“Why Debt Matters”

Testimony of

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The Brookings Institution

Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

I am glad you are holding this hearing to focus Congressional and public attention on why debt matters and appreciate the opportunity to share my views. The question of what to do about rising future debt, which was a hot topic on the political agenda until quite recently, has suddenly disappeared from the legislative radar screen. I am afraid this disappearance is evidence of our short national attention span and gridlock in our polarized politics that prevents our coming to grips with serious long-run problems that are not immediate crises.

I would like to make three main points: First, debt matters. Getting our budget onto a sustainable path—one that will eventually lower the ratio of public debt to GDP-- is essential to our future prosperity and ability to pay a leadership role in the world. Second, we do not have to choose between growing the economy and reducing future debt. We need to do both—and we can. Third, we do not face an immanent debt crisis that requires drastic immediate action to stave off a meltdown. Rather we face a challenge that is harder for our political process to deal with: the need to come together across party lines and take sensible action now that will pay off over decades to come.

Current projections—less scary, but still not sustainable

Back in 2010, when you and I, Mr. Chairman, served on the Simpson Bowles Commission, both the economic and budget outlooks were truly scary. Recovery from the Great Recession had barely started. Unemployment was nearly ten percent of the workforce. The recession combined with measures to mitigate its effects had ballooned the deficit to nearly nine percent of GDP, and the debt/GDP ratio had risen rapidly to more than 60 percent, a level not seen in decades. The stimulus and the Fed’s aggressive monetary easing were helping the economy recover, but it was not certain that stronger growth would take hold. We knew that the high

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deficits would come down as the economy recovered and the stimulus spent out—and they have—but we also realized that later in this the decade deficits would begin to rise again and the debt increase would accelerate. The immanent retirement of the Baby Boom generation, combined with increasing longevity and rapidly rising health care costs would drive federal spending up faster than the economy or revenues could grow, even with solid recovery from the recession. The wedge between projected spending and revenues would widen and push the debt/GDP ratio into uncharted territory in the 2020s. The prospect of a debt crisis in the not too distant future--international investors losing confidence in U.S. Treasuries and interest rates escalating rapidly--was a serious concern.

Bipartisan groups—not just Simpson Bowles, but Domenici Rivlin, the Gang of Six, and others—worked hard to craft "grand bargains" that would stabilize the rising debt burden and eventually begin to lower it. The plans had four common elements: slow the growth of the health care entitlements, get Social Security into long-run balance, reform the tax system to produce more revenue by broadening the base and lowering the rates, and cap the growth of discretionary spending. These plans back-loaded the changes, limiting immediate deficit reduction (or even increasing spending) to avoid derailing the fragile recovery and but slowly phasing in reforms in entitlements and taxes to reverse the long-run debt increases. In my opinion, this was the right policy then and still is.

However, actual policy enacted since 2010 was almost the reverse of the bipartisan groups' recommendations. We have seen a series of substantial near-term cuts in discretionary spending, increases in high-income tax rates, and almost no action on long-run tax and entitlement reform. The Murray Ryan budget agreement had the great virtue of bringing about a two-year cease fire in the budget wars and restoring a semblance of regular order, but it was not a "grand bargain" designed to reduce long-term debt.

Nevertheless, both the economic and budget outlooks have improved. Despite bizarre shenanigans in Washington (shutting the government, the fiscal cliff, and two debt ceiling crises) and severe fiscal drag (partially offset by monetary ease), the remarkably resilient American economy survived the battering and recovery strengthened, albeit not as much as any of us would like. The deficit has fallen rapidly (too rapidly, in my opinion) and future increases in the debt/GDP ratio appear less threatening than they did in 2010. While the debt burden has continued its rise to more than 73 percent of GDP, future increases look more moderate. The debt is still projected to rise faster than GDP over the long run, but not as fast as projected in 2010.

The improvement in long run debt outlook over the projections in 2010 comes from two main sources: (1) policy actions, mostly cuts in spending, especially discretionary spending; (2) slower assumed growth in health spending.[1] But there is some risk that one or both of these developments may prove temporary. CBO projections[2] of discretionary spending based on current law imply future spending levels that are extremely low by historical standards for both defense and domestic programs. Discretionary spending was 8 percent of GDP in 2012—below the average of recent decades—and is projected to fall to 2.3 percent of GDP by 2023. But it is much easier to enact non-specific caps on categories of spending than to fit actual program needs under those caps. Discretionary spending includes money for the armed forces, border control, national parks, research, law enforcement, food safety, pollution control and a long list of other purposes. Will a growing population and a world full of threats prove consistent with a decline in demand for public services? When legislators listen to the public—not to mention interest groups—will they be able to fit actual appropriations under these severe caps? “Other mandatory” spending (EITC, nutrition programs, child credits, etc.) is also projected to decline in relation to the size of the economy and the same questions arise.

For several decades national health care spending rose substantially faster than GDP, swelling the health sector to more than 17 percent of GDP. High per capita spending rates showed up in increasing federal spending for Medicare and Medicaid, as well as in state, local and private budgets. The prospect that health care spending would continue to grow substantially faster than GDP as the population aged led forecasters to expect rapid spending growth for Medicare and Medicaid over the next couple of decades—more eligible beneficiaries multiplied by escalating costs per beneficiary. But over the last decade rates of health spending increase have slowed and for the last several years have been at historic lows. CBO has reduced its projections of the future cost of Medicare and other federal health programs, which contributes to lower projected debt increases compared with those projected in 2010.

But analysts are unsure why health spending growth slowed so much and whether the slowdown will continue. If a substantial part of the slowdown is attributable to the lingering effects of the Great Recession, as many analysts suspect, then current projections could be low-balling future increases in spending and debt.

In short, debt held by the public is at high levels in relation to GDP and current projections show debt continuing to rise faster than the economy is expected to grow. Moreover, there are reasons to worry that the assumptions underlying the projections, especially with respect to discretionary spending and health entitlements, are over-optimistic.

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[1] Kogan, Richard, and William Chen. 2014. “Projected Ten-Year Deficits Have Shrunk by Nearly $5 Trillion Since 2010, Mostly Due to Legislative Changes.” *Center on Budget and Policy Priorities*. March 19th, 2014. Accessed at: http://www.cbpp.org/cms/index.cfm?fa=view&id=4106

[2] “The Budget and Economic Outlook.” *Congressional Budget Office*. February 4th, 2014. Accessed at: http://www.cbo.gov/sites/default/files/cbofiles/attachments/45010-Outlook2014_Feb.pdf

Why Debt Matters

The reasons debt matters are pretty straight forward. First, we have to pay interest on the debt. The interest is a contractual obligation and has to be paid first, before payments for other services that the country expects the government to perform. At any level of total spending, the more we spend on interest, the less is left for anything else. In recent years the United States has been able to borrow at extraordinarily low interest rates—rates held down by Federal Reserve action, world-wide investor confidence in the underlying strength of the U.S. economy, a long history of fiscal responsibility, and lack of good alternative places for investors to put their money. In FY2013, net interest payments were 6.4 percent of budget outlays, but OMB expects them to rise to 11.6 percent by 2019 as interest rates rise.[3] If interest rates increase faster than currently expected net interest could easily rise to, say, 20 percent of outlays.

Historical note: In 1993, when the Clinton Administration budget team was designing a deficit reduction plan, net interest was 14.1 percent of outlays, because interest rates were higher than than now, although the debt/GDP ratio was much smaller. We were worried that unless we reduced the deficit and the projected build-up of debt, we would end up having to raise taxes or cut other spending just to pay the increasing debt service. The chances of getting into a similar bind are higher now because of the higher debt/GDP ratio.

Second, high levels of debt increase our vulnerability to shifts in investor confidence and the whims of foreign governments. With substantial fractions of U.S. Treasuries held by foreign governments and central banks, this is a serious concern and can limit our foreign policy flexibility.

Third, high levels of debt decrease policy flexibility. Before the recent financial crisis and the Great Recession, our debt/GDP ratio was about 35 percent, so taking on more debt, either automatically or deliberately, was far less worrisome than it would be now with a ratio over twice as high. We should take steps to bring our debt burden down gradually over time, so that we have the ability to react constructively to unexpected events at home and abroad without concern about exacerbating an already precarious debt situation.

There is no bright line that tells us how much debt is too much. At the end of World War II the U.S. debt/GDP ratio was over 100 percent and many people were worried. In fact, U.S. productivity growth was high and so was demand. We didn't pay down the debt, but we grew the economy fast enough to lower the debt/GDP ratio fairly steadily to a low of 23 percent by 1974. Now, however, the prospect of continuous growth at post-World War II rates seems

[3] Office of Management and Budget. Table 4.1, FY 2015 Budget, Historical Tables. Accessed at: http://www.whitehouse.gov/omb/budget/historicals

highly unlikely. We need to work simultaneously on raising the growth rate and reining in the debt.

Growth and Debt Reduction are Both Necessary and Both Possible

Recent policy debates, among economists as well as politicians, have often sounded as though America faced a choice: grow the economy or reduce the debt. In fact, we must do both and the two objectives reinforce each other--as long as we get the policy timing right. As the post-World War II experience illustrates, strong steady economic growth will not only improve the standard of living, it will turn a worrisome debt level into a manageable one. Moreover, high levels of debt can inhibit growth by steering resources into debt service instead of productive investment. But good timing is essential. Austerity in a recession will only slow recovery—as many European countries are discovering. The rapid fall in the U.S. budget deficit has not derailed the recovery, as some thought it would, but it has slowed growth and job creation, as well as requiring off-setting monetary easing, which cannot be unwound quickly.

Growth and job creation require steady long run investment, both public and private, to raise the productivity of the American workforce. We need to invest wisely in modernizing infrastructure, dramatically increasing the skills of workers at all ages, especially technical skills, and supporting scientific research. These investments should be designed to enhance future productivity growth, not primarily to create jobs quickly, although they may do some of both. Any near-term deficit increases should be offset by reductions further in the future. Comprehensive immigration reform can also contribute to future growth and enhance productivity, as can well-designed tax reform. Changing the reimbursement criteria for health care providers so that they rewarded for value and quality of care, not volume of services, may also be able to enhance the productivity of the health care sector, as well as slowing the increase in federal health spending, thus mitigating the increase in debt. Maybe the truce in the budget wars can allow time for some creative efforts with the dual objective of increasing economic growth and reducing future debt.

A political challenge, not a crisis

Although the Great Recession is responsible for raising the level of U.S. public debt, upward pressure on federal spending in the future is associated with the imminent surge in the number of seniors eligible for retirement benefits and health care. We have known this challenge was coming at us for a long time and should have acted sooner. The only ways to minimize the burden of a larger dependent population are to invest heavily in the productivity of the relatively smaller work force or to grow the work force. Encouraging seniors to work longer in age-appropriate jobs can be part of the solution; so can increasing the number of productive young immigrants. Squeezing out investment in younger workers or failing to upgrade infrastructure can only lead to a lower standard of living for both young and old.

Compared with many other countries, the challenge of adjusting to an aging population looks relatively easy in the United States. Many other countries—Japan is an extreme example--have longer life expectancies that we do, lower birth rates, and less immigration. We do not have to slash expected entitlement benefits or raise taxes drastically to restore government solvency, as the Greeks do. We can make relatively small changes gradually over time, especially if we start soon.

Unquestionably, solutions such as tax reform and increasing the efficiency of the health care delivery system require hard choices. There will be winners and losers. Someone always benefits from existing inefficiency and fights giving it up. But it is not the inherent difficulty of the problems that is preventing us from getting our budget on a sustainable path toward higher growth and lower debt. It is the current state of partisan politics that is preventing hammering out compromise solutions to these quite manageable problems.

Our Constitutional structure requires compromise to move the country forward. We cannot solve major problems without compromise between the House and the Senate and between Congress and the President, even when the branches are controlled by the same political party and especially when they are not. But if elected leaders can break out of the partisan trenches and work together to solve problems, we can have a more prosperous America with a less dangerous level of debt.