (or less) would more than offset any harm that the additional budget cuts and/or tax increases needed to achieve that reduction might involve. But it does not make sense to set a target today that is not necessary to achieve budget sustainability — and that is politically so difficult to meet that it would make *continued inaction* more likely. Instead, we should set a target that is ambitious and strong, but not so intensely excruciating as to be virtually impossible to attain.

---

[8] Virginia P. Reno and Joni Lavery, "Fixing Social Security: Adequate Benefits, Adequate Financing," National Academy of Social Insurance, October 2009.