COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Testimony of Maya MacGuineas
Committee for a Responsible Federal Budget
Hearing before the House Financial Services Committee:

The Peril of an Ignored National Debt

December 20, 2018

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you very much for inviting me here today to discuss the country's unsustainable fiscal situation. Our national debt is a pressing issue that requires Congress to stop digging a deeper hole and begin addressing it through proactive reforms. If we fail to manage the coming challenges, many of our budget decisions will be made for us.

I am Maya MacGuineas, president of the Committee for a Responsible Federal Budget and head of the Campaign to Fix the Debt. The Committee for a Responsible Federal Budget is a bipartisan organization dedicated to educating the public about and working with policymakers on fiscal policy issues. Our co-chairs are Purdue University President and former OMB Director Mitch Daniels, former Secretary of Defense and former OMB Director Leon Panetta, and former Congressman Tim Penny. Our board includes past directors and chairs of the Office of Management and Budget, the Congressional Budget Office, the Federal Reserve System, the Treasury Department, and the Budget Committees. Our partner organization, Fix the Debt, is a nonpartisan coalition that supports a "grand bargain" to help deal with the debt. The group is chaired by Senator Judd Gregg and Governor Ed Rendell.

I will touch on several points today:

1. The national debt is on an unsustainable path.

2. There are many reasons to care about the debt, ranging from detrimental effects on the economy, to interest payments crowding out the rest of the budget, to the economic, political, and security vulnerabilities of such a large debt.

3. There are many approaches Congress can take to fix the debt, but we must stop denying the problem, stop making it worse, and begin to address it.

The Federal Debt Picture is Bleak

Over the past decade, the nation's fiscal situation has deteriorated. Debt held by the public doubled from 39% of GDP in 2008 to 78% today, leaving debt at its largest share of the economy since just after World War II.

While much of this growth was due to the financial crisis and the response to it, deficit-increasing legislation, an aging population, and rising health care costs have also played a significant role. The deficit is on course to near the trillion-dollar mark this fiscal year, despite a strong economy. Having such a deficit during a time of relative economic prosperity is unprecedented in our nation's history.

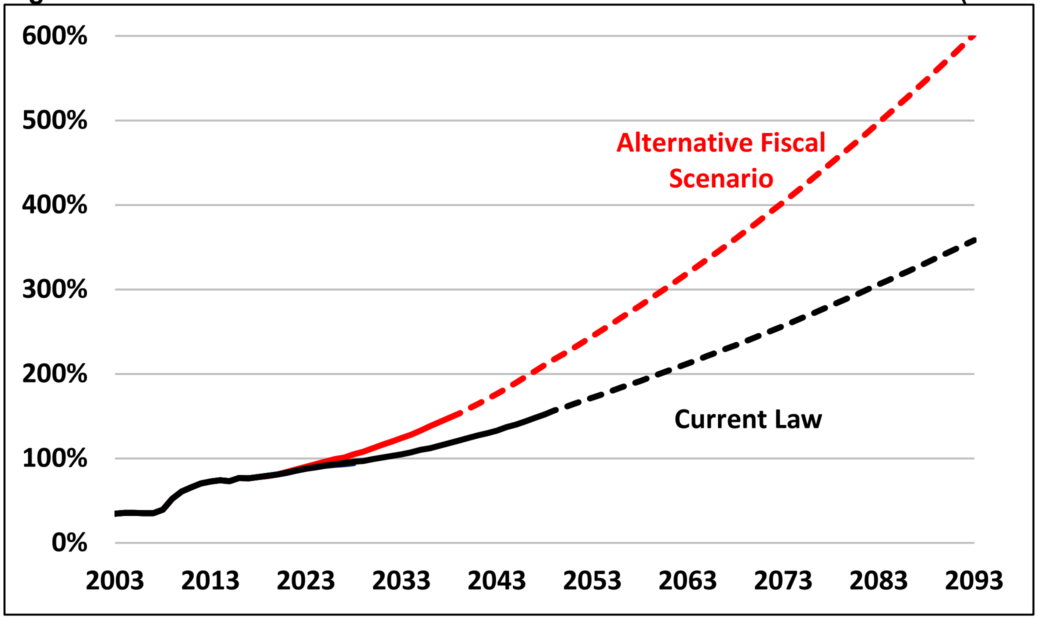
Fig 1. When the Deficit Has Been This Bad Outside WWII, the Economy Has Been Much Worse

Fiscal Year	1934 (1932-1936)	1976	1983 (1983-1986)	1992 (1991-1992)	2009 (2009-2013)	2019
Budget Metrics (% of GDP)						
Revenue	4.8%	16.6%	17.0%	17.0%	14.6%	16.5%
Spending	10.6%	20.8%	22.8%	21.5%	24.4%	21.2%
Deficit	5.8%	4.1%	5.9%	4.5%	9.8%	4.6%
Debt	44%	27%	32%	47%	52%	79%
Economic Metrics						
Unemployment Rate	23.0%	7.8%	10.1%	7.4%	8.5%	3.4%
Real GDP Growth for the Previous Year	--	-1.8%	-2.5%	-0.1%	0.1%	3.0%
Output Gap (% of GDP)	--	-2.8%	-6.3%	-3.5%	-5.9%	1.0%
Immediately After a Recession?	Yes	Yes	Yes	Yes	Yes	No

Sources: CBO, BEA, BLS. For periods where multiple years had deficits above 4% (e.g., 2009-2013), the year with the highest deficit is shown. Not all economic metrics are available before 1950. Unemployment rate in 1934 available from BLS estimates done in 1948. 2019 totals are CBO projections.

To make matters worse, debt is expected to grow drastically in the coming decades. According to the Congressional Budget Office (CBO), debt under current law will grow from 78% of GDP this year to exceed the size of the economy in just 13 years and reach an unprecedented 152% of GDP in 30 years. Our estimates suggest debt under current law will reach 358% of GDP in 75 years.

Fig. 2: 75-Year Debt Under Current Law and the Alternative Fiscal Scenario (Percent of GDP)



Sources: CBO and CRFB calculations. Dashed lines represent CRFB estimates.

Even these estimates are optimistic, since they assume Congress will let various tax cuts and spending increases expire as scheduled. If these policies are extended, debt will reach an all-time high in about a decade, rise to over twice the size of the economy in 30 years, and reach 600% of GDP in 75 years.

Putting debt on a sustainable path will require significant deficit reduction, and the sooner lawmakers start, the better.

- Simply holding debt at today's near-record as a share of GDP (78%) would require savings of $4.8 trillion of spending cuts and/or tax hikes over the next decade.
- Balancing the budget in 2028 would require about $7 trillion in savings over ten years.
- Reducing debt to its historical average of 41% of GDP in 30 years would require $7.6 trillion in deficit reduction over ten years.
- And waiting just ten years increases the size of the adjustments by half.

Given how high our debt is and is projected to grow in the future, it is clear lawmakers must reverse course. The situation is already having negative consequences, and it is not long before it reaches uncharted territory.

The Cost of High and Rising Debt

The risks and consequences of high and rising debt include:

- **Slower economic and income growth due to debt crowding out private sector investment.** As the government issues more debt, investors buy these bonds in place of private investment. Over time, this results in a smaller stock of buildings, machines, and equipment; fewer new ventures and new technologies; and slower wage growth. CBO estimates average income will be $6,000 (6%) lower in 2048 if we allow debt to rise rather than reduce it to historical levels.[1]

- **Higher interest rates on loans for households and businesses.** Rising federal debt tends to put upward pressure on interest rates throughout the economy. This increase trickles into business and consumer loans, making it more expensive for Americans to take out mortgages, car loans, and credit card debt – not to mention small business loans and other borrowing that helps grow the economy. Interest rates have remained low in past years despite growing debt due to Federal Reserve accommodation and a slow recovery, but there is a very strong risk those conditions will and have started to change as the economy has gotten stronger, the Federal Reserve tightens monetary policy, and we come closer to full employment.

- **Higher government interest payments that displace other government priorities.** Due to rising interest rates and an increasing stock of debt, ***interest payments are projected to be the fastest growing part of the federal budget***. Under current law, interest costs will *triple* over the next decade. As a result, interest costs will exceed Medicaid spending by 2020, defense spending by 2023, and total discretionary spending by 2045. We estimate that before 2050, net interest will be the single largest line item in the budget.

- **Reduced fiscal space for the government to react to wars, recessions, or other emergencies.** It is impossible to predict the timing of the next recession. However, the fact that one has not occurred in the last nine years suggests another may be on the horizon. Unless there is a dramatic reduction in debt, we will enter the next recession with the highest debt in nearly 70 years (and higher than any time prior to World War II). This leads to legitimate concerns about the available "fiscal space" in the U.S., or the federal government's financial capacity and willingness to respond to emergencies. While it is impossible to know the precise amount available, the U.S. almost certainly has less fiscal space today than it did a decade ago, and it is projected to have even less in the coming years. The U.S. is less equipped to handle the next recession than it was in handling the Great Recession.

[1] CBO estimates that real GNP per person would be $98,000 in 2048 (in 2019 dollars) if Congress reduced debt to 41% of GDP by 2048, instead of $92,000 under its extended baseline.

- **Lost opportunities to make thoughtful investments or reforms.** Rising debt hinders our ability to enact good public policy. Whether you care about strengthening the military, developing clean energy, reducing burdensome taxes, or investing in education and infrastructure, rising debt will crowd it out. Thanks to the increasing debt burden, next year the country will spend more on interest than on children, which means we will be spending more on financing our past than investing in our future.[2] And there are many new issues on the horizon, from the effects of technology to the future of work to new types of global threats that we are only just developing the capacity to withstand. As time goes on, we will increasingly lose the capability to address our debt situation through thoughtful, gradual, and targeted tax and spending reforms. At some point in the near future, our debt will be so high we will have to forgo new ideas and impose blunt spending cuts and tax hikes.

- **Risk of an eventual fiscal crisis if changes are not made.** The combination of our strong economy, steady monetary policy, and longstanding commitment to pay our debts has allowed us to amass significant debt without severe consequences. This will not last forever. Unsustainable debt may eventually lead some investors to demand higher interest rates, which could set off a chain of events that begins with a small selloff of existing federal bonds and ends with a global financial crisis. No one knows what level of debt or combination of events would set off such a crisis; I hope we will never have to find out.

Why Our Growing Debt is More Risky Today

Those unconcerned about our rising debt have sometimes pointed to the built-up debt in recent years as evidence that the United States can borrow with little consequence. That's a mistake.

During the Great Recession, large deficits and the resulting borrowing helped fill an even larger output gap – activating unemployed labor and capital. Yet when the economy is strong, such fiscal stimulus is more likely to lead to higher interest rates or inflation – and any boost it provides to the economy will likely be temporary.

The U.S. had an easier time borrowing before and during the Great Recession because much of our new debt was purchased by foreign investors. From 2001 through 2014, foreign investors purchased 55% of the $9.4 trillion in new debt. This helped interest rates and debt risks remain low, but the percentage of debt owned by foreign investors climbed from 30% to almost 50%. The Federal Reserve also purchased another $1.8 trillion in federal debt during the Great Recession and its aftermath.

However, lending patterns are likely to change going forward. Already, since 2014, our two largest creditor nations, China and Japan, have decreased their holdings of U.S. debt.

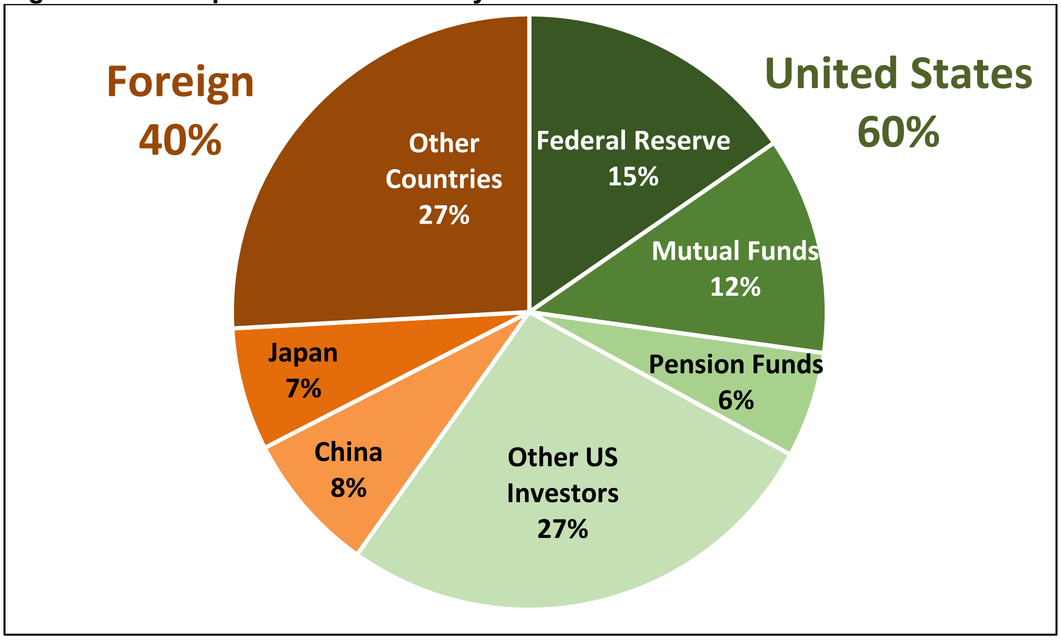
[2] In FY 2020, the U.S. will spend more on interest payments than on children under age 18 across all federal programs combined.

China owns $1.1 trillion of U.S. debt. Trade and other tensions with them can certainly affect their lending decisions. Moreover, given our unstable political relationship with China, it is less than ideal to be as dependent on them as we are for funds.

Japan, which holds another $1 trillion of our debt, has also halted net purchases – possibly due to its aging population. As the population continues to age, this nation of savers is likely to draw down its savings to finance retirement and therefore have fewer assets available to purchase U.S. debt.

Currently, foreign investors and governments own about 40% of the publicly traded debt, a percentage that has decreased in recent years as China and Japan have pulled back and forced domestic investors to finance our debt instead.

Fig. 3: Ownership of U.S. Debt held by the Public



Source: U.S. Treasury Department, June 2018. Countries include purchases by that government and/or by investors with accounts in that country.

Ways Congress Can Fix the Debt

Stop Making the Problem Worse

The primary drivers of long-term debt are growing mandatory spending and the lack of revenue to pay for it. Over the next ten years, 82% of spending growth will be due to Social Security, health programs, and interest payments. Mandatory spending, specifically the costs stemming from an aging population, remains the largest long-term problem to address.

Yet, much of the current deficit is largely self-imposed. Legislation enacted by the last two Congresses is responsible for 55% of this year's deficit. Instead of almost $1 trillion, the deficit would be $440 billion if not for recently enacted legislation.

The Tax Cuts and Jobs Act is responsible for about one-quarter of this year's deficit, after accounting for the increased economic growth caused by the bill. Real economic growth in 2018 and 2019 will be about 3%, which is higher than had been projected before the tax bill passed. But long-term growth projections have not changed. The bill would have been even more pro-growth if it were permanent and not deficit-financed.

The other major deficit-increasing legislative action was the Bipartisan Budget Act of 2018, which stopped the sequester and increased both defense spending and nondefense spending (by more than either side asked for!). It wasn't offset, abandoning the precedent that sequester relief legislation should be paid for. The first two-year sequester deal in 2013 did what Congress should have: offset the increased discretionary funding with mandatory cuts and revenues that led to growing deficit reduction over time. The second deal in 2015 at least offset its costs on paper, though it included multiple gimmicks.

Despite the tax bill's higher sticker price, both the tax and spending bills have about the same annual and ten-year costs if made permanent. If extended in full, both the tax bill and the spending bill would cost about $2 trillion each over a decade (before interest).

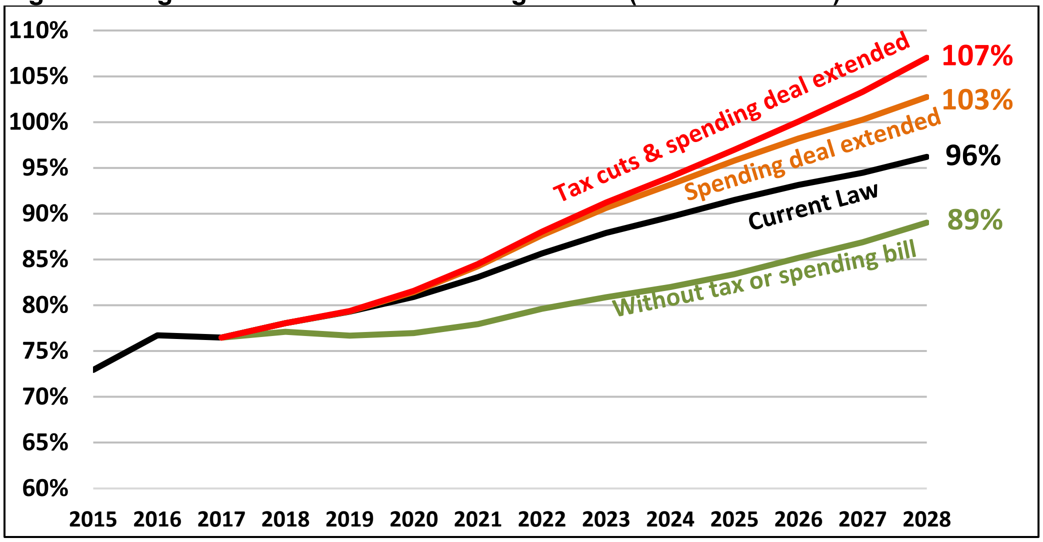
Fig. 3: Spending and Tax Bills have Similar Costs if Extended

	Bill That Was Passed	If Extended	Total
December tax bill	$1.27 trillion	$770 billion	$2.05 trillion
Debt Service	*$580 billion*	*$40 billion*	*$620 billion*
Total, December tax bill	$1.9 trillion	$810 billion	$2.7 trillion
Bipartisan Budget Act of 2018	$320 billion*	$1.70 trillion	$2.02 trillion
Debt service	*$110 billion*	*$250 billion*	*$350 billion*
Total, Bipartisan Budget Act of 2018	$430 billion	$1.95 trillion	$2.4 trillion

Source: CBO estimates of the Bipartisan Budget Act of 2018 and April baseline projections. Tax bill reflects increased economic growth; no such estimate was provided for the spending bill. Figures rounded to the nearest $5 billion. With debt service, the tax bill is more expensive, but part of that effect is the inclusion of economic growth effects: faster economic growth raises interest rates and increases debt service for existing debt as well as new debt added because of the tax bill. *Bipartisan Budget Act of 2018 primary savings scored through 2027, although nearly all costs took place in the short term.

If Congress had passed neither the tax cuts nor the spending increases, debt would have climbed from 78% of GDP today to 89% by 2028. With both bills enacted, debt will now climb to 96% of GDP. If the spending increases and tax cuts (including tax cuts passed this year) are extended, debt will reach 107% of GDP within the decade, surpassing the all-time record set after World War II.

Fig. 4: Change in Debt Due to Recent Legislation (Percent of GDP)



Sources: CBO and CRFB calculations. "Tax cuts and spending bill extended" is more pessimistic than CBO's Alternative Fiscal Scenario because the AFS also assumes disaster spending is reduced to its historical average.

Going forward, the growth in mandatory spending is the bulk of the problem. The fastest growing parts of the budget are Social Security, health programs like Medicare and Medicaid, and interest payments on the debt – each of which does not go through the annual appropriations process and is growing faster than the economy. Mandatory spending and interest have already grown from 61% of the budget in 2010 to 69% today, and they are projected to be at 77% in 2028. One of the many reasons this concerns me is the extent to which it has squeezed productive investments.

While mandatory spending is responsible for the largest spending increases, discretionary spending also plays a role in near-term debt growth, especially after the large unpaid-for increases enacted in the Bipartisan Budget Act of 2018.

As former Chairman of the Joint Chiefs of Staff Admiral Mike Mullen, Secretary of Defense James Mattis, and others have warned, the national debt is the country's most serious national security threat. Pushing continual defense increases that add to the debt is counter to this goal of making us more secure.

Further, increased defense spending also traditionally causes a corresponding increase in domestic discretionary spending. And even if the spending deals are two-year deals, they push up expectations about spending levels in the future.

The best first step our leaders could make is to pledge to not make the debt situation worse (unless there is a smart reason to borrow such as a recession). There is no justification for borrowing more given where our debt and our economy currently are. If one wants to cut taxes, offset that by broadening the tax base, raising other revenues, or cutting spending. If one wants to increase spending, raise taxes or cut spending elsewhere in the budget. That is what budgeting is. Borrowing more at this moment in the economic cycle is purely for political reasons, and it is shortsighted and makes a bad situation even worse.

Make Proactive Changes

Beyond not making the problem worse, lawmakers should focus on making changes to two of the largest drivers of our long-term debt problem: health care spending and Social Security. Reforms in these areas have the most potential for significant savings, and it would be between difficult and impossible to control our debt problem without making changes to these programs.

The largest driver of future costs is health care. The recent slowdown in health spending growth gives hope that some of our efforts can make a difference despite an aging population and higher Medicare and Medicaid enrollment. Still, structural reforms that encourage more efficient use of health care by both providers and patients are needed. In the more immediate moment, reducing prescription drug prices is one area with potential for savings with bipartisan support. Other proposals that have been included in Presidents' budgets from both Democrats and Republicans, such as reducing payments for hospital bad debts and post-acute care, could help reduce Medicare costs without reducing benefits. Policymakers could focus on delivery system reform, medical malpractice changes, and provider payment reforms.

The other major area needing attention is Social Security. The program's trust fund is on track to exhaust its reserves by 2034, at which point benefits will be cut by 20% to 25% without legislative action to stop it. Starting this year, the Social Security trust fund is being drawn down to pay benefits, meaning that the government must borrow from elsewhere so that Social Security can redeem its trust fund reserves. In other words, Social Security is increasing the current deficit and will continue to do so dramatically in the future if the program is not reformed.

There are a myriad of ideas to make the program sustainably solvent. We can fix this program by adjusting benefits, raising revenues, or both. What is missing from the equation is political will. The constant scaremongering that surrounds this issue and leads to delaying needed reforms ultimately hurts the people who depend on it most.

The longer lawmakers wait to address Social Security's shortfall, the more painful the changes will be to fix it. According to the program's Trustees, the necessary benefit cuts or tax increases to achieve solvency would need to be 35% to 40% larger if changes are not enacted until the trust fund runs out in 2034. For example, the program could be made solvent with a 17% across-the-board benefit cut today; in 2034, that cut rises to 23%. Likewise, solvency could be achieved with a 22% payroll tax increase (2.8 percentage points) today, which would rise to 31% (3.9 percentage points) in 2034.

Finally, there are plenty of other ideas for increasing revenue and decreasing mandatory spending that should be considered.

Fig. 5: A Few Options for Reducing Debt

Spending Options	Ten-Year Savings
Adopt Chained CPI	$200 billion
Reduce Prescription Drug Costs	$50 to $200 billion
Reduce Excessive Medicare Provider Payments	$100 to $200 billion
Reform Medicare Cost Sharing and Strengthen Means-Testing	$50 to $200 billion
Reduce Farm Subsidies	$25 to 50 billion
Consolidate Student Loan Programs	$25 to $100 billion
Reform Disability Programs	$25 to $50 billion
Change Federal Retirement Programs	$50 billion
Revenue Options	**10-Year Savings**
Cap Tax Breaks Across the Board	$200 to $500 billion
Reduce Individual Tax Rates Cuts from TCJA in Half	$600 billion
Raise Corporate Rate to 25%	$400 billion
Cap the Tax Benefit for Employer Health Care	$250 to $650 billion
Raise the Gas Tax by 15 Cents	$240 billion
Institute a Carbon Tax	$1.1 trillion
Enact a Financial Transactions Tax	$780 billion

Source: CRFB estimates and CBO budget options.

How to Move Forward

Given the challenges lawmakers will face in the coming years and decades, there are many steps that would call attention to the problem and begin the process of fixing it:

- **Start admitting we have a problem.** This hearing is part of the conversation on fixing our unsustainable debt problem. Lawmakers should consider more ways to promote awareness of the issue. This includes holding more frequent hearings, creating a caucus dedicated to addressing the debt, or using other means of publicizing the difficult fiscal situation. Again, thank you for holding this hearing today.

- **Support process reforms.** We were disappointed that the Joint Select Committee on Budget and Appropriations Process Reform failed to reach consensus, but that does not mean attempts at reform should stop there. Lawmakers should keep at it, focusing on reforms like fiscal goals and debt targets to improve budget outcomes.

- **Stop digging.** As I noted above, the easiest way to start fixing a problem is by not making it worse. Many tax and spending decisions need to be made in the coming years. ***All*** costly items should be completely offset and ideally paired with additional measures to reduce the deficit.

- **Offer ideas to pay for proposals.** Paying for proposals requires spending cuts, revenue increases, or a combination of both. If lawmakers are willing to offer new proposals, they should be willing to propose offsets as well. Those who take the responsible step of proposing their own pay-fors should not be criticized by their colleagues unless those colleagues are willing to offer alternatives. If lawmakers are searching for offsets – please come to us, we will work with you to find ways to pay for proposals.

- **Fix the big three deficit drivers: health costs, retirement programs, and insufficient revenue.** In addition to the reforms I noted in the health and retirement space, lawmakers need to give a hard look at tax expenditures that poke holes in our tax code and distort taxpayer behavior. There are still over $1.5 trillion in tax breaks even after tax reform. Lawmakers should examine each one to see which can be eliminated or scaled back.

- **Start preparing for the next economic downturn.** The Great Recession was the largest recent contributor to our expanding debt. We need to start preparing now with a break-the-glass plan for fiscal stimulus in the next recession, and the plan needs to contain responsible pay-fors to take effect when we emerge from recession.

Tackling this issue will take time, but lawmakers can start by making progress on raising awareness, addressing the problem, and refusing to make it any worse than it already is.

Conclusion

A weak fiscal situation leaves us with a weak foundation for our economy. Delaying action on reforming key mandatory spending programs, not ensuring sufficient revenues are generated to pay for government services, or believing strong economic growth will single-handedly fix the problem is a recipe for economic and fiscal disaster.

It is going to take a bipartisan consensus to implement needed reforms. There should be a massive education effort. We need to level with citizens that this is going to require real budget choices. Most importantly, we are going to need to address the major drivers of our debt sooner rather than later – and the best time to do so is right now while the economy is relatively strong.

The Committee should be commended for holding today's hearing on such an important topic – the unsustainability of our growing national debt. The Committee for a Responsible Federal Budget and I and would be delighted to work with Congress on addressing this enormous challenge. Thank you.