Increasing the Debt Limit

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Mr. Chairman, Senator Murkowski, and members of the Subcommittee, thank you for inviting me to appear today to discuss the Administration's request for an increase in the statutory federal debt limit. I am here representing The Concord Coalition, a bipartisan organization dedicated to strengthening the nation's long-term economic prospects through prudent fiscal policy. Concord's co-chairs are former Senators Warren Rudman (R-NH) and Bob Kerrey (D-NE).

Let me begin by noting the irony of having to increase the debt limit this year. In 1997, when the current debt limit was set, Congress and the Clinton Administration agreed on a plan to balance the federal budget by 2002. To everyone's surprise, we actually achieved surpluses in every year since then. But now that the balanced budget target year of 2002 has arrived, we are going back into deficit. This kind of uncertainty in budget projections should be kept in mind as you consider the amount of leeway to give in establishing a higher debt limit.

The Concord Coalition believes that fiscal discipline in the short-term is the key to providing for the huge unfunded long-term obligations of Social Security and Medicare that loom just beyond the 10-year budget window. We are concerned that current pressures for new spending and further tax cuts, however well-intentioned, will erode fiscal discipline and result in deeper, longer deficits than anyone intends – thus making it all the more difficult to prepare for the fiscal challenges ahead. While the debt limit is not, by itself, a fiscal firewall it does impose an obligation to confront the consequences past fiscal policy. With the goal of fiscal policy in the post-surplus, post September 11 environment quite uncertain, The Concord Coalition recommends that the debt limit increase you approve this year be limited in scope. No large-scale extension, such as the one proposed by the Administration, should be approved until Congress and the President agree on a new fiscal policy goal — preferably a plan to balance the budget excluding the Social Security surplus within a reasonable time using prudent economic and fiscal assumptions. Ideally, such a plan should also include an extension of the discretionary spending caps and pay-as-you-go provision for tax cuts and entitlement spending that expire this year.

I. The Short-term Context: A Dramatic Change With Many Uncertainties

The Administration's request for a debt limit increase is necessitated by a number of factors that have dramatically altered the budget outlook from just a year ago:

- We have embarked upon a worthy, but costly, effort to defeat the worldwide terrorist network that launched a deadly attack on our nation last September.

- We have come to recognize the need to substantially increase spending on homeland security.

- We are in an economic recession for the first time in 10 years.

- We have enacted a series of escalating tax reductions over the next decade that will reduce revenues and increase debt service costs by an estimated $1.7 trillion.

- As a result of the above factors, the huge surpluses, which were projected just a year ago, have been diminished by about 70 percent.

- The non-Social Security surplus has vanished, and for the first time in many years there is no clear, agreed upon fiscal policy goal to constrain spending increases and tax cuts.

- The budgetary enforcement mechanisms, caps on discretionary spending and the pay-as-you-go requirement for tax cuts and entitlement spending, no longer apply.

The President's budget, like the January 2002 report of the Congressional Budget Office (CBO), clearly demonstrates the rapid decline in the government's fiscal position over the past year. Deficit spending will return this year for the first time since 1997, and continue through 2004 assuming enactment of the President's policies.

The numbers demonstrate a startling turnaround:

- Last year the President's budget projected that even with enactment of his recommended tax cut and other policy priorities there would be a 10-year budget surplus of $3.4 trillion — enough to eliminate the debt held by the public. This year's budget, assuming enactment of the President's policies, projects a surplus of just $665 billion over the same 10-year timeframe. Gone is any concern about paying off the debt too quickly.

- The budgetary effect of higher debt is higher interest payments. Here too there has been a major change. Last year's budget projected net interest payments on the debt of $1.13 trillion over 10 years with a payment in 2011 of just $20 billion. This year's budget projects net interest payments of $1.79 trillion over the same 10-year period with the 2011 payment at $159 billion — not far below its current level of about $175 billion.

- The effects of higher debt can also be seen in the CBO baseline, which unlike the President's budget, does not assume policy changes. Last year's CBO baseline projected that debt held by the public would be essentially eliminated by 2008 and the statutory debt ceiling would not be reached until 2009. Net interest over the period 2002 through 2011 was estimated to be $622 billion. This year's CBO baseline no longer projects elimination of debt held by the public. In fact in this year's baseline debt held by the public is $2.8 trillion in 2008. Interest payments add $1 trillion to government spending over the same 10-year projection, going from $622 billion to $1.6 trillion.

- Last year the President's budget showed a 10-year non-Social Security surplus of $841 billion. This year's 10-year projection is for a non-Social Security deficit of about $1.6 trillion over the same period (FY2002-2011).

- In last year's budget, non-Social Security surpluses were projected for every year. In the current budget, the opposite is true. There is no year in which a non-Social Security surplus is projected.

As the President notes in his Budget Message, the government "will have new bills to pay." These new costs, plus the proposed new tax cuts in the President's budget, are expected to produce deficits for the next couple of years. If so, they would be the first federal budget deficits since 1997.

The Concord Coalition is as strong an advocate of balanced budgets and debt reduction as there is. We recognize, however, that there are times when a deficit is an appropriate response to pressing national needs. This may well be true in fiscal year 2002 and perhaps 2003. But the temporary need for deficit spending should not be taken as an excuse to abandon fiscal discipline, which is still needed to prepare for the long-term challenges. We should not dig such a large hole now that it will be impossible to climb back out of it before the baby boomers begin to leave the workforce and qualify for Social Security and Medicare. That is not a "new bill," but one we are already on the hook for.

II. The Administration's Debt Limit Request

Under current projections from both OMB and the CBO, the level of gross federal debt is expected to exceed the $5.95 trillion statutory limit at some point during the current year — perhaps as soon as next month. As of Friday, February 8, 2002 the debt subject to limit stood at $5.859 trillion, leaving about $91 billion under the cap. The exact date when Treasury will bump up against the limit is difficult to say because it depends on many daily transactions of the federal government. The bottom line is that at some point in the coming months, Congress will have to raise the debt limit. This is "must pass" legislation. Defaulting on obligations is unthinkable because of the damage it would do to the credit of the United States.

The Administration has requested an increase in the debt limit of $750 billion, which would move the ceiling from $5.95 trillion to $6.7 trillion. Under the President's budget, this would be sufficient to cover the government's financing needs until sometime in fiscal year 2004. Under the CBO baseline, which does not account for the President's policy proposals, the new debt limit would be hit sometime in fiscal year 2005.

While an increase in the debt limit is necessary this year, it is not necessary to increase the limit by as much as the Administration requests. A much smaller increase would be sufficient to get through the remainder of the current fiscal year. That is all that needs to be done at this time. Raising the limit by too much would only tempt more election year spending or tax cuts than is prudent in the absence of some larger agreement to control fiscal policy. To quote Concord's Co-Chair, former Senator Warren B. Rudman (R-NH), "If you give a kid an 8 ounce chocolate bar, he'll eat it. If you give him a 36 ounce chocolate bar, he'll eat it. If you give him a 5 pound chocolate bar, he'll probably eat that too."

Senator Rudman's analogy is simply a reminder that the statutory debt limit is the only mechanism left to provide a sense of fiscal restraint. For the first time in several years there is no clear, agreed upon, fiscal policy goal to prevent things from getting out of hand. The budget caps and pay-as-you-go rule for tax cuts and entitlement spending, last renewed in the 1997 Balanced Budget Act, expire this year. The need to pry open the so-called Social Security lockbox in response to the terrible events of September 11 has opened up a Pandora's box of interest group demands that had been held in check by the fear of causing a "raid" on the trust funds.

As a result, open-ended budgeting may be back. Rather than setting priorities and making hard choices, it will be very tempting to fall back on old habits — cut taxes, increase spending, eat up the Social Security surplus, and run up the debt.

It's a dangerous path to follow when looming just beyond the artificial 10-year budget window are the huge unfunded retirement and health care costs of the coming senior boom. It will take over $8 trillion in today's dollars just to cover the cash shortfalls in Social Security and Medicare Part A between 2016 and 2040. Things only get worse from there. Sufficient resources have not been set aside to finance these costs, and the re-emergence of budget deficits will make it more difficult to do so.

The problem is not that we may have to run a short-term deficit in response to both a recession and military conflict. The problem is that politicians may once again get comfortable with the habit of running deficits and using the Social Security surplus to finance routine government operations or to offset tax cuts — which simply amounts to paying for the government services we demand by sending the bill to our kids.

Before that happens, some markers must be laid down. A good first step would be to keep this year's debt limit increase to an amount that will force another look at the situation within the near future. Meanwhile, Congress and the Administration should establish a new fiscal policy goal. And the best goal is the one that commands strong bipartisan support — balancing the budget without using the Social Security surplus. It will take a few years to achieve, but unless the goal is set we face the very real risk of drifting back into an era of sustained deficits before we have done anything to address the long-term challenge. Once the goal has been reestablished, Congress and the Administration can go to work on a new balanced budget plan using the non-Social Security surplus as the definition of balance.

Only after such an agreement has been reached should the debt limit be raised by a significant amount. In the past, major increases in the debt limit have often been accompanied by major budgetary agreements such as the November 1990 increase of $915 billion, the August 1993 increase of $530 billion, and the August 1997 increase of $450 billion. The rationale for this trade-off is clear — greater flexibility to increase the debt is allowed, but only within the context of a fiscally responsible policy goal. In the absence of such linkage, Congress has been appropriately reluctant to raise the debt limit for more than a short period, sometimes as short as a few months. For example, six temporary adjustments were made to the debt limit before enactment of the 1990 budget agreement even though troops were in the field preparing for what would become the Persian Gulf War. A temporary debt limit increases also preceded the broader budgetary agreement in 1993. The 1997 balanced budget agreement was preceded by three increases in 1996. A similar pattern may be appropriate in the current situation, although care must be taken not be treat the debt limit as a political football.

III. The Looming Fiscal Challenges

Today's major budgetary decisions must not be viewed through a short-term lens. Fiscal discipline is the key to providing for the unmet needs of the future. Somehow, sufficient resources must be set aside to meet the huge retirement and health care costs associated with the coming "senior boom." The time to address the long-term challenge is now, while the demographics are favorable and changes can be phased in.

After September 11, attention has been understandably diverted from the need for long-term fiscal discipline. But the need is still there. The unfunded obligations of Social Security and Medicare are as large as ever. If anything, the events of September 11 reinforce the need for hard choices and long-term planning because it's clear that the government is going to have to spend more in the short-term on homeland security, disaster relief and the war on terrorism.

We are a rich enough nation to be able to pay for the level of government we want without asking our children to pay the bills later or to spend the money we pretend to save by crediting it to a government trust fund. And while running a short-term deficit in response to an emergency is entirely appropriate, the decision to run sustained deficits is simply a decision to have future generations pick up the bills we leave behind. It is neither fiscally responsible nor generationally responsible.

Unfortunately, the current trend in entitlement spending remains unsustainable:

- The three biggest benefit programs for seniors—Social Security, Medicare, and Medicaid—along with net interest consume all federal revenues by 2030 under the August 2001 GAO "eliminate unified surpluses simulation." This may look a little worse when GAO updates the numbers at the end of this month.

- All told, CBO projects that these three programs will nearly double as a percent of GDP by 2030, from about 7 percent to almost 15 percent.

- According to the 2001 Trustees' report, Social Security outlays will exceed earmarked tax revenues by a widening margin starting in 2016. By 2025, Social Security will face an annual cash shortfall of over $400 billion. By 2038, the last year the trust funds are technically solvent, the annual shortfall will be over $1 trillion.

- To cover these deficits, the trust funds will have to redeem their IOUs from the Treasury. And to come up with the cash, Congress will have to hike taxes, cut other spending, consume surpluses if they exist, or borrow from the public—exactly as if the trust funds never existed.

- This year, all Social Security benefits could be paid for with a tax rate of 10.5 percent of payroll. By 2040, the Trustees project that they will cost 17.7 percent of payroll. Add in Medicare Part A and the projected burden rises to 24 percent of each worker's taxable paycheck.

- The recent prosperity has not lowered Medicare's long-term cost rate. Nor has it altered the demographic, social, and technological forces driving up the future cost of health care. Far from it: Following the recommendation of an official technical panel, the Trustees this year increased their projection of Medicare's long-term cost rate by a staggering 60 percent.

This year's dynamic of increasing spending and cutting taxes creates the threat of squandering the Social Security and Medicare surpluses that should be used to increase savings. Savings from deficit and debt reduction have helped provide the capital to increase the productivity of American workers – a major factor in the record growth of the last 10 years. Further gains in productivity will become especially urgent when the retirement of the huge baby boom generation virtually halts the growth in the size of the U.S. work force.

The challenges of an aging society include fiscal pressures that cannot be remedied simply by assuming that renewed economic growth, following a brief period of deficits, will bail us out. The inevitable growth in spending on age-related entitlement programs will put pressure on discretionary spending, revenues, and public debt. Tough choices will need to be made to avoid burgeoning public debt in the future. Spending the Social Security surplus allows today's economy to benefit from the increased consumption, but it leaves tomorrow's economy burdened with the huge stack of unfunded IOUs building up in the Social Security trust fund. By contrast, saving the Social Security surplus for debt reduction will make it easier for future generations to afford the costs of the coming "senior boom."

IV. Debt reduction is still an important goal over the long-term

As noted above, there is nothing wrong with running a deficit in response to events such as we have seen in the past year. But debt reduction still makes sense over the long-term. Running a substantial budget surplus over the next decade or so and using it to pay down the publicly held debt would be enormously beneficial for the economy, the budget, and future generations.

The early years of the 21st century mark a period when the federal budget should be substantially in surplus, not barely in balance. One of our nation's greatest economic challenges is to find sufficient resources to fund the huge retirement and health care costs associated with the retirement of the baby boom generation. The economy will be called upon in the future to transfer significant resources to a much larger population of retirees. These resources will be much easier to find in a healthy, growing economy than in a stagnant one.

The Concord Coalition believes that the best way to achieve economic growth and increase real income in the future is to increase national savings today. No country can enjoy sustained living standard growth without investing, and no country can sustain high investment for long without saving. The link between saving, investment and growth has been aptly described by the General Accounting Office:

> "Saving provides the resources to build new factories, develop new technologies, and improve the skills of the workforce. Such investments may boost workers' productivity, which in turn provides higher wages and faster economic growth. Less investment today means slower economic growth tomorrow."

The most direct way the government can increase national savings is to reduce its own debt, thereby freeing up resources that the private sector can turn into productive investments. It should come as no surprise that the declining budget deficits and eventual surpluses of the 1990s coincided with a rise in business investment and surging productivity growth. This combination resulted in the longest economic expansion in our nation's history.

Moreover, increasing the supply of capital through debt reduction has a positive impact on interest rates, which in turn helps continued economic growth. Scarcity governs the price of all commodities, including the price of capital. When the supply increases, the price falls. As the trillions of dollars trapped in government bonds are released into the financial markets, the increase in the supply of capital will exert significant downward pressure on interest rates.

Lower interest rates benefit household consumers as wells as firms. When interest rates are low, households are better able afford major purchases such as homes, cars, and durable consumer goods. Much of the prosperity over the past several years has been due principally to strong consumer spending, and rapid productivity growth, both of which have been fueled by low interest rates.

It is true that other government policies including pro-savings tax cuts, and greater federal investments in education, research and infrastructure, could help increase long term growth. But none would translate as efficiently as debt reduction into increased savings, which is so essential for ensuring that the current boom in productivity growth can be maintained.

From a budgetary standpoint, debt reduction means lower interest costs and a smaller percentage of the federal budget devoted to servicing the debt (now 11%). According to the Congressional Budget Office, the higher debt now projected translates into a spending increase of about $1 trillion over the next 10 years.

Beyond economic efficiency, there's also the question of generational equity. A fair budget policy should ensure some correspondence between how much a generation pays into the government and how much it gets back in return. But younger generations are destined to pay far more than older generations in exchange for no more and possibly less.

While the Concord Coalition has long advocated entitlement reforms that would reduce the long-term growth in federal spending, no realistic array of reforms will allow an aging America to hold spending to today's level. Simple fairness to our kids therefore dictates that we return to a policy of budget surpluses when the economy rebounds so that government can afford to borrow a bit more tomorrow.

Closing the gap between what government promises and what it can afford will require someone to give something up. The one way to mitigate the sacrifice is to boost national savings in advance of the age wave. Debt reduction is the government's most direct contribution to net national savings. Increasing national and personal savings is the single most effective policy the government can pursue to promote long-term economic growth and retirement security.

V. The Concord Coalition Recommends a Return to Fiscal Discipline

As you consider the Administration's request to raise the debt limit, The Concord Coalition recommends five fiscal policy guidelines to help ensure that the long-term fiscal health of our nation is not sacrificed to short-term concerns. While not directed specifically at the debt limit, they may provide a framework within which to consider the issues raised by Administration's request:

1. <u>Reaffirm the fiscally responsible goal of balancing the budget without using the Social Security surplus.</u> It may take a few years to achieve, but unless the goal is set there is a clear danger of drifting back into an era of sustained deficits. We cannot afford taking such a risk in advance of the huge fiscal challenges that loom just beyond the 10-year budget window.

2. <u>Recognize that the post-September 11 environment requires a careful examination of budgetary priorities.</u> Policymakers can no longer delude themselves that large perpetual budget surpluses will allow them to avoid making hard choices — not just for the long-term, but now. Everything should be on the table.

3. <u>If it is decided that an economic stimulus bill is needed, it should be carefully designed to have its maximum effect in the very near future, minimize costs in later years, and provide the most bang for the buck.</u> Back loaded options, whether tax cuts or spending increases, are not the right method of providing short-term economic stimulus.

4. Establish a new budgetary enforcement framework to replace the expiring provisions of the 1997 Balanced Budget Act. The prospect of renewed budget deficits makes this all the more important. A realistic set of spending caps and renewal of some type of pay-as-you-go rule for mandatory spending and tax provisions would help achieve the goal of returning to non-Social Security surpluses.

5. Don't put Social Security reform on the back burner. There is no good reason why this issue should be kept off the 2002 legislative agenda. The demographic and fiscal challenges facing Social Security in the years ahead are well known. Failure to change current law amounts to an endorsement of a deep benefit cut for today's 25 year olds, or a steep payroll tax increase. It is understandable that political leaders will disagree on the details of any reform plan. But what's needed now is rejection of the Do Nothing Plan.