Testimony of
Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
And Vice-Chairman, Promontory Interfinancial Network
Princeton University
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Chairman Baucus, Ranking Member Hatch, members of the Committee, I'd like to thank you for the opportunity to share my views on the budget deficit and the national debt with you today. I really have only three points to make. I'll state them up front and then elaborate just a bit on each.

1. The short-term federal budget deficit, large as it is, is really not much of a problem. Indeed, it's probably desirable.
2. By contrast, the government's long-run deficit problem is huge, horrendous, and demands Congressional action. Sooner would be better than later.
3. No one should seriously consider letting the government hit the national debt limit.

<u>The Short-Run Budget Picture</u>

CBO now estimates that the FY11 deficit will be about $1.4 trillion, roughly 9½% of GDP. That looks huge compared to the 40-year average of about 3% of GDP—and it is. But let me make three quick points about the 6½ point gap.

First, it's inherently temporary. In round numbers, the recession has added about 2% of GDP to the deficit. That part will naturally fade away as the economy improves. About 1% of GDP comes from the Recovery Act, and that will certainly disappear. Another 1% comes from the wars we are fighting, and I certainly hope that will disappear. Finally, roughly another 2½%

comes from the tax-cut package that Congress enacted last December. That is scheduled to lapse in 2012, but I worry because that's an election year. If you add up all these "temporary" components, you get about 6½% of GDP. So, in principle, Congress should be able to get the deficit back down to 3% of GDP without breaking a sweat. Yet the House and Senate are tying themselves up in knots over about $30 billion.

Second point: The economic recovery is mediocre at best and unemployment remains high. To me, those conditions describe a bad time to put the economy on a diet of either spending cuts or tax increases.

And third, if we are facing any near-term financing problems, they are invisible. The capital markets are now charging the U.S. Treasury a real interest rate of about 1% for 10-year money, and strongly *negative* real interest rates for short-term money. That is very cheap financing.

So there is no deficit crisis today. But we could create one by letting the government crash headlong into the national debt ceiling.

The Dysfunctional National Debt Limit

Each year—well, except for this one—Congress passes a budget that implies certain amounts of spending and receipts. The difference between those two numbers is the implied increase in the national debt over that fiscal year. Given the budget, it makes no sense whatsoever to place an *additional*, lower limit on the amount of debt the Treasury can issue. How can we bar the Treasury from borrowing the money that the budget dictates?

Letting the debt limit bind is, at one level, comical—because it purports to defy the laws of arithmetic. But at a more important level, it's potentially dangerous if it robs Treasury of the borrowing authority it needs. We have enough problems and should not shoot ourselves in the foot.

The Long-Term Budget Problem

Let me now turn to the long-term budget problem. As I'm sure every member of this Committee knows, the U. S. government is on an unsustainable budget path that will drive the ratio of debt to GDP ever higher. The next 10 years are not where the problem really is; it's what comes after that.

CBOs latest long-term projection showed the deficit as a share of GDP, under the more realistic "alternative scenario," falling from about 9½% now to about 6½% in 2020, but then soaring to 16% by 2035—after which it continues ever upward. That's not only unconscionable, it's impossible.

What's driving these numbers? Other than the inexorable logic of rising debt and interest payments, it's Social Security and health care, mostly the latter. For example, if you look at the *primary* deficit, which excludes interest payments, Medicare and Medicaid account for roughly 85% of the increase between 2020 and 2035. As Rabbi Hillel said about the Golden Rule, "All the rest is commentary."

The explosion of medical costs is, in turn, driven by two factors: increasing longevity and rising *relative* prices for health care. I don't think Congress wants people living shorter lives. So it is approximately true that, if we figure out how to "bend" the healthcare "cost curve" enough, we can fix the long-run deficit problem. And if we can't, we can't.

Unfortunately, nobody really knows how to do that. Some people believe that last year's healthcare reform has the potential to do the job. After all, it tries almost every cost-control idea that's been suggested. But others are skeptical. I don't pretend to know the answer. The most intelligent course of action, it seems to me, is to watch how the various cost-containment efforts play out over the coming years and then do more of whatever seems to work.

As I say this, I'm painfully aware that cutting losers and riding winners is one of the hardest things for any government to do. Nonetheless, I think you senators should try—and I wish you good luck.

Thank you for listening.