Testimony on:
Lifting the Crushing Burden of Debt

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Introduction

Chairman Ryan, Ranking Member Van Hollen and Members of the Committee thank you for the privilege of appearing today. In this short statement, I wish to make the following points:

- The outlook for deficits and debt threatens the Nation's prosperity and freedom. Changing the fiscal course should be our top national priority.

- Controlling the growth of future federal spending should be the central objective of policymakers in pursing this goal.

- Effectively controlling spending, reducing deficits, and eliminating future debt accumulation can aid near-term economic growth.

Let me discuss each in turn.

The Threat of Future Debt

The Fiscal Outlook. The federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook*[1]. In broad terms, over the next 30 years, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of Gross

[*] The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Sam Batkins, Ike Brannon, Cameron Smith and Matt Thoman for assistance.
[1] Congressional Budget Office. 2010. *The Long-Term Budget Outlook.* Pub. No. 4130. http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf

Domestic Product (GDP) to anywhere from 30 to 40 percent of GDP. Any attempt to keep taxes at their post-war norm of 18 percent of GDP will generate an unmanageable federal debt spiral.

This depiction of the federal budgetary future and its diagnosis and prescription has all remained unchanged for at least a decade. Despite this, action (in the right direction) has yet to be seen.

Those were the good old days. In the past several years, the outlook has worsened significantly.

Over the next ten years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2011[2], the deficit will never fall below $700 billion. Ten years from now, in 2020, the deficit will be 5.6 percent of GDP, roughly $1.3 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.

As a result of the spending binge, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will continue its upward trajectory.

The President has now released his budget for Fiscal Year 2012. While CBO has yet to have the opportunity to provide a non-partisan look its implications, my reading of the budget is that it is largely replicates the previous year's outlook.

The "Bad News" Future under Massive Debt Accumulation. A United States fiscal crisis is now a threatening reality. It wasn't always so, even though – as noted above – the Congressional Budget Office has long published a pessimistic *Long-Term Budget Outlook*. Despite these gloomy forecasts, nobody seemed to care. Bond markets were quiescent. Voters were indifferent. And politicians were positively in denial that the "spend now, worry later" era would ever end.

Those days have passed. Now Greece, Portugal, Spain, Ireland, and even Britain are under the scrutiny of skeptical financial markets. And there are signs that the U.S. is next. The federal government ran a fiscal 2010 deficit of $1.3 trillion – nearly 9 percent of GDP, as spending reached nearly 24 percent of GDP and receipts fell below 15 percent of GDP.

What happened? First, the U.S. frittered away its lead time. It was widely recognized that the crunch would only arrive when the baby boomers began to retire. Guess what? The very first official baby boomer already chose to retire early at age 62, and the number of retirees will rise as the years progress. Crunch time has arrived and nothing was done in the interim to solve the basic spending

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[2] Congressional Budget Office. 2010. *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011.* Pub. No. 4111.
http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf

problem – indeed the passage of the Medicare prescription drug bill in 2003 made it worse.

Second, the events of the financial crisis and recession used up the federal government's cushion. In 2008, debt outstanding was only 40 percent of GDP. Already it is over 60 percent and rising rapidly.

Third, active steps continue to make the problem worse. The Affordable Care Act "reform" adds two new entitlement programs for insurance subsidies and long-term care insurance without fixing the existing problems in Social Security, Medicare, and Medicaid.

Financial markets no longer can comfort themselves with the fact that the United States has time and flexibility to get its fiscal act together. Time passed, wiggle room vanished, and the only actions taken thus far have made matters worse.

As noted above, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will continue its upward trajectory. Traditionally, a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis.

Indeed, there are warning signs even before the debt rises to those levels. As outlined in a recent report[3], the credit rating agency Moody's looks at the fraction of federal revenues dedicated to paying interest as a key metric for retaining a triple-A rating. Specifically, the large, creditworthy sovereign borrowers are expected to devote less than 10 percent of their revenues to paying interest. Moody's grants the U.S. extra wiggle room based on its judgment that the U.S. has a strong ability to repair its condition after a bad shock. The upshot: no downgrade until interest equals 14 percent of revenues.

This is small comfort as the 2011 Obama Administration budget targets 2015 as the year when the federal government crosses the threshold and reaches 14.8 percent. Moreover, the plan is not merely to flirt with a modest deterioration in credit-worthiness. In 2020, the ratio reaches 20.1 percent.

Perhaps even more troubling, much of this borrowing comes from international lending sources, including sovereign lenders like China that do not share our core values.

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[3] Moody's determines debt reversibility from a ratio of interest payments to revenue on a base of 10 percent. Wider margins are awarded to various governments to indicate the additional "benefit of the doubt" Moody's awards. The US finds itself on the upper end at 14 percent. The ratios are "illustrative and are not hard triggers for rating decisions." See: *Aaa Sovereign Monitor Quarterly Monitor No. 3*. Moody's Investor Service. March 2010.

For Main Street America, the "bad news" version of the fiscal crisis occurs when international lenders revolt over the outlook for debt and cut off U.S. access to international credit. In an eerie reprise of the recent financial crisis, the credit freeze would drag down business activity and household spending. The resulting deep recession would be exacerbated by the inability of the federal government's automatic stabilizers – unemployment insurance, lower taxes, etc. – to operate freely.

Worse, the crisis would arrive without the U.S. having fixed the fundamental problems. Getting spending under control in a crisis will be much more painful than a thoughtful, pro-active approach. In a crisis, there will be a greater pressure to resort to damaging tax increases. The upshot will be a threat to the ability of the United States to bequeath to future generations a standard of living greater than experienced at the present.

Future generations will find their freedoms diminished as well. The ability of the United States to project its values around the globe is fundamentally dependent upon its large, robust economy. Its diminished state will have security repercussions, as will the need to negotiate with less-than-friendly international lenders.

The "Good News" Future under Massive Debt Accumulation. Some will argue that it is unrealistic to anticipate a cataclysmic financial market upheaval for the United States. Perhaps so. But an alternative future that simply skirts the major crisis would likely entail piecemeal revenue increases and spending cuts – just enough to keep an explosion from occurring. Under this "good news" version, the debt would continue to edge northward – perhaps at times slowed by modest and ineffectual "reforms" – and borrowing costs in the United States would remain elevated.

Profitable innovation and investment will flow elsewhere in the global economy. As U.S. productivity growth suffers, wage growth stagnates, and standards of living stall. With little economic advancement prior to tax, and a very large tax burden from the debt, the next generation will inherit a standard of living inferior to that bequeathed to this one.

Controlling Spending to Reduce Deficits and Debt

The policy problem facing the United States is that spending rises above any reasonable metric of taxation for the indefinite future. Period. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of large mandatory spending programs and the appetite for federal outlays, in general.

As an example, using the President's 2011 Budget, the CBO projects that over the next decade the economy will fully recover and revenues in 2020 will be 19.6 percent of GDP – over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP – about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era.

Just as some would mistakenly believe that the federal government can easily "tax its way out" of this budgetary box there is an equally misguided notion in other quarters that it can "grow its way out." The pace of spending growth simply must be reduced.

The Need for Rapid Action. The potential for a U.S. fiscal crisis is rising each day. This, it makes sense to quickly adopt reductions in annual discretionary spending to reduce future deficits. Discretionary spending is appealing as a starting point because it is the spending most easily and quickly modified by Congress. Any successful strategy will likely be built on three pillars:

- Rolling back spending to the "normal" funding levels preceding the financial crisis in 2008 and economic downturn;

- Adhering to a disciplined vision for a small, contained government. Such a vision would provide a demarcation between those things the government is uniquely equipped to undertake and those that are best not funded and left to the private sector; and

- Relying on strict oversight to defund those programs that do not effectively meet the government's service obligations.

At the same time, mandatory spending programs cannot be left to evolve as dictated by current law. It is equally important to quickly undertake entitlement reform. To see the need for urgency, consider first Social Security.

Social Security contributes to the current deficit. At present, Social Security is running a modest cash-flow deficit, increasing the overall shortfall. As the years progress, these Social Security deficits will become increasingly larger. They are central to the deficit outlook. More importantly, the stream of future outlays is heavily driven by demography. In particular, if the future benefits of the baby boom generation are exempted from reform, either by design or a failure to move quickly, then the outlay "problem" will have been effectively exempted from reform. This would be a fundamental policy failure.

For this reasons, an immediate reform and improvement in the outlook for entitlement spending would send a valuable signal to credit markets and improve the economic outlook.

Naturally, it would be desirable to focus on the larger future growth in outlays associated with Medicare, Medicaid, and the Patient Protection and Affordable Care Act (ACA). These share the demographic pressures that drive Social Security, but include the inexorable increase in health care spending per person in the United States. From a policy perspective, it would be desirable to replace the ACA with reforms that raised the efficiency of health care spending and slowed the growth of per capita health care outlays. At the centerpiece of such reforms would be reforms to the Medicare and Medicaid programs. However, in the absence of a political consensus to revisit the ACA, Medicare and Medicaid reforms will remain paralyzed and the most promising area for bipartisan entitlement reform is Social Security.

The Role for Tax Policy. While it will not be possible or desirable to rely on pure revenue increases to address the looming debt explosion, there is a role for improved tax policy to support economic growth. What is needed now is a tax policy that has incentives for businesses and entrepreneurs to locate in America and spend at a faster rate on innovation, workers, repairs, and new plants and equipment.

The place to start is the corporate income tax, which harms our international competitiveness in two important ways. First, the 35 percent rate is far too high: when combined with state-level taxes, American corporations face the highest tax rates among our developed competitors.[4] The rate should be reduced to 25 percent or lower.

Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.

Proponents of the worldwide approach argue that because it doesn't let American firms enjoy lower taxes when they invest abroad, it gives them no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these

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[4] Some defend the high corporate tax rate by arguing that the effective corporate tax rate is much lower. This misses an important point. Every country's effective tax rate is also lower than its statutory rate. A recent study by two economists at the University of Calgary (http://www.cato.org/pubs/tbb/tbb_64.pdf)concludes that the marginal tax rate in the U.S on new investment is 34.6 percent, higher than any other country in the OECD.

two investments equally, wisely giving the company that invests in Brazil no advantage over its competitor.

But this line of reasoning ignores three points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will fail, unable to compete effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business. And finally, because the U.S. is the holdout using a worldwide approach, it is at a disadvantage as the location for the headquarters of large, global firms. As the U.S. loses the headquarters, it will lose as well the employment, research and manufacturing that typically is located nearby.

The corporate tax should be reformed further. At present, companies must depreciate their capital purchases over time. Instead, they should be allowed to deduct immediately the full cost of all investments, which would provide a dramatic incentive for spending. We should also consider phasing out the tax-deductibility of the interest that companies pay on their borrowing. Because this interest is deductible and the companies' own dividends are not, firms have an incentive to borrow excessively. Removing that incentive—making a firm's tax liability dependent not on its financial decisions but on its real economic profitability—would discourage financial engineering and focus corporations on their core mission.

A more competitive corporate-tax system would be a good start in our effort to encourage private-sector growth. But a lot of private-sector economic activity in the U.S. isn't affected by the corporate tax at all. Activity that takes place in sole proprietorships, partnerships, and other "pass-through entities"—organizations whose income is treated solely as that of their investors or owners—is instead affected by the individual income tax. Congress' Joint Committee on Taxation projects that in 2011, $1 trillion in business income will be reported on individual income-tax returns.

It's important to note that nearly half of that $1 trillion—$470 billion—will be reported on returns that face the top two income-tax rates. A conservative estimate is that more than 20 million workers would be employed by firms directly affected by those two tax rates. Tax reform should avoid higher marginal tax rates in favor of lower rates and a broader base. Marginal tax rates and the taxation of dividends and capital gains directly affect companies' decisions about innovation, investment, and savings.

Americans—from homeowners to small businesspeople to the millions of unemployed—are in desperate need of faster and prolonged economic growth.

Congress should therefore evaluate tax proposals based on whether they're likely to trigger and support that growth. Tax policy can play a key role in spurring an economic recovery—but not without sustained reform of both the corporate and individual income-tax systems.

The Economics of Spending Control

The top issue facing Americans is the need for robust job growth. According to the National Bureau of Economic Research the recession began in December 2007. Their data show that there were 142.0 million jobs in December of 2007 – the average of payroll and household survey data. In June 2009, NBER's date for the end of the recession, the same method showed 135.3 million jobs, for a total job loss of 6.7 million attributed to the recession. These numbers are quite close to those using the Bureau of Labor Statistics non-farm payroll data, which showed a loss of 6.8 million.

There are glimmers of promise. Since December 2009, 945,000 payroll employment jobs have been added. However at the same time, there are 14.5 million unemployed persons in the economy and many more discouraged workers. Since the start of the recession the labor force has fallen by nearly 500,000.

For these reasons, the current unemployment rate of 8.9 percent likely understates the real duress. Using the BLS alternative unemployment rate (U-6), one finds that unemployed, underutilized and discouraged workers are 15.9 percent of the total. As evidence of the difficulties, the number of long-term unemployed (27 weeks or more) is currently 5.9 million and accounts for 43.9 percent of all unemployed persons.

The fiscal future outlined above represents a direct impediment to job creation and growth. The United States is courting downgrade as a sovereign borrower and a commensurate increase in borrowing costs. In a world characterized by financial market volatility stemming from Ireland, Greece, Portugal, and other locations this raises the possibility that the United States could find itself facing a financial crisis. Any sharp rise in interest rates would have dramatically negative economic impacts; even worse an actual liquidity panic would replicate (or worse) the experience of the fall of 2008.

Alternatively, businesses, entrepreneurs and investors perceive the future deficits as an implicit promise of higher taxes, higher interest rates, or both. For any employer contemplating locating in the United States or expansion of existing facilities and payrolls, rudimentary business planning reveals this to be an extremely unpalatable environment.

In short, cutting spending is a pro-growth policy move at this juncture. As summarized by a recent American Action Forum the research indicates that the best strategy to both grow and eliminate deficits is to keep taxes low and reduce public employee costs and transfer payments.[5]

Keynesian Arguments and Reducing Spending. Recent analyses of H.R. 1, the continuing resolution that called for $61 billion in reduced federal spending, by Goldman Sachs[6] and Economy.com[7] have been touted by some as evidence that it is not feasible to engage in spending reductions. I believe these arguments miss several key points.

The first thing to note is that while Members are aware that a reduction of $61 billion in <u>budget authority</u> does <u>not</u> translate into an immediate $61 billion cut in <u>outlays</u>, many analysts appear to not understand these budgetary facts. Indeed, on average, a $1 cut would translate into only 52 cents during the current fiscal year.

To generate their estimates, Goldman Sachs assumed outlay reductions of $15 billion in the 2nd quarter and $30 billion in the 3rd quarter of calendar 2011. Naively interpreted, this could produce noticeable impacts on quarter-to-quarter GDP growth. But this is a misleading and highly <u>overstated</u> estimate of the likely impact because:

- The CBO estimates an outlay reduction of only $9 billion in fiscal 2011, or an impact of at most 0.3 percentage points;

- The calculation assumes full dollar-for-dollar reduction in GDP as spending declines. This is too large, especially because;

- Not all outlay reductions are actual cuts in the purchases of goods and services to contribute to measured GDP. Instead, some are transfers payments to states or individuals that will have a more muted impact. Indeed, while FY 2010 showed outlays of $3,456 billion on a budget basis, the National Income and Product Accounts[8] showed under 30 percent ($1,030 billion) as consumption purchases;

- Not all of the budget authority cuts are from new spending. Instead, some are rescissions of the authority for <u>spending that never occurred and might never occur</u>; and

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[5] See http://americanactionforum.org/news/repairing-fiscal-hole-how-and-why-spending-cuts-trump-tax-increases
[6] http://blogs.abcnews.com/thenote/2011/02/goldman-sachs-house-spending-cuts-will-hurt-economic-growth.html
[7] Zandi, Mark. 2011. *A Federal Shutdown Could Derail the Recovery.* Moody's Analytics. http://www.economy.com/dismal/article_free.asp?cid=197630&src=wp
[8] Congressional Budget Office. 2011. *CBO's Projections of Federal Receipts and Expenditures in the Framework of the National Income and Product Accounts.* Pub. No. 4250.

- Most importantly this is a static calculation that assumes no beneficial offset in private sector spending because of the improved budget outlook and prospect of lower future taxes and interest rates. Put differently, the criticisms ignore the rationale for making these beneficial cuts to begin with: to clear the way for private sector jobs and growth.

A different way to make the last point is to note that these "Keynesian" arguments invoke a sterile, mechanical view of his economic views. In fact, Lord Keynes placed considerable importance on the role of expectations and optimism regarding the economic environment – so-called "animal spirits". Policies that enhance the willingness and desirability of businesses to invest fit neatly in to his view of business cycles and economic growth.

Importantly, recent movements in indexes of economic confidence ranging from small businesses, to CEOs, to households have shown considerable improvement (See Table).

Measures of Economic Confidence

NFIB Small Business Optimism Index[1]

Jul 10'	***Aug 10'***	***Sept 10'***	***Oct 10'***	***Nov 10'***	***Dec 10'***	***Jan 11'***	***Feb 11'***
88.1	88.8	89	91.7	93.2	92.6	94.1	NA

Chief Executive CEO Confidence Index[2]

Jul 10'	***Aug 10'***	***Sept 10'***	***Oct 10'***	***Nov 10'***	***Dec 10'***	***Jan 11'***	***Feb 11'***
4.7	5	4.9	5.1	5.8	5.8	6.3	6.4

Reuters/Michigan Survey of Consumer Sentiment[3]

Jul 10'	***Aug 10'***	***Sept 10'***	***Oct 10'***	***Nov 10'***	***Dec 10'***	***Jan 11'***	***Feb 11'***
67.8	68.9	68.2	67.7	71.6	74.5	74.2	77.5

[1]http://www.nfib.com/Portals/0/PDF/sbet/sbet201102.pdf
[2]http://www.chiefexecutive.net/ME2/Audiences/Default.asp?AudID=328DCF73ACA1493ABBD34BF8AB37D74A
3https://customers.reuters.com/community/university/

No definitive explanation of month-to-month movements in measures of confidence will emerge from this hearing. However, I find it supportive of the basic argument that confidence improved markedly as the election and Congressional debate shifted toward control of future spending, deficits, and debt.

Two final aspects of the recent, Keynesian-based opposition to controlling spending are perplexing. Often those who make the claim that a $61 billion cut in spending will endanger the recovery are equally willing to argue that tax increases are needed to close the deficit. However, in a Keynesian model tax increases and transfer decreases enter in exactly the same manner. If the latter endanger the recovery, so must the former!

More importantly, entitlement reform – the repeal of the Affordable Care Act, Medicare reform, Medicaid reform, or Social Security reform – is likely to have no immediate impact on federal outlays. Instead, they are commitments in the present to reduced spending in the future. By construction, they can have no negative, Keynesian impacts on recovery. Instead, they carry only beneficial impacts on the expectations of employers and other market participants.

Conclusion

At this juncture, the United States needs a keen focus on enhancing the rate of economic growth. Workers and economy as a whole will benefit from pro-growth policies. Central aspects of a pro-jobs and growth agenda are controlling federal spending growth; eliminating the potential for debt accumulation that generates a fiscal crisis, or higher taxes and interest rates; and improved tax policy.

I look forward to answering your questions.