TESTIMONY TO COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

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Washington, DC
June 30, 2010

Senator Simpson, Senator Bowles, and Members of the Commission, thank you for holding this hearing. By way of introduction, I am Edward Gresser, President of the Democratic Leadership Council, a non-profit think tank conducting policy research and publishing on topics areas ranging from trade and globalization to government reform, environmental and energy policies and other issues.

INTRODUCTION

Fiscal responsibility has been a central issue for the DLC through the 25 years since our founding in 1985. We view this principle as a key to good economic policy and a foundation for public support of activist and progressive government. This has never been more true than today, when we face not only the large budget gap emerging from our economic crisis, but – looking to 2020 and beyond – a long-term fiscal challenge perhaps more difficult than any since the early years of the republic. Because of this, we are grateful to President Obama for establishing the Commission, and to each of you for making the commitment to guide the nation toward solutions.

Our fiscal challenge is great – but it also offers a chance to reshape some institutions for a new century and new needs. If we approach it with creativity as well as willingness to make tough choices, America can emerge from it with fairer taxation, more opportunity in retirement, better economic prospects than we have today, and a more engaged citizenry. Let me suggest six principles as we begin:

- *Nothing Off the Table:* Encourage open debate on all spending, tax and budget-process options.
- *Pay for Wars:* Cease financing wars solely through deficits, and return to a commitment to share sacrifice by financing wars in part through special taxes.
- *Budget Process Reform:* Create and enforce strong institutional restraints on deficits, beginning with budget caps and revived pay-as-you-go requirements for new tax cuts and spending.
- *Reinvent Government:* Reshape federal agencies to focus more effectively on the highest-priority services, and deliver those services to the public more efficiently.
- *Pro-Growth Policies:* Adopt (and preserve) policies in spending, taxation, trade and other fields that encourage innovation, efficiency, and therefore the higher long-term growth rates that allow us to raise more revenue.
- *Change Demographic Facts:* Rethink retirement, encourage high-skill immigration, and take other options that raise the number of workers, entrepreneurs and inventors while reducing the growth of the retired population.

THE 2010 DEFICIT IN CONTEXT

Let me now offer some more detailed thoughts, beginning with our immediate circumstances.

Last March, halfway through Fiscal Year 2010, the Congressional Budget Office estimated that this year the government will take in $2.12 trillion in taxation and other revenue, and spend $3.62 trillion. The resulting deficit, of $1.5 trillion, is nearly 10 percent of GDP and includes $1.3 trillion exclusive of interest payments on existing debt. Some historical context illuminates its true scale.

The peak New Deal budget deficit in 1934 was 5.9 percent of GDP. A generation ago, the Reagan administration's deficits exceeded the New Deal record, peaking in 1983 at 6.0 percent of GDP. The current deficit is well above either – so to find a comparable deficit we must look to wartime eras.

The World War II deficits were the largest we have ever run, rising to 30.3 percent of GDP in 1943 and leaving a national debt above 100 percent of GDP by the later 1940s. Since our first measurements of GDP date to 1929, we have no highly accurate measurement of earlier deficits. But based on academic estimates, President Wilson's World War I deficit was probably 17 percent of GDP in 1918, and the Union's Civil War deficit more tentatively around 20 percent of GDP for several years.

Our ability to manage these earlier deficits suggests grounds for optimism. After the Civil War, World War I and World War II, administrations and Congresses restored fiscal discipline rapidly through military demobilization and taxes. Economic growth then brought down the level of debt without crippling later generations or forcing massive austerity and public suffering. The budget bills of 1990 and 1993 are recent precedent for deficit cuts which shared sacrifice, reduced debt burdens, and helped create an era of confidence and growth.

But our current challenges are in some ways greater than those posed by these earlier deficit peaks. After 2015, large and severe budget deficits re-emerge under CBO's forecast and debt buildups rise very fast. These deficits will be the structural consequence of facts about demography, health costs and debt buildups, rather than the result of the temporary measures which make up most of our 2010 deficit and which raised earlier wartime deficits to their peak levels. By 2020, CBO forecasts that deficits will raise our public debt from 60 percent of GDP to nearly 100 percent of GDP. Alternative forecasts by the Office of Management and Budget, or by independent groups like the IMF or OECD, differ in detail but suggest a similar outlook. This deficit will not close again for natural and cyclical reasons. The only effective responses will be fundamental changes in policies and national institutions. The sooner we begin these changes, the less painful and the more rewarding they will be.

TASK 1: MANAGEMENT TOWARD 2015

With this outlook in the background, the president's Executive Order assigns the Commission two tasks. The first is short-term:

> "[T]he Commission shall propose recommendations designed to balance the budget, excluding interest payments on the debt, by 2015. This result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers. The magnitude and timing of the policy measures necessary to achieve this goal are subject to considerable uncertainty and will depend on the evolution of the economy."

Today's deficit has risen from 2.8 percent of GDP in 2007 to this year's 10 percent of GDP principally for temporary (or at least semi-temporary) reasons. We can expect some of these to ease in the next two years. First, the crisis which began in 2008, combined with the tax features of the 2009 stimulus bill, have reduced revenue from about 19 percent of GDP in 2007 to 14.6 percent of GDP in FY201. Second, the crisis simultaneously increased the need for transfer payments to help the unemployed, fiscal stimulus to prevent a severe and lasting depression, and support for state and local governments. Third, the wars in Afghanistan and Iraq are expensive, but not permanent obligations, and if we can maintain the president's planned withdrawal schedule in the coming years, their expenses will drop. And finally, as the tax cuts of 2001 and 2003 expire at least in part, revenue will rise further.

CBO's projection for the coming years reflect these facts. Without new emergencies, deficits will fall to 4.1 percent of GDP, and or to an absolute total of $284 billion exclusive of interest, by fiscal year 2014. This is not enough to reach the Executive Order's goal, but brings it within sight. With several policy reforms – often valuable in themselves as well as desirable on fiscal grounds – we will be able to meet this goal:

- Enforce the discretionary budget caps and pay-as-you-go rules adopted this year.
- Begin paying for the expense of the Afghanistan and Iraq deployments through special taxes rather than through emergency appropriations and borrowing.
- Conclude a WTO Doha Round which reduces entitlement spending on farm programs, in particular for wealthy farmers, while compensating by opening new export markets for farmers.

As the Executive Order implies, short-term deficit reduction does have some risks. Our economy sustained a severe shock in 2008 and remains weak. Premature withdrawal of aid to unemployed people and state/local governments can pose a risk of relapse. We need to monitor policy carefully to avoid this, and be aware that new emergencies are entirely possible. But it is also true as we reduce our large short-term deficit, our debt buildup in the later years of this decade slow and our future interest payments will become less burdensome.

2015 AND BEYOND: STRUCTURAL GAPS AND INSTITUIONAL CHANGE

The Executive Order's second assignment looks further ahead, to the structural problems which emerge in the second half of this decade:

> "the Commission shall propose recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government."

Here the Executive Order highlights our central challenge. In contrast to the 2010 deficit – and also in contrast to the deficits of the New Deal, the Reagan era, World War I, and World War II – our longer-term fiscal deterioration reflects facts about demographics, health and compounding interest rather than policy choices:

- First, the retiree population will grow faster than the workforce. The Bureau of Labor Statistics predicts that after 2015, and at least up to 2030, America's workforce will grow by about 1.1 million per year. Meanwhile the Census Bureau predicts that our population above 65 will grow by about 1.5 million per year.

- Second, retirees will use Medicare and Social Security for longer periods of time. American life expectancies after 65 are steadily rising as medical technology improves. This means that the next decade's retirees will take health and pension benefits for longer periods of time than the retirees of earlier decades, and federal obligations under Medicare and Social Security will grow faster than the pace of retirement.

- Third, health-care costs continue to rise more rapidly than inflation, meaning that the cost of Medicare (and other health entitlement programs) is likely to grow especially rapidly.

- Fourth, the annual net interest payments implied by steadily rising annual deficits will grow, rising from this year's $209 billion to more than $900 billion by 2020, or from one dollar in every thirteen spent to one dollar in eight.

CBO's forecast makes the implications of these facts clear. After recovering from this crisis, revenue will remain roughly at historical levels of around 19 percent of GDP. Spending, by contrast, will rise above 25 percent of GDP by 2020. (And it will likely continue to rise thereafter, though the years after 2020 are outside the scope of CBO's forecasts.) The table below, adapted from CBO's March 2010 projections, shows the consequence: deficits will rise steadily, not because of a drop in revenue or because of discretionary spending, but because of aging-related entitlement spending along with interest payments.

BUDGET OUTLOOK TOWARD 2020

	2010	**2014**	**2020**	**Growth 2014 - 2020**
Revenue	$2.12 trillion	$3.34 trillion	$4.42 trillion	$1.08 trillion
Total spending	$3.62 trillion	$4.07 trillion	$5.67 trillion	$1.60 trillion
Discretionary	$1.38 trillion	$1.30 trillion	$1.45 trillion	$150 billion
Entitlement	$2.03 trillion	$2.32 trillion	$3.27 trillion	$950 billion
Medicare	*$0.53 trillion*	*$0.72 trillion*	*$1.05 trillion*	*$330 billion*
Social Security	*$0.70 trillion*	*$0.84 trillion*	*$1.17 trillion*	*$330 billion*
Medicaid	*$0.27 trillion*	*$0.29 trillion*	*$0.44 trillion*	*$150 billion*
Interest payments	$0.21 trillion	$0.42 trillion	$0.92 trillion	$500 billion
Deficit	$1.50 trillion	$0.72 trillion	$1.25 trillion	$530 billion

TOWARDS SOLUTIONS

We cannot rely solely on tax increases, discretionary spending cuts or combinations of these options to meet this challenge. They can reduce any annual deficit and delay the growth of the debt burden. But if the demographic facts driving the long-term deficit do not change, the fiscal challenge will not go away. Rather, we will see the tax burden steadily increase while the government’s ability to provide the essential services funded by discretionary spending – military readiness, road safety, environmental protection and education – declines.

Nor can we rely solely on cuts in entitlement spending. Medicare and Social Security are part of a national commitment to provide older men and women a reasonable degree of security in retirement, to which retirees have made their own contribution, through payroll tax payments made throughout their working lives. If cuts in these programs simply reduce security in old age, a relatively smaller working population will need to make up the difference. In that case, government’s books will improve, but the fundamental economic health of the nation will not.

An effective response, therefore, begins with the principle that nothing is off the table. No tax measure, spending cut, entitlement reform, budget-process rule or other option should be rejected at the outset. All these options should play some part in solving our challenge. But at bottom, our long-term fiscal challenge is the result of facts about demography and health costs, and the consequences of these facts. Therefore our policy measures need to be combined with an effort to change the facts: to provide more workers and entrepreneurs despite slower population growth, to have fewer retirees despite an aging population, to reduce health inflation despite new medical technologies, and to promote faster growth in GDP despite slower growth in the workforce. To achieve this, we suggest the following measures:

- *Tight and permanent budget process reforms:* If we set clear rules for budgeting, applying not only to discretionary spending but to revenue policy and entitlements, we will more effectively control the budget as a whole. In addition to the pay-as-you-go rules and discretionary caps, we should consider long-run targets for entitlement spending and tax expenditures. If unexpected events or changes in trends push spending or tax expenditures above these targets, automatic triggers could be used to slow spending growth, increase revenues, or some combination of the two.

- *Pay for Wars:* If we end the habit developed since the Vietnam War of financing wars wholly through deficits, we will encounter fewer emergency-driven deficit spikes and foster an ethic of citizenship and shared sacrifice. War's human cost falls on soldiers in the field and their families at home. Governments which ask this of them should also be willing to ask the people on the home front to make smaller sacrifices; and civilians should be willing to share in the burden of war, as they did in all wars until recently, through paying a large part of the cost through taxation.

- *Reform taxation:* If we create a tax system simpler than today's, with a broader and fairer base and incentives that do more for growth, efficiency and savings than our current thickets of credits, exclusions and deductions, we will have a fairer tax system and ensure that as much of our additional revenue as possible comes from closing loopholes rather than raising rates. When we do raise rates, if possible we should do so in ways that discourage behavior which drives up federal spending and costs – the "Cadillac tax" imposed on high-cost health plans in this year's national health reform bill is a good example – or serves some other major policy goal such as energy conservation.

- *Reinvent government*: If we reform government to increase efficiency, we preserve services and reduce spending. Health services can draw on the experience of state governments like Pennsylvania's, which have saved money by relying more heavily on care by nurses, rigorously preventing expensive hospital-acquired illnesses, and reducing overhead by computerizing records. Military spending can focus more directly on national security by closing unneeded bases and rethinking spending on commitments in Europe. More generally, David Osborne's concept of "budgeting for outcomes," in which agencies annually or semi-annually rank their top priorities and direct spending to them and away from lower priorities, will help agencies shift away from a 'baseline' mentality which protects dated or less effective programs while preventing investments in areas of higher priority or greater return.

- *Support Growth:* If we find policies that promote higher rates of growth, we raise the growth of revenue and shrink the budget gap. One would be to speed up trade liberalization that opens export markets abroad, and creates more efficient markets at home by removing tariffs and business subsidies. Another would be to preserve and in some cases strengthen public investments and tax incentives which have clear links to growth and competitiveness: examples include infrastructure improvements, government support for scientific research and education, and tax incentives for private-sector research and development.

- *Encourage Faster Work-Force Growth, Innovation and Business Formation:* If we increase the number of active workers, inventors and entrepreneurs, we raise the growth rate and increase the flow of tax revenue into the Treasury. Sharp and immediate increases in high-skilled immigration are an easy option, penalizing nobody and rewarding many by adding the high-wage workers, inventors and entrepreneurs who raise national productivity, invent new products and start new businesses.

- *Rethink Retirement:* If we reduce the number of physically and mentally fit people who choose to retire in their late 60s and early 70s, we reduce the government's entitlement spending obligations. The simplest approach is to raise the retirement age, at minimum for workers in less physically demanding jobs. Other options could include offering ways to mix part-time and on-line work with partial Social Security benefits after age 67 and into the eighth decade of life, with somewhat higher benefits for in exchange for later retirement.

CONCLUSION

The CBO's charts and data reveal a period of fiscal challenge unlike any in our nation's history. To meet it we need more than adjustments in course, belt-tightening, or tough choices among competing goals. We need to change the way government provides services and collects revenue, the way we think about retirement, the way we think about work among older Americans, and the way we look at workforce growth and the promotion of innovation and entrepreneurialism.

We are not alone in this. Fate has not singled out America for an unusually difficult challenge. Other major economies – the European Union, Japan, China, Korea – face identical questions. Most have more private savings to cushion the impact; but they also have faster aging rates and less willingness to accept immigrants, and therefore have fewer policy options and a more rapidly arriving fiscal crisis than we do. But for any country, including the United States, to avoid action is to court the fate of Greece, in which financial markets solve a structural budget gap at great cost in living standards and national power.

America has a space of time in which to act. If we lack the vision for bold institutional change, we will face an unappealing choice: on the one hand, simply waiting for financial markets to make the choices for us; on the other, relying solely on higher taxes and reduced services, narrowing the opportunities for our young people, and simply delaying the arrival of crisis. But if we have the boldness to reshape institutions, reimagine retirement and reinvent government, we can look ahead – to a fairer society, to a more rewarding life for a growing population of older Americans, to government better able to earn public confidence and trust, and to a 21st-century America as able to lead the world as was the America of the 20th century.

Members of the Commission, this is the task the president has set before you. We are grateful to you for taking it up, and we thank you for this chance to present our views.