COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Hearing before the Senate Budget Committee

Benefits of a Balanced Budget

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Testimony of Maya MacGuineas
Committee for a Responsible Federal Budget

Chairman Enzi, Ranking Member Sanders, and Members of the Committee, thank you for inviting me here today to discuss the important topic of how our country can best budget for the future. The fiscal challenges we face are significant, and I appreciate the opportunity to discuss the types of solutions that can move us towards a healthier economy.

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 non-partisan organization dedicated to educating the public about and working with policymakers on fiscal policy issues. 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 movement that mobilizes key communities – including leaders from business, government, policy, and academia – who believe lawmakers must work together to deal with the nation's fiscal challenges to help protect our citizens and grow the economy.

I will make several main points today:

1. Our deficit and debt problems are far from solved

2. Having a fiscal goal is a key part of budgeting

3. There are many advantages to getting the debt to more manageable levels

4. Policymakers should avoid backward steps that add to the debt

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Our Deficit and Debt Problems are Far From Solved

The United States has the potential for a real economic renaissance. We're still coming out of the terrible downturn, but we were recently described by the head of the IMF as the best performer of the advanced economies.[1] Low energy prices, strong consumer demand and impressive job growth and all assisting in our economic recovery. Given the damage and severity of the downturn, this is tremendous news.

But we are not yet out of the woods. We face very real economic challenges and we need to make sure the economic recovery holds. The fabric of a successful economy is strong production, good jobs, investment in the future, and a growing standard of living. The best solutions would enhance our competitiveness, grow our economy, and make sure the benefits of that growth are shared broadly.

Controlling our debt is a key factor in achieving all of these critical national objectives.

And on this front, we are not doing well. Our debt is twice the historical average relative to the economy, and it is on an unsustainable path. Interest payments are projected to be the single fastest growing part of the budget; our budget favors consumption rather than investment, which does not bode well for future growth; and we are dangerously short-sighted in how we budget. There also seems to be a near endless list of *political* excuses about why we should not do anything to get our debt under control, while there are no *economic* reasons to delay coming up with solutions to our medium and long-term debt challenges. Needed changes, which are manageable now, will get much more difficult over time.

Let me dig into our current debt situation a little deeper.

To start, let us recognize the good news. The deficit has come down by about two-thirds since the 2009 peak. On top of that, significant deficit reduction has been enacted – mainly through higher taxes on upper income households and lower discretionary spending, including from sequestration. Furthermore, health care costs are growing much slower than anticipated, leading to $1 trillion less spending from 2012-2021 compared to what we thought in 2011 and over half of those reductions come from Medicare.[2]

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[1] See the appearance of Christine Lagarde on MSNBC's *Morning Joe*. March 4, 2015. Available at http://www.msnbc.com/morning-joe/watch/study--equality-laws-are-good-for-the-economy-407975491726.

[2] A fuller, though slightly dated analysis is available from CRFB, "The $900 Billion Slowdown in Federal Health Care Spending," May 6, 2014, http://crfb.org/blogs/900-billion-slowdown-federal-health-care-spending.

However, the good news has led some to conclude that we no longer need to address our fiscal challenges—a dangerous conclusion.

First, this 66 percent decline in the deficit since 2009 follows an unprecedented ***780 percent increase*** in the prior two years, when deficits rose from $160 billion to *$1.4 trillion.*

Of course, that huge increase in deficits was mostly the result of the Great Recession (and the subsequent decline largely the result of the recovery). Specifically, large drops in employment, wages, profits, and capital gains during the Great Recession all led to much lower revenue collection and higher spending on countercyclical programs like unemployment benefits and SNAP. Meanwhile, the economic rescue cost hundreds of billions of dollars, and the money injected into the financial system and for the bailout of Fannie Mae and Freddie Mac added to the deficit.

Likewise, much of the recent decline in deficit is largely due to the economic recovery. As unemployment is falling and profits are rising, we're seeing higher revenue and lower countercyclical spending. Meanwhile, nearly all federal stimulus spending has tapered off. And instead of the government paying money to financial firms and Fannie Mae and Freddie Mac, it's *receiving* money from those organizations. On top of that, deficits remain low in part due to the Federal Reserve's continued actions to fight deflation and support full employment, which have resulted both in historically low interest rates paid by the government and higher Federal Reserve profits remitted back to the Treasury.

There have also been policy changes that have reduced the deficit, notably the fiscal cliff deal, which raised taxes on wealthier Americans, and cuts in discretionary spending from caps and the sequester. However, depending on how you measure it, these changes only account for about one-fourth of the drop in the deficit since 2009. Furthermore, I would also argue that these have not been the wisest of policies to help bring down the deficit, especially given that they are focused mainly on the short-term when reductions in the short-term deficit is far less important than a reduction in the medium- and long-term debt, given that we are still focusing on helping the economy recover.[3] A much smarter approach would have included real reforms of the tax code and entitlement programs.

Importantly, the recent reductions we've seen in the deficit are only temporary.

Under CBO's current law projections, deficits will begin to rise rapidly after 2017, from today's levels of about $490 billion (2.7 percent of GDP) this year to more than *$1 trillion*

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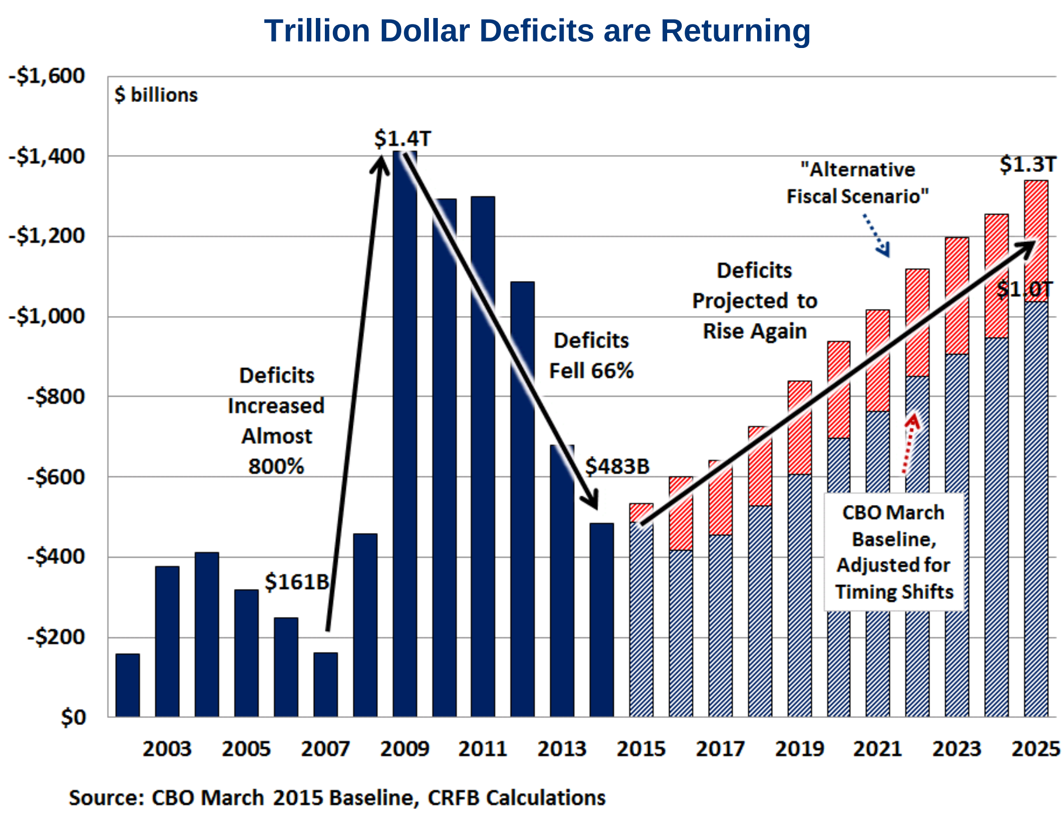
[3] For more information, see my piece "Yes, the Deficit Is Smaller. But That Wasn't the Main Problem," Oct 21, 2014, http://blogs.wsj.com/washwire/2014/10/21/yes-the-deficit-is-smaller-but-that-wasnt-the-main-problem/.

(3.8 percent of GDP) by 2025. In other words, the deficit is only projected to shrink for the next three years, and trillion-dollar deficits are projected to come back within a decade. Normally our group worries about politicians pushing hard choices into the future and then never really doing them. But in this case, I would have traded larger deficits today as the economy continues to recover, for more progress on the future imbalances we face as a result of continued structural deficits, growing healthcare costs, the aging of the population, and growing interest payments.

Unfortunately, CBO's already bleak projections might be too optimistic, since they assume that lawmakers won't further increase the deficit, including by continuing current or recent policies as they often have in recent years. Under CBO's "Alternative Fiscal Scenario, which includes more pessimistic projections by assuming temporary tax policies are continued, the sequester is repealed, and a permanent "doc fix" is enacted, trillion-dollar deficits will return by 2021 and the deficit will reach more than $1.3 trillion in 2025.[4]



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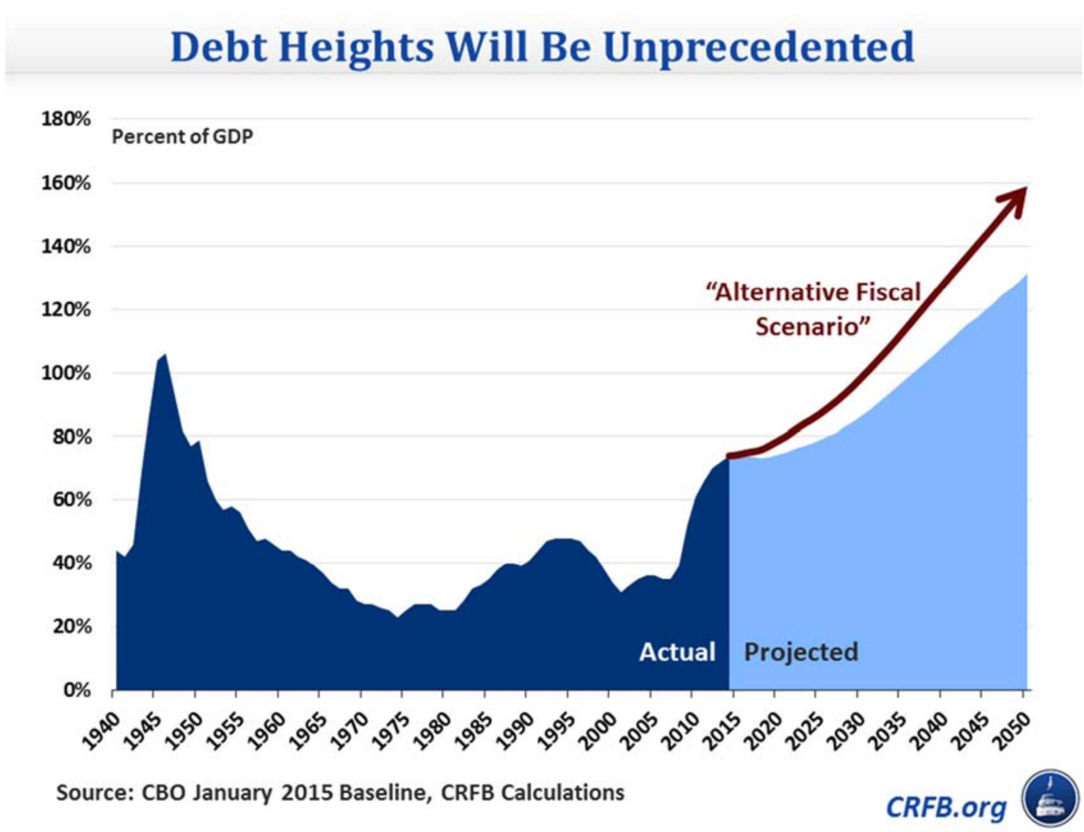
[4] CBO has not published an Alternative Fiscal Scenario since July 2014, when it represented additional ten-year deficits approximately $2 trillion above the current law baseline. CRFB constructs a similar "Alternative Fiscal Scenario" using estimates that CBO provides, which combine for about an additional $2.5 trillion in deficits over ten years. The alternatives used are: repealing the sequester, extending all expiring tax provisions, permanently averting the doc fix.

More troublesome than our rising deficits is our too large and growing national debt. Over the same period that nominal deficits fell by 66 percent, our national debt grew by roughly 70 percent – from $7.5 trillion in 2009 to $13 trillion today. And based on CBO projections, debt will continue rising, reaching $21 trillion within a decade under current law and nearly $24 trillion under the more pessimistic scenario.

Arguably the most important metric of a country's fiscal health is its debt-to-GDP ratio. At 74 percent of GDP, debt is currently the highest it has ever been as a share of the economy in this nation's history, other than around World War II. This is more than *double* the size of our national debt back in 2007 before we entered the economic crisis. And after remaining roughly stable through 2020 at this record-high level, debt-to-GDP will again grow reaching 77 percent of GDP by 2025, exceeding the size of the economy before 2040, and doubling it by the 2070s. Under our approximation of CBO's Alternative Fiscal Scenario, debt would reach 84 percent by 2025, exceed the size of the economy by the early 2030s, and double it by the 2060s.



This pace of debt growth is clearly unsustainable. As the non-partisan Congressional Budget Office (CBO) explained in the January 2015 baseline:

Such large and growing federal debt would have serious negative consequences, including increasing federal spending for interest payments; restraining economic growth in the long term; giving policymakers less flexibility to respond to unexpected challenges; and eventually heightening the risk of a fiscal crisis.

Similar warnings have been issued by Chair of the Federal Reserve Janet Yellen. Yellen said:

I also worry that if we were to again be hit by an adverse shock, that there's not much scope to use fiscal policy. It was used in the early years after the financial crisis -- we ran large deficits -- but in the course of doing that, the debt-to-GDP ratio rose. And were another negative shock to come along, it's questionable how much scope we would now have to put in place even on a temporary multiyear basis expansionary fiscal policy, and I think it's important to deal with these issues – for the Congress to do so.[5]

In one of his last testimonies in front of Congress, Federal Reserve Chairman Ben Bernanke said:

To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path. Importantly, the objectives of effectively addressing longer-term fiscal imbalances and of minimizing the near-term fiscal headwinds facing the economic recovery are not incompatible. To achieve both goals simultaneously, the Congress and the Administration could consider replacing some of the near-term fiscal restraint now in law with policies that reduce the federal deficit more gradually in the near term but more substantially in the longer run.[6]

Benefits of Reducing the Debt and Balancing the Budget over the Business Cycle

The last time this country seriously confronted our deficit challenges in the 1990s, a series of three major deficit reduction agreements – in 1990, 1993, and 1997 – ultimately lead to a balanced budget, even generating surpluses between 1998 and 2001.

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[5] Yellen, Janet, *Semiannual Monetary Policy Report to the Congress*, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, February 24, 2015, http://www.federalreserve.gov/newsevents/testimony/yellen20150224a.htm and Lagarde's remarks at the Council on Foreign Relations, January 15, 2015, http://www.cfr.org/economics/christine-lagarde-new-multilateralism-global-economy/p35973.

[6] Bernanke, Ben, *The Economic Outlook*, Before the Joint Economic Committee, May 22, 2013, http://www.federalreserve.gov/newsevents/testimony/bernanke20130522a.htm

There is no question that long-term deficits are projected to remain far too high.

Ideally, our country would balance the budget over the business cycle. This doesn't mean we should balance the budget every year. In fact, it makes economic sense to borrow during recessions, and save during times of higher growth. But getting to balance on average would allow us to save when the economy is strong and have the government help inject more money into the economy when it is weak. Yet we seem much better at the borrowing part than the saving part. As John Maynard Keynes once said:

> *"Just as it was advisable for the Government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy… The boom, not the slump, is the right time for austerity at the Treasury."*[7]

The reality is that balancing the budget for any sustained period is probably not in our immediate future. Our projected deficits are too large for us to reach balance in the very near future without making some extremely difficult choices about what spending to cut and/or taxes to raise. For instance, balancing the budget starting next year would require $7.2 trillion of deficit reduction over the next decade. Depending on the path of savings, balancing the budget by 2025 would require roughly $5.5 trillion of deficit reduction.
For perspective, $5.5 trillion is 8 times as much as raised in the fiscal cliff deal, 7 times as much as the initial spending reductions in the Budget Control Act, and 65 times more than the gross savings in the Ryan-Murray Bipartisan Budget Act.

Ten-Year Savings Needed to Reach Fiscal Targets

Target	**Current Law**	**Alternative Fiscal Scenario**
Stabilize Debt at 2015 Level through 2025	$0.8 trillion	$3.3 trillion
Reduce Debt to 70% of GDP by 2025	$1.9 trillion	$5.3 trillion
Reduce Debt to 60% of GDP by 2025	$4.7 trillion	$7.2 trillion
Balance the Budget by 2025	~$5.5 trillion	~$8.0 trillion
Balance the Budget Every Year through 2025	$7.2 trillion	$9.7 trillion

Source: CRFB calculations based on Congressional Budget Office documents and assuming deficit reduction is gradually increased over the budget window. These numbers are illustrative representations of one potential savings path. All numbers are rounded.

[7] Keynes, John Maynard. *The Collected Writings of John Maynard Keynes,* Volume 11, ed. by Donald Moggridge, Cambridge University Press, p. 390.

And the political system has shown very little willingness to confront even small difficult choices let alone the large ones. The polarization between the parties and the unwillingness of many to compromise has made this even more difficult.

The first step towards balance will be keeping our deficits from significantly increasing again and getting to at least a place where the debt is shrinking relative to the economy. Once the debt is on a downward path, we will start to see a number of the benefits that come with balance.

These important benefits include:

- **Greater Investment and Economic Growth.** When the government borrows, it diverts savings away from productive private investments and toward government bonds. This ultimately "crowds out" new growth opportunities and in doing so slows GDP growth. Based in part on CBO projections, we estimate balancing the budget within a decade could increase the size of the economy above current law projections by more than 2 percent in 2025 and almost 10 percent by 2040.
- **Higher Income and Wages**. Faster economic growth translates to a higher average income. Using the Congressional Budget Office's rules of thumb, we calculate that a balanced budget would increase per-capita GNP (or roughly average income), by 7 percent more in 2040, relative to following current law. In today's dollars, that's a $6,000 annual wage increase per person. And over a 40-year career starting today, it represents $200,000 of additional income for an average worker.
- **Lower Interest Rates.** Growing national debt can drive up interest rates throughout the economy, leading to higher interest payments on mortgages, car loans, student loans, and credit card debt. Under a balanced budget, according to CBO's rules of thumb, interest rates could be roughly 1 point lower than under current law. Put another way, a family with a $300,000 mortgage could expect to pay at least $60,000 less over the course of the mortgage. While interest rates have not been an issue in recent years, keeping them low would provide significant benefits to families.
- **Declining Government Interest Payments, Thus Freeing Up Resources.** Under current law, the government will spend about $230 billion on interest payments this year, and is projected to spend $810 billion in 2025 and $2.5 trillion in 2040. Ten years from now, interest on the debt is projected to consume more of the budget than on research, education, highways, and all spending on children combined.[8] Were we to get to balance in 2025, interest would consume about $630

[8] CRFB calculations based on various Congressional Budget documents and *Kids' Share 2014: Report on Federal Expenditures on Children Through 2013, published by The Urban Institute in September 2014.*

billion in 2025 and about $960 billion in 2040, leaving more room for other important priorities.

- **Increased Ability to Respond to Problems.** Governments often borrow to address unexpected events, like wars, financial crises, and natural disasters. This is relatively easy to do when the federal debt is small as a share of the economy. However, with a large and growing federal debt, government has fewer options available. For example, borrowing was a helpful response to the financial crisis several years ago, increasing spending and cutting taxes in order to stimulate the economy. However, the federal debt is more than double what it was in 2007 as a share of GDP and we could be dangerously constrained were we to face another crisis while debt is this high.
- **Reduced Risk of Fiscal Crisis.** If the debt continues to climb, at some point investors will lose confidence in the government's ability to pay back borrowed funds. Investors would demand higher interest rates on the debt, and as a result interest rates could rise sharply and suddenly, creating a debt spiral crisis, as we have seen in other nation's when their debt is no longer manageable. While there is no country historically analogous to the United States position in the world economy, so there's no sound mechanism for determining if and when a fiscal crisis could occur, CBO warns that, "the larger a government's debt, the greater the risk of a fiscal crisis."[9]

Importantly, many of the benefits to balanced budget described above would also apply to other amounts of deficit reduction. But one major advantage of specifically getting to a balanced budget is that it is a tangible, easily measurable goal that can be easily explained to the American people. Numerous international and domestic examples show the power of having fiscal goals. CRFB published a paper "Fiscal Turnarounds" that showed "Credible fiscal rules and fiscal goals… helped policymakers and taxpayers maintain discipline" in six countries that turned around large deficits and debt: Canada, Denmark, Finland, Ireland, and Sweden.[10] Our *Better Budget Process Initiative* also explained the benefits of an easy-to-understand budget in *The Budget Act at 40: Time for a Tune Up?*.

It is critical that the country pick a fiscal metric. Right now, there are virtually no limits on our borrowing, and no agreed-upon fiscal goal. If there were one, such as balancing the budget by a date certain, or getting the debt to a specific level in a certain amount of time, policymakers would be required to show their preferred paths for doing so, and we could discuss the various trade-offs of different approaches. That is a core principle of what budgeting is supposed to be. Right now, we have a free-for-all with lawmakers often invoking fiscal discipline only as a means of stopping the other party's priorities, but not

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[9] CBO, *The 2014 Long-Term Budget Outlook*, July 2014, p. 15.
[10] CRFB, "Fiscal Turnarounds," February 2010, http://crfb.org/sites/default/files/Fiscal_Turnarounds.pdf

applying the same discipline to their own. A unified fiscal metric is a very important step in responsible budgeting, and one we strongly encourage lawmakers to adopt.

All of the advantages of a balanced budget do not mean we need to balance our budget immediately. Not only does the political system not seem able to agree on such a large plan, the economy is still recovering from a devastating crisis. The timing of consolidation is therefore extremely important. This is the reason so many bipartisan deficit reduction plans phased in their savings slowly, and often deferred them until the economy was expected to be on more solid ground. This was true of the Simpson-Bowles Fiscal Commission, which included a specific principle not to "disrupt the fragile economic recovery."[11]

At this time, it is most important we focus on getting the longer-term situation under control. Thus the smartest policies we could implement would be those where the savings grow gradually and compound over time, and are conducive to economic growth.

In addition to timing deficit reduction to the business cycle, it is important to recognize balancing the budget can take time. Rising interest rates on a significant new stock of debt, the retirement of the baby boom population, and political promises made to limit changes on the over 65 population, all make achieving a near-term balanced budget more difficult. Most plans phase in changes gradually and with at least some amount of grandfathering. As a result, the House budget resolution last year didn't achieve balance until 2024, and the Simpson-Bowles plan didn't do so until 2035. But they do reach balance. And importantly, in the interim years, the plans keep deficits low and slowly introduce ways to reduce them.

Avoid Stepping Backwards by Adding to the Debt

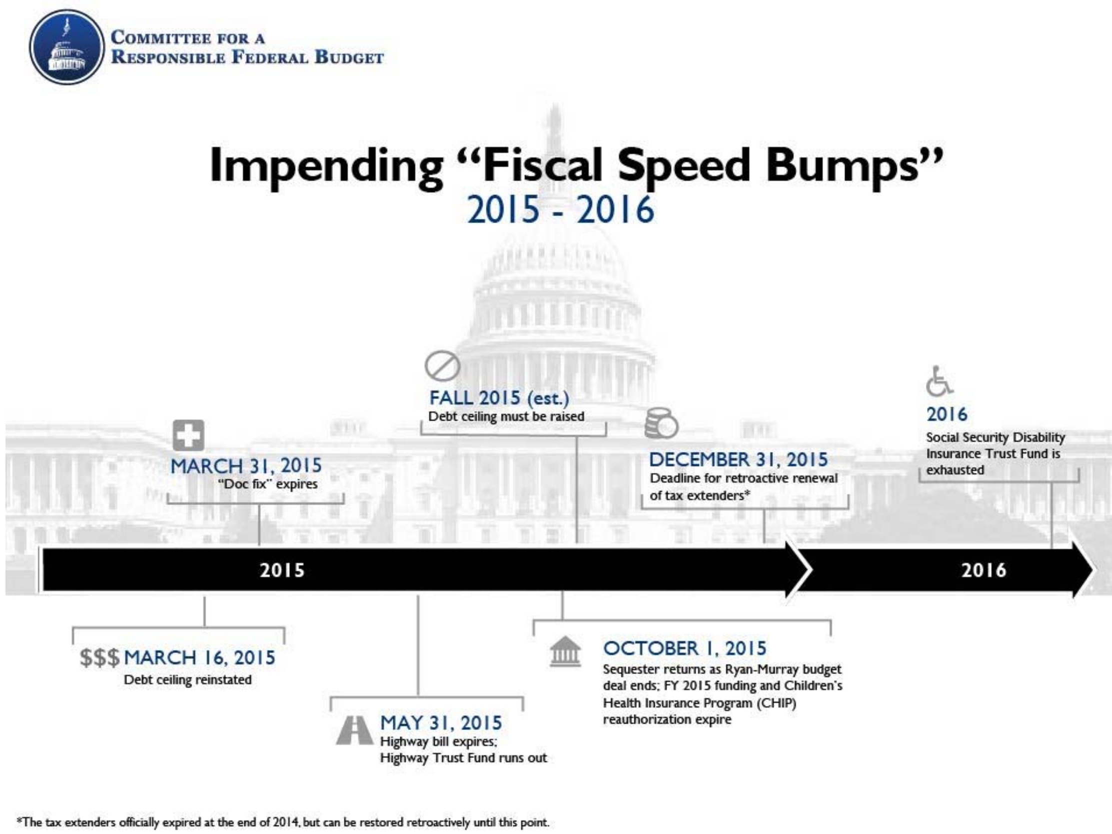
I'm encouraged the Budget Committee is holding a hearing on the merits of reducing deficits and balancing the budget. One concern of ours – based on experience - is that Congress and the President will instead act to *increase* deficits over the next year, particularly when faced with the multitude of upcoming "Fiscal Speed Bumps".

Last year, as an example, lawmakers deficit-financed new funding for veterans health care, fighting Ebola and ISIS, and a package of "tax extenders," while relying on budget gimmicks (fake savings) to help pay for shoring up the highway system and passing a "doc fix," and also sneaking significant new spending into the end of year "CROmnibus" bill. In total, these changes added more than $100 billion to the debt through 2024, which translates to over $1,100 per household. Many of these were important priorities that

[11] "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform," p. 13.

made sense as policies, but given that they were important enough to do, **<u>they should have been paid for</u>**.

Over the next year, Congress will again face a number of "Fiscal Speed Bumps" which could prompt further borrowing. Among those with the most potential to lead policymakers to add to the debt are the expiration of the "doc fix" and the return of the SGR at the end of March, the expiration of the highway bill at the end of May, the return of sequestration on October first, and the desire to retroactively renew expired tax extenders before the end of the year. The Social Security Disability Trust Fund will also become exhausted sometime in late 2016.



These Fiscal Speed Bumps represent challenges and risks, but also opportunities. Addressed responsibly, they offer policymakers the opportunity to at least stabilize the national debt at its current levels. Each one of these offers lawmakers the opportunity to swap not-very-sensible policies with more thoughtful, targeted and lasting reforms.

If policymakers act irresponsibly at each of these bumps, on the other hand, they could increase debt levels by over $2 trillion above what current law allows, to 85 percent of GDP by the end of the decade. Acting to offset the costs of these changes with smarter policies will not fix the debt, but will represent steps towards that goal and avoid backsliding. We encourage you to take meaningful and responsible actions to offset the costs of all of these speedbumps, and we will be providing "mini-plans" for each one of them.

Speed Bump	One-Year Cost	Ten-Year Cost
Sustainable Growth Rate	$15 billion	$135-$175 billion
Highway Trust Fund	$20 billion	$170 billion
Sequestration	$100 billion	$1.01 trillion
Tax Extenders	$45 billion	$470-$695 billion
Disability Insurance Trust Fund	$30 billion	$340 billion
Total	**$210 billion**	**$2.1–$2.4 trillion**

To be sure, addressing our Fiscal Speed Bumps responsibly won't get us to a balanced budget or even put us on a sustainable debt path. But it can help us make things a little better, and avoid making them much worse. As CBO Director Elmendorf explained to the Budget Conference Committee in 2013, "big steps are better than small steps, but small steps are better than no steps at all. And no steps at all would be better than steps backwards." We couldn't agree more.

Growing debt levels will dramatically impact Americans, who will feel the effects through slower economic growth, lower wages, fewer government investments, and higher interest rates on everything from mortgages to small business loans.

Conclusion

Controlling America's debt is a key part of a comprehensive economic growth plan. We need to grow our economy, keep our businesses competitive, and invest in workers, innovations and infrastructure. We need to ensure the gains from growth are broadly shared. And we need to control our debt for any of these efforts to be effective.

To truly tackle our fiscal challenges we need to reform our tax code, strengthen our entitlement programs and control and better-target our spending.

Tax reform will require broadening the tax base and ridding it of many of the $1.3 trillion in annual tax expenditures that are largely regressive, ineffective, economically distorting, and tilt the playing field in undesirable ways. A broader base can pay for lower tax rates and a simpler and more competitive code while contributing to deficit reduction, and helping to grow the economy.

We need to fix our important entitlement programs so we can make good on what we promise. For starters, our disability program will run out of reserves next year. It is stunningly irresponsible that we have done nothing to get ahead of this problem. There are many reasonable reforms that could be enacted today that would actually help SSDI better serve its beneficiaries and taxpayers, providing services to help people with disabilities remain in the workforce. Moreover, we need to do more to prepare for an aging population and growing health care costs, keeping Social Security, Medicare and other important programs strong. And yet, even as the programs' Trustees warn that changes need to be made, we delay year after year.

And we need to think about how we spend more thoughtfully to direct resources to investments, particularly those that will strengthen the country for the next generation. Finding ways to make the budget more focused on the long-term would be beneficial in many ways.

The pay-offs from responsible fiscal policies are immense. I thank the committee for holding this hearing today and would be delighted to work with you on any of these issues.

Thank you.