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July 28, 2010

Chairman Bowles, Chairman Simpson, members of the Commission – thank you very much for the opportunity to appear before you today.

I am the president of the bipartisan Committee for a Responsible Federal Budget and the director of the Fiscal Policy Program at the New America Foundation. I also am part of the Peterson-Pew Commission on Budget Reform and a member of the Domenici-Rivlin Debt Reduction Task Force. Today, I will discuss a number of the outside initiatives that are underway to try to help change our nation's fiscal future.

I know that all the members of this commission have been working incredibly hard scouring all areas of the budget for potential reforms to improve our fiscal future, and I thank you for all the effort that you are putting into this task.

If we don't make changes to our debt trajectory, we will pay a heavy price through a weaker economy, a lower standard of living, less growth potential, a less flexible budget, and a loss of leadership in the world.

Just yesterday, the Congressional Budget Office released a report on federal debt and the risk of financial crisis. The document not only warns that debt levels are already quite high compared to historical levels, but that the debt is set to grow faster than the economy—forever. Future debt growth will be driven by higher government spending caused by the aging of the populating, escalating healthcare costs, and the biggest waste in the budget – spiraling interest payments (my words, not the ever-diplomatic CBO's), and revenues that, even though they will be higher than historical averages, will not be high enough to pay for all the spending.

The CBO report focuses on the growing risk of a fiscal crisis if we do not change course. A crisis could take the form of a gradual rise in interest rates.

Or as we have seen in other nations, it could be startlingly abrupt, as investor concern suddenly grows over the risk of default or attempts to inflate our way out of our fiscal problems. No one knows at what point we would hit the tipping point. The Committee for a Responsible Federal Budget recently held an entire conference with some of the world's top financial and economic experts on the topic of what would cause a fiscal

crisis and what exactly it would look like. There was nothing close to a consensus about what would kick off a crisis—only that we may well be dangerously close to finding out and that we'd rather not. Fears like these –which would have seemed so exaggerated in the past—now are disturbingly relevant.

Other than how much we should not want to find out what a fiscal crisis would look and feel like, there are a few main points I want to make today:

- We need fiscal goals for both the medium and long term
- We have to be cognizant of the sluggish economy as we proceed
- We should focus on policies that will help grow the economy
- Along with important work of the Fiscal Commission, there are many outside the group trying to develop ideas that will help lay the groundwork for, and dovetail with, whatever the commission comes up with.

I'll focus on the Peterson-Pew Commission on Budget Reform, the National Research Council and National Academy of Public Administration's "Choosing the Nation's Fiscal Future," and the still in-progress Domenici-Rivlin Debt Reduction Task Force.

By way of background, The Peterson-Pew Commission on Budget Reform is sponsored by the Peter G. Peterson Foundation and the Pew Charitable Trusts and its Members are those of the Committee for a Responsible Federal Budget—all the former directors of CBO and many of the formers heads of OMB, the budget committees and the Fed.

Last December the Commission released a six-step plan to stabilize the debt including:

Step 1: Commit immediately to stabilize the debt
Step 2: Develop a specific and credible debt stabilization package as quickly as possible
Step 3: Begin to phase in policy changes gradually in 2012;
Step 4: Review progress annually and implement an enforcement regime to stay on track;
Step 5: Stabilize the debt by 2018; and
Step 6: Continue to reduce the debt as a share of the economy over the longer-term.

The National Academy of Sciences/National Academy of Public Administration study was funded by the Macarthur Foundation. The co-chairs were John Palmer of Syracuse University and Rudy Penner, former CBO director, now with the Urban Institute. It was tasked with showing different comprehensive policy packages, reflecting different values, all of which would return the U.S. to a sustainable path.

Finally, the Domenici–Rivlin Debt Reduction Task Force hosted by the Bipartisan Policy Center is still at work. The groups is co-chaired by former Senate Budget Chairman Pete Domenici, and Alice Rivlin, formerly head of CBO and OMB, and vice chair at the Fed.

The Task Force is equally split between Republicans and Democrats—as well as a few Independents, of which I count myself as one. It will focus on debt reduction and stabilization. And our starting point is that everything is on the table. The report will be released this fall.

There also are many important outside engagement efforts as well, including the Concord Coalition and Dave Walker of the Peterson Foundation 's "Fiscal Wake Up Tour," which holds Town Hall meetings across the country with the Heritage Foundation and the Brookings Institution, and the recent multi-city town hall hook-up convened by America Speaks. But I have been asked to focus on the outside policy and process efforts underway rather than engagement efforts.

We Need Both Medium and Long-term Fiscal Targets

In terms of a fiscal goal, it is actually quite remarkable how regularly US policymakers craft budgets without a specific goal in mind. It is like flying blind, yet the budget process does not require a goal or target to be the starting point of the process.

A fiscal goal has the advantage of helping policymakers say no, as in "I'd love to give you that shiny new spending program or that alluring targeted tax cut, but it will keep us from achieving our fiscal goal."

It also allows us to make comparisons. For instance, say there is one politician courageous enough to lay out the specifics of how he or she would fix the budget. Without a goal, others can criticize the plan without offering a productive alternative. But if you have a common fiscal target, if you don't care for those policies, you can show a different plan that achieves the same goal and allow a fair comparisons of the pros and cons of each approach. It helps bring back the basic notion of trade-offs to budgeting.

This commission has its specific goals which have been laid out for it, which focuses on the short-term target of 2015, and a more vague longer term objective. Specifically:

"The Commission shall propose recommendations to balance the budget, excluding interest payment on the debt, by 2015. This result is projected to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers. In addition, the Commission shall propose recommendations to the President 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."

The Peterson-Pew Commission has recommended a medium-term goal of stabilizing the debt by 2018 at 60%--a well-recognized international standard, which is important given the emphasis we must put on reassuring global credit markets. The Fiscal Future Committee, also chose this goal, with 2022 as the target year. And the Domenici-Rivlin

commission has not settled on a specific goal, and nothing is decided until everything is decided, but some type of medium-term debt target appears to be likely.

Recently, the International Monetary Fund has pointed out that the goal cannot just include stabilizing the debt at post-crisis levels, but rather, must involve bringing it down to pre-crisis levels.

To achieve such a medium-term goal, all three commissions agree that a reasonable plan would be: Credibly commit to reforms as quickly as possible, and phase them in gradually in order to avoid derailing the economic recovery.

But this will not be enough. In order to reassure credit markets and help strengthen the economy, a longer-term plan also will have to be adopted to control federal spending, close the gap between spending and revenues, and alleviate the current uncertainty that confuses citizens and creditors about the direction of future fiscal policy.

Over the longer-term, Peterson-Pew also strongly advocates further gradually reducing the debt relative to the economy – closer to the historical average of below 40%– after 2018. The Fiscal Future Committee recommends policy changes to ensure that "revenues and spending are closely aligned". The primary reason, other than economic, is to ensure that we have the fiscal flexibility in the future to respond to crises that inevitably will rise.

Both medium-and long-term fiscal targets are critical. They also may well require very different policies, with the medium term changes relying more on savings from discretionary programs—including both defense and domestic discretionary—and revenue changes, including everything from cutting tax expenditures to fundamental reform. The Wyden-Gregg plan is certainly one good place to look for ideas.

Both groups point out that in the longer-term, the bulk of reforms will have to come from programs related to the drivers of spending growth—the aging of the population and soaring health care costs—primarily government health care and retirement programs. Simply put, without changes in these areas of the budget, the debt cannot be stabilized.

These policy conclusions are borne out by the types of policies in The Fiscal Future Committee report as well as the illustrative budget blueprint developed for the Peterson-Pew Commission to show one way we might achieve the debt goal. They reflect the general desire by policymakers to make changes more gradually to entitlement program to allow people time to adjust, as well as the reality that that is the area of the budget where the long-term unsustainable growth comes from.

This is particularly relevant to the mission of this commission whose mission is to balance the primary deficit by 2015 which is assumed will stabilize the debt once the

economy recovers. This will only be true if you address the unsustainable drivers of budget deficits; otherwise, the budget will again fall out of balance.

I would emphasize that though both medium- and long-term fiscal targets are needed, the exact target is far less important than coming up with significant improvements that show that we have the ability to change course and avoid the fiscal calamity we are otherwise headed for.

We all are aware of the political polarization that exists in this country, and one of the major concerns is that the two parties will not be able to work together to develop a fiscal roadmap to get us out of this mess. I hope this Commission proves doubters wrong. If this commission comes up with either a modest, or far better, a significant plan, it will go a long way toward reassuring our creditors that we will fix this situation before we are forced to.

I believe it is the hope of all the outside commissions that they will help pave the way to getting there by offering specific ideas and approaches.

Balancing Economic Recovery and Fiscal Consolidation

There are legitimate concerns that enacting a fiscal consolidation plan prematurely could derail the economic recovery. It is my personal belief that the economy still faces many challenges and that *well-crafted stimulus measures* – and I emphasize that – are in order—though I should state that my board of directors has mixed views about this.

However, we are now also experiencing the loss of fiscal flexibility that comes with high debt levels. Instead of just borrowing for stimulus, we should add stimulus measures as necessary and offset the costs of the measures over a longer period of time, so that the funds—whether for unemployment insurance, state and local governments, or business tax incentives—do not lead to more debt over the longer-term.

This also does not mean that there is no room for some tax increases or spending reductions this year or next if they affect areas that are not particularly stimulative. Allowing the tax cuts for the well-off to expire for instance, or cutting wasteful or ineffective programs out of the budget, is unlikely to harm the recovery while cutting unemployment insurance, aid to states or raising payroll taxes probably would. Removing non-stimulative programs is more likely to aid the recovery by showing markets that we are indeed serious about making the changes we need to the budget. A down payment on a full package will be very important in reassuring markets and the public—which will help improve consumer confidence.

Importantly, just committing to a credible fiscal consolidation plan right now, even if the policies are not phased in for a few more years, can help the recovery. The so-called "Announcement Effect" can reassure investors and help keep interest rates from rising

as they otherwise might due to all the debt, as the economy starts to recover. We have seen this in other countries, such as Denmark and Ireland in the past.

For these reasons again, both the Peterson-Pew and the Fiscal Future Committee recommend committing to changes immediately, while actually implementing them more gradually. Given where the economy was at the time the reports were produced, both recommended phasing in very small changes starting in 2012, with the savings growing quickly each year thereafter as the economy strengthens.

The question is: What would constitute a credible commitment? It will take more than a promise.

For a plan to be credible, and for our creditors to buy it, it will have to be statutory, specific, bipartisan, and transparent to public. It should be put in law immediately with the policies slated to phase in as gradually as necessary. The specific policies in the plan must be developed now, not just filled with magic asterisk. The plan has to be bipartisan. The necessary policy changes will be too difficult if either party tries to do this alone. Moreover, if something is pushed through by one party alone, and is met with calls to repeal it, it will undermine confidence that the plan will stay in place. Finally, the public has to understand the plan, be on board, and hold politicians accountable for staying on track. This kind of public commitment has been very helpful in other countries.

One look at the levels of debt we now face should remind all of us that the current favorable interest rate environment could change at any moment and investors could turn on a dime. Stimulus is easy – it involves tax cuts and spending increases – the stuff politicians like. It is the reverse—the fiscal consolidation part—that policymakers do their best to avoid and that is one of the many reasons all these outside groups are pushing that it not be sidelined even as the economy recovers slowly.

Specific Policy Ideas

Moving on to specifics, The Fiscal Future Committee developed four illustrative paths that would achieve its goals.

The low spending and revenue plan would maintain revenues at traditional levels and rely on large spending cuts to all areas of the budget. It would shift responsibilities to households and state and local governments. It would balance Social Security by increasing the retirement age, progressive price indexing, and changing COLAs. And it would limit excess health care cost growth to aging of population. Investments would probably be detrimentally low in this option.

The high spending and revenue plan would only restrain growth of Medicare and Medicaid spending slightly, maintain currently scheduled Social Security benefits, and

permit expanded spending on defense and other domestic programs. It would require very substantial increases in revenues. The Commission thus looked at alternative tax structures, including a radically reformed income tax that limits many tax expenditures and consolidates tax rates, and a VAT. It also assumed a dramatic increases in payroll taxes.

Between these two, the commission provides two intermediate paths, which fall between these two “bookends”.

The Domenici-Rivlin Task Force is still working, and again nothing is decided until everything is decided, but I can say the Task Force will recommend a specific set of reforms with the goals of:

- Making Social Security solvent for 75 years
- Reigning in growing health care costs
- Limiting growth in other entitlement programs, including reforms to civilian and military retirement and farm programs
- Looking at possible freezes in discretionary spending
- Dramatically simplifying the tax code and considering a range of other revenue options

Last month, when I appeared before the Commission, we were asked to provide specific ideas for reducing the deficit. I submitted a plan, which represents my own views, not necessarily those of my board members. It is not presented as the perfect plan, but hopefully as a helpful example of the types of policies that will be necessary to reach a credible target. (Appendix 2)

The Peterson-Pew Commission also developed an illustrative plan of how to stabilize the debt at 60% by 2018, which can be found here. http://budgetreform.org/document/budget-blueprint-paths-60-percent

Some of the major policy conclusions of the groups so far include:

- Entitlement growth will have to be controlled
- You can not get to any reasonable goal without new revenues
- All discretionary spending – including defense -- will have to be part of a plan
- Fundamental tax reform is desirable, and even more so if and when revenues go up.

In developing specific proposals, the groups also recognize and acknowledge the need to deal with the black holes in the budget – the policies that are different in the budget than they will be in reality. So for instance, these groups – or any developing a budget plan – have to deal with fixing the AMT and the Sustainable Growth Rate once and for all. The expiring tax extenders that also are always renewed have to be addressed. I

would assume this commission should hold itself to that same standard and deal directly with these parts of the fiscal challenges, as well as not assuming new policies assumed to expire that really are not intended to.

The Importance of Economic Growth

This budget challenge cannot be viewed as an exercise in merely getting the numbers to add up. We have to be conscious of the most important national priorities, and the effectiveness of government activities.

And we have to pay particular attention to the economic effects of various policy choices. Economic growth will not be able to fix our fiscal problems, but without it, they will be ever so much harder to solve. Our current budget—fraught with short-termism—over-emphasizes consumption and under-invests. We tax the things we want more of—like work—and less of the things we want less of—such as pollution.

There is plenty of room for improvement along with rebalancing. Cutting out wasteful, inefficient and redundant programs is an obvious first step. Shifting our spending from consumption to investment-based programs will have medium-and long-term benefits for the economy. Fundamental tax reform—with a strong emphasis on broadening the base by reducing tax expenditures, will be essential.

So where do we go from here? The Domenici-Rivlin group plans to release our report this fall. I dare say it will be full of specific policies that reflect the kinds of tough choices we have to make to set the country on a better path.

Peterson-Pew is now working on a companion proposal, to be released this fall. In this volume, we will focus on a number of budget process changes including instituting fiscal targets committed to by both the White House and Congress, along with annual debt targets to provide a glide path to the stabilization goal. Additionally, we will recommend a long-term target that will bring the debt down further, yet be flexible enough to accommodate economic cycles and emergencies.

The commission is leaning towards an enhanced use of automatic budgetary triggers which would be used to keep policymakers on track in coming up with budget plans to meet their fiscal goals and then staying on track once they are in place.

And finally, the report will include a number of improvements to the budget process to make the process more transparent to 1) reduce short-term budgeting, 2) highlight budget trade-offs, and 3) improve fiscal outcomes

I will end by saying there are an infinite number of ways to achieve the fiscal goals we are examining. The Committee for a Responsible Federal Budget has developed a Stabilize the Debt simulator as part of the Peterson-Pew effort, which allows people to

pick the policies they would use to get there. http://crfb.org/stabilizethedebt/ (I have brought each of you your own personal simulator you can play in your office.) The results have been gratifying. People are willing to make the tough choices. We are tracking the results to share with policymakers and the public, and there are 35 options –totally about $600 billion in savings in 2018, that have received over 50% support. Not bad.

The point is that the requisite changes are large and tough. But the public appears willing to make them. Thus while the task before this commission is incredibly hard, and ironing out the different values and priorities of the members is a true challenge, voters appear ready to sign on, and it is without question what we have to do for the sake of the future economic well-being of the country.

All of the outside groups I mentioned today—as well as many others—stand willing to assist in any way we can. You have been given a large, and exceedingly important task. Given our debt trajectory, developing a plan to address it is the single most important thing we must do to assure the long-term strength of our economy and well-being for future generations. Thank you for your work on this important task.

Appendix 1:
Members of Fiscal Groups

Peterson-Pew Commission on Budget Reform

Bill Frenzel
Tim Penny
Charlie Stenholm

Barry Anderson
Roy Ash
Charles Bowsher
Steve Coll
Carol Cox Wait
Dan Crippen
Vic Fazio
Bill Gradison Jr.
William H. Gray III
William Hoagland
Douglas Holtz-Eakin
James Jones
Lou Kerr
Jim Kolbe
James Lynn
Maya MacGuineas
James T. McIntyre
David Minge
Jim Nussle
Marne Obernauer Jr.
June O'Neill
Paul O'Neill
Rudy Penner
Peter G. Peterson
Bob Reischauer
Alice Rivlin
Charles Robb
Martin Sabo
Gene Steuerle
David Stockman
Laura Tyson
Paul Volcker
David Walker
Joseph R. Wright

Choosing the Nation's Fiscal Future Project

John L. Palmer
Rudolph G. Penner

Joseph Antos
Kenneth S. Apfel
Richard C. Atkinson
Alan J. Auerbach
Rebecca M. Blank
Andrea L. Campbell
Chris Edwards
Dana P. Goldman
Ellen Hughes-Cromwick
Joseph J. Minarik
Olivia S. Mitchell
Gilbert S. Omenn
Sean O'Keefe
June E O'Neill
Paul L. Posner
Robert D. Reischauer
Margaret C. Simms
William E. Spriggs
Thomas C. Sutton
Susan Tanaka
Ruth A. Wooden

Domenici-Rivlin Debt Reduction Task Force

Pete Domenici
Alice Rivlin

A.R. Bernard, Sr.
Robert L. Bixby
James Blanchard
Sheila Burke
Leonard E. Burman
Robert N. Campbell
Henry Cisneros
Carlos M. Gutierrez
G. William Hoagland
Frank Keating
Karen Kerrigan
Maya MacGuineas
Donald Marron
Edward McElroy
Joe Minarik
Marc H. Morial
William D. Novelli
Tony Williams

Appendix 2:

PLAN TO STABILIZE THE DEBT AT 60% OF GDP

	Savings in 2018 ($Bil)
Defense	**$70**
• Reduce weapon systems, reduce troop levels, reform procurement policies, reform Tricare	
Discretionary	**$140**
• Eliminate outdated programs • Reduce domestic discretionary spending by 5%, short-term freeze, cap growth	
Social Security	**$60**
• Speed up/increase retirement age to 68 and index for longevity • Slow growth of benefits for middle and upper earners • Switch to superlative CPI • Update/reduce spousal benefits	
Heath Care	**$120**
• Reduce new insurance subsidies • Increase cost sharing/premiums for Medicare • Increase retirement age for Medicare • Reform malpractice policies • Reduce Medicaid funding to the states • Introduce a voucher option • Institute a cap on federal health spending to restrict growth to GDP + population + 1% starting next decade	
Other	**$60**
• Eliminate agriculture subsidies • Reduce other mandatory spending • Freeze government salaries for two years, reduce workforce by 5%, reforms contracting process	
Revenues	**$300**
• Tax expenditure reform: Gradually eliminate the health care exclusions; phase down the home mortgage deduction from $1 million to $500k; eliminate state and local tax deduction, reduce corporate subsidies, other consolidations/eliminations, cap total amount of tax breaks as a share of income • Implement a carbon tax • Only extend the expiring 2001/2003 tax cuts temporarily (2 years at most) with the commitment to only extend permanently once a debt reduction package has been put in place	
Sweeteners	**- 100**
• Corporate income tax rate cut • Bump up in spending on some of the most productive public investments (education, R&D, infrastructure)	
Total Savings	**650**

Note: These numbers have not been officially scored and reflect only very rough estimates.

MAJOR METRICS UNDER BASELINE AND PLAN

	2018 Baseline	2018 Plan	2030 Baseline	2030 Plan
Spending	24%	22%	29%	23%
Revenues	19.5%	21%	19%	21%
Deficit	5%	1%	10%	2%
Debt	84%	60%	130%	45%

Note: These numbers have not been officially scored and reflect only very rough estimates.