Hearing before the House Budget Committee on

Lifting the Crushing Burden of Debt

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Testimony of Maya MacGuineas

Committee for a Responsible Federal Budget at

The New America Foundation

Chairman Ryan, Congressman Van Hollen, Members of the Committee, thank you for inviting me here today to discuss the problems presented by our large and growing federal debt.

I am Maya MacGuineas, president of the bipartisan Committee for a Responsible Federal Budget and the director of the Fiscal Policy Program at the New America Foundation. I am also a member of the Peterson-Pew Commission on Budget Reform, which recently released two reports—*Red Ink Rising* and *Getting Back in the Black*, which focus on the need to adopt multi-year budgetary targets and automatic triggers to help improve the budget process, and which we believe can be a helpful part of fixing our budgetary challenges.

You all know better than most, the tremendous threats the United States' debt situation poses. Not only is our debt higher than it has ever been in the post-war period as a percentage of our economy, we are on track to continue adding to this debt indefinitely.

This year, public debt—the amount the U.S. government owes to domestic and foreign investors, and ignoring sums that the government owes to itself via intergovernmental accounts—is set to grow from $9.0 trillion, or 62 percent of GDP at the end of last year to $10.4 trillion, or 69 percent of GDP at the end of this year, according to the most recent projections from the Congressional Budget Office. By the end of the 10-year period, the debt will have grown to an astronomical $18.3 trillion, or 77 percent of GDP. Interest payments will be nearly $800 billion in that last year, or more than all domestic discretionary spending.

Yet even these assumptions are probably too optimistic. The Committee for a Responsible Federal Budget recently released its "Realistic Baseline", which includes more realistic assumptions about future tax and spending policies than the current law assumptions CBO is directed to follow.[1] Our baseline shows deficits growing to over $1.3 trillion, or 5.7 percent of GDP by the end of the ten-year window; debt growing to $21.8 trillion, or 91.5 percent of GDP; and interest payments reaching $947 billion in that final year.

Fig. 1: CRFB Realistic Baseline

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year
					Billions of Dollars						
Net Interest	$264	$329	$406	$484	$569	$652	$727	$800	$880	$947	$6,058
Deficits	$1,103	$896	$821	$870	$1,006	$1,000	$1,037	$1,170	$1,267	$1,347	$10,516
Debt	$11,601	$12,581	$13,479	$14,427	$15,507	$16,596	$17,726	$18,990	$20,353	$21,798	N/A
					Percent of GDP						
Net Interest	1.7%	2.0%	2.4%	2.7%	3.0%	3.3%	3.5%	3.7%	3.9%	4.0%	3.0%
Deficits	7.0%	5.5%	4.8%	4.8%	5.3%	5.0%	5.0%	5.4%	5.6%	5.7%	5.4%
Debt	73.9%	76.7%	78.1%	79.3%	81.0%	82.8%	84.7%	86.9%	89.2%	91.5%	N/A
Memorandum:											
CBO Baseline Interest	1.7%	2.0%	2.3%	2.5%	2.8%	3.0%	3.1%	3.2%	3.3%	3.3%	2.8%
CBO Baseline Deficits	7.0%	4.3%	3.1%	3.0%	3.4%	3.1%	2.9%	3.2%	3.2%	3.2%	3.6%
CBO Baseline Debt	73.9%	75.5%	75.3%	74.9%	75.0%	75.2%	75.3%	75.8%	76.2%	76.7%	N/A

I believe it is highly unlikely we would even make it to that point without experiencing some type of a fiscal crisis.

Under realistic assumptions, debt will continue to grow throughout and beyond the decade, rising to over 100 percent of the economy in the mid-2020s, to over 200 percent in the 2040s, and eventually to over 500 percent by 2080. Driving the growth in debt will be the aging of the U.S. population, rising health care costs, and of course, spiraling interest costs.

Clearly, no country could sustain debt levels at such heights without destroying economic growth, eliminating vital investments, and slashing standards of living. But even at

[1] Projections based on CRFB Realistic Baseline, which assumes the 2001/2003/2010 tax cuts are fully extended, war costs slowly decline, scheduled reductions to Medicare payments to physicians continue to be waived for remainder of the decade. After 2021, projections follow CBO Alternative Fiscal Scenario, except that revenues are allowed to rise slowly.

heightened levels of debt, like those the U.S. is currently experiencing in the short-term and increasingly into the medium- and long-terms, the economy and society at large can suffer.

The solution to all of the risks of higher debt is a multi-year, comprehensive fiscal plan that tackles each area of the budget. The sooner we enact such a plan, the better.

We face two paths. Under one, fiscal consolidation is used as part of an economic strategy that also includes preserving—and in many cases, increasing—productive public investments and a sound safety net and fundamentally reforming our tax code to enhance competitiveness. The economy and U.S. standard of living would benefit from having taken thoughtful preemptive actions. Under the other, we delay due to the difficult policy choices and political stalemate, which causes the debt to continue to grow, pushing up interest rates and payments, squeezing out more important priorities, choking off economic growth and affecting working families, and ultimately leading to a vicious debt spiral, which damages the entire economy and country. And under that scenario we still have to make the same difficult spending and tax choices we face now—but they would have to be larger and more painful.

I'd like to dig a little deeper into the problems caused by high debt levels:

1. Economic: Many noted economists and respected organizations, including the International Monetary Found (IMF) and the Congressional Budget Office (CBO), have conducted analyses on the effects of heightened debt on interest rates; inflation; incentives for workers, businesses, and investors; and economic growth in general. They have found that higher levels of debt do not bode well for continued economic strength or living standards.

Increased federal borrowing and debt would eventually crowd out private investment in potentially more productive ventures via higher interest rates for government debt. Down the road, the nation would face a smaller capital stock. This need not be the case if increased federal borrowing was directed toward investments on public capital with returns greater than or equal to returns on forgone private investments.[2] Examples of

[2] Other complicating factors are that larger budget deficits tend to increase private savings, for several reasons, and can help increase foreign investment, both of which can mitigate the negative effects of

such investments could include infrastructure, research and development, and education. However, the U.S. budget is primarily a consumption oriented budget, with spending on health care and retirement costs far out stripping investments, and oftentimes, our public investments are not well-directed.

A smaller capital stock down the road would eventually cause incomes to fall, making future generations worse off. Lower incomes would reduce people's incentives to work. The combined effects of a lower capital stock and labor supply would harm economic output in the long-term and decreases U.S. global competitiveness.

Economists Carmen Reinhart, who is here today, and Ken Rogoff of Harvard University have estimated that debt levels of roughly 90 percent of the economy—looking at a broader measure of debt, which incorporates debts the government owes to itself—are correlated with lower annual economic growth of about 1 percentage point.[3] Likewise, economists at the IMF have estimated that a 10 percentage point increase in debt lowers potential output growth by 0.15 percentage point in advanced economies.[4]

Higher debt can also contribute to higher inflation, whereby deficits add too much to aggregate demand in a given time frame, lead monetary authorities to try to reduce the real value of debt by printing more money (often referred to as "monetizing" the debt), or lead some people to believe that monetary authorities could deliberately increase inflation.[5] Such outcomes would have obvious negative implications for business and investor confidence and economic growth, as well as many savers in society—in particular, the elderly.

2. Budget: Higher debt levels necessitate higher interest payments on existing debt. Last year, interest payments on our $9 trillion debt totaled $197 billion. By 2021, however, interest payments are projected to jump fourfold to $792 billion, according to CBO. If policymakers enact legislation that increases deficits and debt over the next ten years, interest payments will also increase by even larger factors. All of these scenarios assume rather favorable interest rates. As interest payments rise, they will squeeze out room for

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increased borrowing. However, CBO states that, overall, these factors do not reverse the conclusion that increased borrowing would crowd out private investment.

[3] Reinhart and Rogoff. Growth in a Time of Debt, January 2010.

[4] Kumar and Woo, Public Debt and Growth, July 2010.

[5] Sargent and Wallace (1981), Barro (1995), Cochrane (2010), cited in Kumar and Woo.

other spending priorities and tax cuts. This will make the current battle over limited resources seem easy when compared to what is looming in the future.

3. Fiscal: Higher debt levels lead to reduced budget flexibility as interest payments grow to consume larger and larger portions of the federal budget, and compromise our ability to respond to future crises and opportunities.

Policymakers would have limited resources to respond to unforeseen events, such as wars, humanitarian crises, and economic downturns. In 2008, public debt stood at about 40 percent of the economy, affording us the fiscal space to significantly increase spending and cut taxes to support an economic turnaround. Larger debt would have hindered such efforts, and threatens our ability to respond to the next emergency. By nature, these budgetary costs are unpredictable, both in timing and in magnitude. Living at our fiscal limits is an immensely dangerous way to operate the government given the many uncertainties the nation faces.

4. Psychological: Uncertainty surrounding the country's fiscal path is eroding confidence among businesses and individuals. They don't know what spending and tax policies to expect in the future, and thus cannot plan accordingly. If businesses and individuals do not know what spending cuts and/or tax increases they might face in the future, or even if the country might face a fiscal crisis of some form or another, they will be less willing to make longer-term investment decisions in our economy. As the economic recovery continues to lag, uncertainty contributes to the problem of how to encourage businesses to be the engine of growth.

A lack of confidence or certainty can stem not only from economic expectations, but also from policy uncertainty. Whether large spending cuts or tax increases, uncertainty over which spending programs lawmakers might eliminate or which taxes they might create or increase are not optimal for growth.

Just as one example, we know in no uncertain terms that changes need to be made to Social Security. We know that the sooner they are made, the better. And yet the years and years of delay means that current retirees, workers, and taxpayers, don't know what changes will be made to make the program sustainable, and thus, cannot plan accordingly. It is a terrible disservice to all participants of Social Security. The same level of uncertainty with regard to other needed policy changes affects business owners, students, and normal families trying to plan for their futures.

5. Intergenerational: Higher debt levels not only threaten current standards of living, but the wellbeing of future generations of Americans. Higher borrowing today pushes the costs onto our children and grandchildren. Each generation of Americans has passed on improved opportunities and standards of living to the next generation. But for the first time, our fiscal course threatens to burden our children and grandchildren with enormous debt and reduced opportunities for the future, as well as a lack of fiscal flexibility as we lock them into certain programs and large interest burdens.

Basically we should all just look our kids in the eye and say, sorry, we wanted to spend a lot but not pay for it, so we are passing the bills onto you. Good luck with that.

A Fiscal Crisis

Ultimately, if changes are not made, the country will experience some type of fiscal crisis. Under such a scenario, creditors would demand spending and/or tax changes to set a new fiscal course. No one knows exactly when this will happen, what it will look like, or what will set it off. But we know this problem will not fix itself and that without changes, there will be a fiscal crisis.

A year ago, we held a conference on what a tipping point might look like. At this cheery gathering economists and budget experts in attendance noted that a crisis could take many forms, including scenarios ranging from a gradual rise in interest rates and slowing of economic growth, to a rapid crisis where investors pull the plug on an economy—with triggering events ranging from a credit rating warning, to state budget problems, to a totally unforeseen factor. There was general concern that markets were underestimating how soon such a crisis might hit, and that the greatest risk was that our economy is already negatively affected by high debt levels, and that a crisis could hit in the next few years.

Under an abrupt fiscal crisis scenario, the U.S. would not have the luxury of spreading fiscal adjustment out among a larger group of federal spending programs or taxes, or across more generations. Investors would force immediate spending cuts and/or tax increases, threatening our ability to protect the programs on which the most vulnerable in society rely. A fiscal crisis would surely exacerbate all the negative economic, fiscal, psychological, and intergenerational effects of high debt.

For older generations, a fiscal crisis would hurt job security and incomes, and threaten retirement security if federal spending on retirement programs or taxes had to be altered abruptly. For younger generations, a crisis would also threaten job opportunities, incomes, and affordability of big ticket items. Workers would have to expect to work much longer than their parents and grandparents' generations.

We can never be sure when we might confront such a scenario, but we know for sure that we would ultimately face some type of crisis. It is far better to make fiscal changes on our accord than have markets force changes on us.[6]

The Solution: A Fiscal Plan

We need to adopt a multi-year, comprehensive budget plan to put the country on a glide path to stabilize the debt at a sustainable level. We probably want to bring the debt down to around 60 percent of GDP over a decade—still significantly higher than the historic average of below 40 percent, and continue on a path that leads us back down closer to historical averages beyond that.

All areas of the budget should be on the table. Spending caps on discretionary portions of the budget—including both defense and non-defense programs—, entitlement reform, and fundamental tax reform are critical for tackling the magnitude of future deficits.

The debt threat is serious, but it is also an opportunity to restructure our budget and tax system for the 21st century. In order to be competitive down the road, we must strengthen critical investments in infrastructure, high value research and development, and education. By shifting our budget from one based more on consumption to investment, we can lay a new foundation for growth.

[6] CRFB, Fiscal Turnarounds: International Success Stories, February 2010.

Entitlement reform must be at the center of any turnaround plan. The largest programs in our budget that are growing faster than the economy—Social Security, Medicare, and Medicaid—must be reformed. Their open-ended growth is already squeezing out other parts of the budget, threatens to push up tax rates to truly damaging levels, and their automatic nature removes the critical oversight and evaluation processes that should be a central part of budgeting.

And finally, our tax code is simply a massive mess. It is littered with over 250 special credits, deductions, exemptions, and exclusions that cost us nearly $1.1 trillion a year. These "tax expenditures" are truly just spending by another name. By reducing, if not eliminating, many of them, we can reduce tax rates to more effectively encourage work and investment, while also helping to reduce deficits. Fundamental tax reform is key in turning our fiscal situation around and strengthening our economic well-being.

A comprehensive fiscal plan that stabilizes debt and then reduces it thereafter must be center to any economic recovery and growth strategy. The economy and private investment would become unburdened by debt, the country would have the budget flexibility to respond to emergencies and to invest in critical areas for long-term prosperity, investors would remain confident in our ability to repay our debts, and businesses and consumers would have certainty over future spending cuts and tax changes. Most importantly, we would be handing down even better opportunities to the next generation.

While the policy choices involved in tackling our out of control debt are not easy, they are far easier than what we will face if we continue to delay. It is our hope that we will spend this year developing specific options for tackling the debt, discussing the trade-offs, making the necessary compromises, and ultimately passing a multi-year plan to change course. This will reassure markets, provide families and businesses with the stability they need, and set us on a course for a much brighter economic future. Continuing to delay is a very risky strategy.

Thank you to the Committee for all your work on this and the opportunity to appear here today.