Rising Debt—Not a Crisis, but a Serious Problem to be Managed

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Joint Economic Committee

United States Congress

September 8, 2016

Mr. Chairman and Members of the Committee:

I am happy to be back testifying before the Joint Economic Committee, one of the few venues on Capitol Hill where serious bipartisan discussion of economic policy happens. The JEC deserves great credit for having the fortitude to refocus attention on the budget future and the national debt—major economic policy challenges that have dropped from sight in this contentious election.

As the CBO has recently reminded us, our national debt is high in relation to the size of our economy and will likely rise faster than the economy can grow over the next several decades if budget policies are not changed. Debt held by public is about 74 percent of GDP and likely to rise to about 87 percent in ten years and to keep rising after that.

This rising debt burden is a particularly hard problem for our political system to handle because it is <u>not</u> a crisis. Nothing terrible will happen if we

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take no action this year or next. Investors here and around the world will continue to lend us all the money we need at low interest rates with touching confidence that they are buying the safest securities money can buy. Rather, the prospect of a rising debt burden is a serious problem that demands sensible management beginning now and continuing for the foreseeable future.

What makes reducing the debt burden so challenging is that we need to tackle two aspects of the debt burden at the same time. We need policies that help grow the GDP faster and slow the growth of debt simultaneously. To grow faster we need a substantial sustained increase in public and private investment aimed at accelerating the growth of productivity and incomes in ways that benefit average workers and provide opportunities for those stuck in low wage jobs. At the same time we need to adjust our tax and entitlement programs to reverse the growth in the ratio of debt to GDP. Winning broad public understanding and support of basic elements of this agenda will require the leadership of the both parties to work together, which would be difficult even in a less polarized atmosphere. The big uncertainty is whether our deeply broken political system is still up to the challenge.

The American economy is the strongest in the world. It has shown great resilience in recent years and recovered much better than others from the devastation of the Great Recession. But with an aging population, slow productivity growth, lagging wages and increasing inequality we cannot afford policy gridlock. We need aggressive economic policies to grow the economy faster and create more and better paying jobs. We do not lack for opportunities to do this. In recent years we have neglected our public infrastructure, allowed roads, bridges, rail, and water systems to fall into disrepair. We have failed to modernize our airports and air traffic control systems to keep up with the volume of flights or to invest adequately in public health. We have failed to keep the skills of our workforce growing in step with changing technology and to prepare young workers, especially those from low-income families, for the jobs the economy requires. And we have reduced the flow of funding into basic research on which future technological progress depends.

After years of neglect and under-investment, opportunities abound for public investment and public-private partnerships to increase future productivity growth and open new opportunities for current and future workers. We would be stupid and irresponsible not to take advantage of these opportunities to enhance the future productivity and income growth needed to keep the American economy strong and enhance American ability to be an effective world leader.

These growth-enhancing investments will require substantial public resources over quite a long period. What is needed is a well-planned and executed program of investment in knowledge, skills and basic infrastructure, not a short-term stimulus designed to create as many jobs as possible quickly. Even if part of this spending is off-set by reducing lower priority spending or rising revenues—as it should be--a sufficiently aggressive investment program will likely increase the near-term deficit. It will create additional jobs and take some of the burden off the Federal Reserve and monetary policy, which has recently borne the sole policy responsibility for keeping the economic recovery from stalling.

Opponents of undertaking a major productivity-increasing investment program argue that we can't afford the additional spending because government is already spending too much and the debt burden is already too high, so any additional spending must be fully "paid for" in the near-term. Proponents, by contrast, argue that we should borrow as much as we need for investment at current low interest rates and worry about the debt burden later. Both are wrong. Investment in future growth is essential to a prosperous future, but must be undertaken simultaneously with actions to reduce the growth of future debt. Faster growth alone will not reduce the debt to GDP ratio in a society that has already committed itself to benefits for a growing older population--benefits that will increase more rapidly than revenues even at hoped-for higher rates of GDP growth.

Why can't we focus on investments now and worry about the debt problem later? The main reason is that the adjustments that we need to reduce the growth in entitlement spending and increase tax revenues in the future take time and must be well designed and phased in slowly. Moreover, unless a credible longer run debt reduction plan is put in place, it will be impossible to build bi-partisan support for the needed investments or to deal effectively with another recession when one occurs. Moreover, without enactment of a credible long-run deficit plan, our creditors may gradually—and understandably--lose their faith that the United States is a credit-worthy nation. Then we would be faced with the far more serious problem of paying much higher interest rates on a larger debt.

There are three necessary elements of a long-run debt reduction plan:

- Putting the Social Security program on sustainable track for the long run with some combination higher revenues and reductions in benefits for higher earners.
- Gradually adjusting Medicare and Medicaid so that federal health spending is not rising faster than the economy is growing. Indeed, we should use these programs to transform the whole American health delivery system, so that total health spending no longer absorbs a growing portion of total resources.
- Adjusting our complex, inefficient tax system so that we raise more revenue in a more progressive and growth-friendly way and encourage the shift from fossil fuels to sustainable energy sources. Such a tax reform program could involve limiting or restructuring tax expenditures that differentially benefit high income people in exchange for lower marginal income tax rates; corporate tax reform aimed at taxing a broader base at lower rates; a carbon tax that starts low, but rises predictably over time; and possibly a progressive consumption tax.

You will notice that I do not believe that cutting discretionary spending further should be part of a long-run plan to reduce the debt burden. We need to work hard to increase the effectiveness of both domestic and defense spending (and we can argue about the balance between the two), but I believe that the Budget Control Act of 2011 cut discretionary spending too much. The investment program I outlined above would increase discretionary spending above the current caps.

Reaching agreement on the politically sensitive changes necessary to reduce the debt burden will take bipartisan negotiation and strong leadership in the White House and Congress--leadership committed to working together to get the economy growing faster and the debt burden coming down. In a country with a Constitutional structure that requires consensus and compromise, there is no way that the needed changes in taxes and entitlements can be made without bipartisan cooperation and compromise.

The major elements of such a plan closely resemble those of all the bipartisan plans seriously discussed in recent years-- Simpson-Bowles, Domenici Rivlin, Obama-Boehner, the Super Committee, and the "gangs" of Six or Eight or whatever. The arithmetic of the budget drives all bipartisan problem-solvers to the same general conclusions and much of the staff work has already been done. However, I am not suggesting another grand bargain—at least not another attempt to wrap all these complex adjustments into a single piece of legislation to be voted on at once. That is too heavy a lift and would not produce the necessary buy-in. Instead, I am suggesting that the new Administration and Congressional leadership work out a general framework for investing in growth and getting the debt/GDP ratio coming down over time. Then the relevant committees can get to work on the major components (investment in infrastructure, skills, and knowledge; restoring Social Security solvency; reforming Medicare and Medicaid; and transforming the tax code). All this will be difficult and contentious and no one will be fully satisfied with the result, but the point is to break out of gridlock and start working on constructive solutions.

Thank you for listening. I would be happy to answer questions.