

**ADMINISTRATION'S REQUEST TO INCREASE  
THE FEDERAL DEBT LIMIT**

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**HEARING**

BEFORE THE

SUBCOMMITTEE ON LONG-TERM GROWTH  
AND DEBT REDUCTION

OF THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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## **ADMINISTRATION'S REQUEST TO INCREASE THE FEDERAL DEBT LIMIT**

**THURSDAY, FEBRUARY 14, 2002**

U.S. SENATE,  
SUBCOMMITTEE ON LONG-TERM GROWTH  
AND DEBT REDUCTION,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:06 a.m., in room 215, Dirksen Senate Office Building, Hon. Bob Graham (chairman of the subcommittee) presiding.

### **OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA, CHAIRMAN, SUBCOMMITTEE ON LONG- TERM GROWTH AND DEBT REDUCTION**

Senator GRAHAM. I will call the hearing to order.

I want to thank Secretary O'Neill and the other gentlemen who will be witnesses here this morning.

This hearing has been held as a result of a letter which was sent by the Secretary of the Treasury on December 11, 2001 indicating that the administration was requesting an increase in the debt ceiling from its current \$5.950 trillion to a total of \$6.7 trillion, with a forecast date of February of 2002 as being when we would reach the statutory debt ceiling.

I understand that yesterday we received a subsequent letter which basically reaffirmed the December 11 statement, other than changing the date by which we would reach the debt ceiling to late March.

The purpose of the hearing today is to take testimony on that request.

To put this in some historical perspective, in January of 2001, the President said that there was enough surplus coming into the Federal Government to do it all: debt reduction, new spending, and significant tax cuts.

In the President's budget message, the following statement was included: "After funding important priorities and retiring all government debt possible, my budget uses the remaining portion of the surplus to provide fair and reasonable tax relief to every American who pays income taxes." The clear meaning of this message is that debt reduction should take priority over tax cuts.

The President justified the tax cut by stating that, over the next decade, there was more surplus available for debt reduction than there would be debt held by the public to repay. In other words,

the Federal Government would be left with money for which it had no use.

Today's budget picture is not so rosy, and no reference to the fact that today is Valentine's Day. The \$5.6 trillion 10-year surplus has shrunk to \$1.6 trillion, in part due to the slowdown in the economy and in part due to the enactment of last year's tax cut.

Over the next 10 years, the tax cut is estimated to account for 42 percent of the reduction in the surplus. How will debt reduction fare in this new budget climate? Frankly, not so well.

The estimate a year ago was that, as we began this current fiscal year, the debt held by the public would be \$3.174 trillion. This represents the debt held by mutual funds, institutional investors, individuals through savings bonds, and all the other forms of indebtedness held by entities other than the Federal Government itself.

Debt held by the public, in fact, as we end fiscal year 2001, was \$3.32 trillion. According to the President's budget, debt held by the public at the end of FY 2007—and although the President's budget has both 5-year and 10-year projections, the level of the debt held by the public is projected for only 5 years—is \$3.379 trillion.

That represents an increase of \$59 billion over our current indebtedness, and is a dramatic increase over last year's projection which was that by 2007, our National debt held by the public would be \$1.602 trillion.

At the beginning of the calendar year 2001, we were not expected to reach the statutory debt limit until the year 2008. We now have a letter indicating that an increase will be required by late March of this year.

A fundamental question which we will be talking about today is does all of this matter? There are some who argue that, in a Nation with a gross domestic product in the range of \$10 trillion, that the issue of the level of national debt is irrelevant.

Our national debt, as a percentage of GDP, is substantially below that of most other industrialized nations. I, as a self-described fiscal hawk, would not be so sanguine.

Debt can be productive if the proceeds of debt are used for the right purposes. To put this in the context of a family, a family that borrows \$10,000 to send a child to college would, in most people's judgment, be making a prudent investment.

On the other hand, most economists would argue that borrowing the same \$10,000 to be able to take the summer off from work or to borrow to pay for groceries or other necessities would be a poor economic decision.

We are quite aware that the economy can also benefit from debt reduction. We need only to look back to the results of the late 1990's for concrete evidence. Debt reduction increases national savings and lowers long-term interest rates. Those lower rates benefit consumers and businesses and reduce future Federal interest costs.

In contrast to the extent that the Federal Government increases its borrowing, it becomes an increasing factor in the capital markets, where private sector businesses, consumers, and State and local governments are all squeezed out or will be forced to pay higher interest rates. With higher interest rates, we have historically experienced depressed economic growth and depressed job creation.

Reducing today's debt has another significance which has particular timeliness: it helps prepare the Federal Government for the impending retirement of the baby boom generation.

Let us consider a family with a 14-year-old daughter or son who is considering going to college, the same child for whom they will be considering borrowing the \$10,000.

Knowing that a significant financial obligation is just around the corner, the family would start to prepare by, among other things, reducing the amount of debt that they currently owed. Doing so would put them in a better financial position when the time came to have to borrow to meet the child's college expenses.

The same is true for the Federal Government. To the extent that we lower debt held by the public today, the Federal Government is better positioned to meet its obligations under the Social Security and Medicare contracts which it has with the American people tomorrow. That tomorrow is not far away, and is very significant.

Today, the number of Social Security beneficiaries is approximately 46,352,000. Twenty years from today, that same number—and these are not speculations, these are lives in being today, based on life expectancy—is 69,316,000 Americans on Social Security. That is the baby boom wave for which we need to think today of how to prepare.

Today's hearing explores the request to increase the debt limit by \$750 billion, which my research indicates would be the second-largest one-time debt increase in the history of the country.

In doing so, the subcommittee will explore four broad questions: what factors led the administration to make a one-time request for an increase of \$750 billion; for what purposes will the \$750 billion be used; what are the ramifications of this increase in the debt ceiling for our economy; and how will the Nation's return to deficit spending affect its fiscal situation today and in the near future?

Our first witness, on behalf of the administration, is Treasury Secretary Paul O'Neill. We are very appreciative that he is able to be with us today.

Following Secretary O'Neill, we will hear from a second panel of economists and budget experts: Bruce Bartlett, a senior fellow at the National Center for Policy Analysis; Robert Bixby, the executive director of the Concord Coalition; and Gene Sperling, a visiting fellow at the Brookings Institute.

Mr. Secretary, again, we are very pleased and honored at your presence and will look forward to receiving your testimony.

**STATEMENT OF HON. PAUL O'NEILL, SECRETARY, U.S.  
DEPARTMENT OF THE TREASURY, WASHINGTON, DC**

Secretary O'NEILL. Mr. Chairman, thank you very much for inviting me to be with you today.

I have a brief statement which, with your permission, I will read into the record and then stand ready for questions.

Mr. Chairman, just 3 months ago to the day after the tragic events of September 11, I wrote to the Congress requesting an increase in the statutory debt ceiling by \$750 billion.

Yesterday I sent another letter repeating this request, with a revised projection that the debt ceiling will be reached in late March.

Failure to enact a permanent increase in a timely manner would only serve to undermine confidence in our government and in our economy.

Last August, we forecast that the debt ceiling would be reached in late 2003. Since then, war, recession, and national emergency have intervened. This year's surplus has been eroded by the economic downturn and the response to the September 11 attacks.

While the timing of the need to increase the statutory ceiling is sooner than we had anticipated just 6 months ago, because of the untoward events we have always known it would need to be raised at some point.

Payroll taxes that the American people put aside and send to the Social Security trust fund result in an increase in the level of debt subject to this limit because these funds are invested in special Treasury securities.

The same holds true for collections for Medicare, highways, airports, and other special purposes for which the government has established trust funds.

Government account holdings of these special Treasury securities increase by more than \$200 billion each year. As these trust funds grow, they push up the level of the Treasury's outstanding debt.

Indeed, over time, the growth of the Social Security trust fund is, and will continue to be, the most significant contributor to the increase in the level of the government's debt subject to limit.

The U.S. Government has the premier position in world capital markets because there is no doubt the United States will honor its financial commitments. Legislative action on the debt ceiling is necessary to preserve the U.S. position in world capital markets.

Any delay could create uncertainty that would raise the cost of borrowing paid for by U.S. taxpayers. This is an unnecessary expense. Of course, any uncertainty added to the early stages of our economic recovery would be particularly unwelcome at this time. I, therefore, urge the Congress to enact this increase in the debt ceiling as quickly as possible.

That is my statement, Mr. Chairman.

Senator GRAHAM. Thank you, Mr. Secretary.

I would like to explore the Administration's request for what I stated to be the second-largest one-time increase in the debt ceiling in the Nation's history, an increase of \$750 billion.

What were the factors that led the administration to request an increase of this magnitude?

Secretary O'NEILL. Well, as the Chairman knows, for the debt ceiling, arguably, we could ask for an amount smaller than this, we could ask for an amount much larger than this. What we have done, is to have looked at how long the \$750 billion increase would carry us and judge that it made sense to look ahead as long as a couple of years from now.

But, in truth, as we look at this debt ceiling question, we do not see it related to one decision or another because, in truth, the debt ceiling is a limitation that the Congress puts on itself and it limits the ability of the Treasury Department of the Treasury Secretary to borrow money. Perhaps in olden days it had a significant effect on the conduct of government business.



My own view is, since the creation of the Congressional Budget Act of 1974, the real decision making about the composition of government spending and government revenue, and therefore government debt or surplus, has been moved to the venues of budget committees and appropriations committees, and behind that authorization committees, I suppose.

So we still have this process of setting debt ceilings, but in truth we really do not have much of a choice unless we are prepared to go back and undo any number of decisions about the combination of spending and revenues. So, we see this as a carry-over process from days gone by.

The \$750 billion is as arbitrary as any other number. I do not think there is high utility in having this process done on a very frequent basis, because I really do not think it adds very much to our deliberations and consideration of a total fiscal policy of the U.S. Government.

Senator GRAHAM. Well, I might have some disagreement on that subject. It seems to me that having periodic, rather than one-time, debt ceiling increases does, in fact, create and force a debate on some fundamental fiscal issues for the country.

During the administration of the previous President Bush, the debt ceiling was increased five times over that 4-year period. So, there has been some recent history of approaching debt ceiling increases in incremental steps rather than in the \$750 billion leap that is currently being requested.

For what time frame would the Treasury estimate this \$750 billion increase be sufficient to cover?

Secretary O'NEILL. We think this will carry us through for 2 years or more. This estimating process is, as you know, not a precise science, but we think for a couple of years.

Senator GRAHAM. So you think that in the next two years we will add \$750 billion to the national debt.

Secretary O'NEILL. Those are the best estimates at the moment.

Senator GRAHAM. In terms of those estimates, what are your expectations for the growth in GDP over that period of time?

Secretary O'NEILL. We are looking at returning to a running rate of 3.5 percent real growth by the end of this year, and in 2003, probably a somewhat better than trend line growth rate.

I do not have a number in my head, but something a little higher than that, then flattening out as we go forward on a steady-state basis, someplace in the range of 3.1 to 3.2 percent.

Senator GRAHAM. If those projections proved to be too pessimistic, I would assume that that would result in extending the period that this debt ceiling increase would cover, and commensurately if they were too optimistic, we may reach the debt ceiling in less than the 2 years.

Secretary O'NEILL. That could very well be. But over any extended period of time, the Congress, of course, has the ability to make different decisions about the level of spending or the level of taxation.

What we have put before you is as a consequence of the President reviewing where we are with our war on terrorism, what we believe needs to be done to bolster homeland security, and to meet the obligations we all feel must be honored for Social Security,

Medicare, and improvement in education spending, as has been recommended.

And not believing that we should be raising taxes at this time, we have come to the conclusion that we need to anticipate the fact that we are going to be on the edge of being in a unified budget balance, which, because of the accounting conventions, will require the debt limit to be raised for the reason that I gave you, that we count increases in Social Security obligations that are in certificates in a lock box as obligations subject to the debt ceiling. So even under budget balanced conditions, the debt subject to limit will be going up.

Senator GRAHAM. But the assumption was that, while, yes, in the next period as the number of people in Social Security remains relatively constant until we face that big surge that begins in about 10 years, that we would be reducing the debt held by the public to offset the increased accumulation of funds in the Social Security and other trust funds. We are not going to be having that offset, according to the President's current budget projections.

Secretary O'NEILL. A year ago, we and the independent Congressional Budget Office were in substantial agreement that, all other things being equal, we were going to have the kind of profile that your chart suggests and we were going to be substantially paying down debt held by the public. While we were doing that, it would serve to offset the otherwise increasing amount of debt subject to ceiling represented by the Social Security deposits.

Senator GRAHAM. I would like to come back to the questions relative to the factors that led to the administration's request for this \$750 billion increase.

What is your projection as to the balance of payments of the country over the period covered by this debt ceiling increase?

Secretary O'NEILL. I do not have a number in my head for balance of payments. Honestly, I just do not have the number. I will have to give you one for the record. Maybe you are asking the question about current account surplus or deficits?

Senator GRAHAM. Our trade deficit, yes.

Secretary O'NEILL. Let us see. On a merchandise basis, we are going to be probably net positive, but on a financial flows basis we are going to continue to see net money coming into the United States because it is the safest place in the world for people to invest their money, which is a very good thing.

Senator GRAHAM. And I would like to get the administration's projection of the trade surplus or deficit upon which the projections of economic growth were predicated.

What effect do you anticipate this increase will have on the value of the dollar? Do you think that 2 years from now the dollar will be stronger or weaker?

Secretary O'NEILL. There is almost no value in talking about foreign exchange rates, but let me see if I can respond to your question with that caveat.

If you say nothing, people assume you mean something by it in this particular area. It is really a thorny question. But having put the caveats on, let me tell you what I believe.

I believe the dollar, and its value relative to the rest of the world, is a function of the prospective productivity of everything in our

economy compared to the productivity expectations and realizations in all other countries around the world.

My own view is that the productivity numbers that we saw for the fourth quarter, 3.5 percent increase in productivity, is not a fluke. In fact, the productivity experience we have had over the last 10 or 12 years is not a fluke, it is a function of the U.S. being in a different league than almost all the rest of the world with regard to the ability of our system to produce higher levels of productivity that improve the living standards for our population and give us the wherewithal to defend ourselves against terrorists and to help the rest of the world with its economic development.

So I am a great believer, I think, on the basis of demonstrated evidence, that our economy is a model for what the rest of the world should try to do. Because of the people that one sees out there who are driving this, people in little firms of 10, 15, or 25 people, and then firms that have hundreds of thousands of people, we have the ability to keep producing ever-higher levels of living standards and productivity, therefore, our currency will be strong.

Senator GRAHAM. I would appreciate it if, with your assessment of what you think the balance of payments would be over the duration of this increase, if you could also indicate with some quantification what you think that effect will be on the value of the dollar.

And what are the administration's expectations in terms of arriving at this \$750 billion need to cover our indebtedness? What are your expectations for short- and long-term interest rates?

Secretary O'NEILL. We have some numbers in the economic report of the President, and I will give you those.

It is our belief that, in the territory that we are talking about here of debt held by the public compared to the size of our gross national product, that in this range and in this time that this level of debt will not have an important implication for interest rates.

It is partly because we believe that interest rates are substantially a function of two things. One thing, is the necessary base rate of return that capital requires in order to be diverted from consumption into investment.

If you look back over a 125-year period, and I would say it is about as long as the economic data is good enough to look at, the base rate of return for capital is 3 to 3.5 percent. The difference between that base rate and the longer dated rate is a forward projection and expectation about the level of inflation on the economy.

So that for the most risk-free investment, i.e., U.S. Government debt, one should look at the rate to be 3 or 3.5 percent, plus whatever you believe the correct expectation will be for inflation.

In this range of debt to total capital available either in the U.S. market or in the world markets, we do not think the numbers we are talking about here have a demonstrable effect on the long-term rates.

Senator GRAHAM. I think we may be substituting cause and effect. I am assuming that there were a series of economic assumptions which were used to arrive at the consequence that \$750 billion of additional indebtedness is what the Nation would require over the next 24 months.

I am trying to find out what the assumptions were, not what the consequences of taking on this additional debt would be.

Secretary O'NEILL. I am saying the assumptions and the consequences are the same because we do not think the \$750 billion has a material effect on the interest rates.

Senator GRAHAM. Again, I would like to get the administration's assumptions on that.

I would like to now turn to what was the second question of the four. The President, in his State of the Union address, identified three national priorities: winning the war on terrorism, securing the homeland, and stimulating the economy.

Could you indicate for how much of this \$750 billion of additional borrowing will go to each of those three accounts?

Secretary O'NEILL. In truth, Senator, they are really not related to each other. Over this time period we are going to be spending, this year, \$2.1 trillion, and then moving up from there in each of the next several years.

So let us say for shorthand purposes, we are talking about the \$10 trillion worth of spending over the next 5-year period.

If you would rather do it for 2 years, let us say \$4 trillion. Because of the way this process works, it is not possible to directly tie the debt outstanding to any particular piece of spending. We do not have a way of saying, this dollar is related to this piece of spending.

The totality of the Federal budget over this next period will be financed by revenues coming in, which are not insignificant. We are still talking about taking historically higher levels of money away from the American people than we have.

Since 1945, the average rate of Federal taxes on the general population has been 18 percent. Even with the tax reductions you all voted last year, we are going to be taking 19 percent over this period of time. That will pay for a very substantial part, if not almost all, of spending during this period of time.

Then we have taxes from payroll taxes and the like that will come in and other tariffs and duties. Then to the degree that we do not have enough cash coming from those tax sources, we will necessarily do some borrowing.

Now, in the budget the President sent you a week or so ago we suggested, on a unified budget basis, that we were going to need \$80 billion or so of debt financing to carry us through the year.

Last week, the Congress decided, at least temporarily, not to agree to do the stimulus bill the President has recommended. If you do not think that has any consequence for generating more revenue, then you could say, well, we have reduced the spending level or the net difference between spending and revenue by \$75 billion.

So you could argue, if you are satisfied that we do not need a stimulus bill—which, by the way, the President still believes we do—that we are, in effect, in balance.

Then the only number that we are talking about here is the accounting number related to showing the Social Security credit to the trust fund where we are going to use the cash to pay for the general purpose of running the government.

Senator GRAHAM. Going back to these three priorities of the President, what portion of the \$750 billion do you anticipate will be spent on items that are attributable to the war on terrorism?

Secretary O'NEILL. Again, Senator, they are not related to each other. We have cash needs to pay for all the things that the Congress decides we should pay for. When we do not have enough money, then we have to go and borrow it.

I do not know how to associate the last dollar of borrowing with some particular expenditure. Shall we say it is for Social Security? I would not say that. Shall we say it is to pay salaries to the legislative and executive branch? Because they are not directly associated with each other, I think it is not possible to answer your question the way it is posed.

Senator GRAHAM. I go back to my Scotch ancestry. I think there is a difference between borrowing for investment purposes and borrowing for immediate necessities. To borrow to buy another 10 cows to make your dairy farm more efficient may be a prudent investment. To borrow the same amount of money to spend it on immediate necessities is not a prudent or sustainable practice.

So I am trying to distinguish, with this request, how much are we going to be spending on what the President has identified as his priorities, and how much are we going to be spending on ongoing necessities, but not priorities?

Secretary O'NEILL. Well, the President thinks all the things that he has put into his budget are priority things, otherwise we would not have them.

But to follow your line of logic, I guess I would say preserving our freedom is the most important thing, so all the money is going to be spent for defense, if you like. A different formulation would say, well, we have decided as a people that there are certain things we are going to do.

Again, to follow your line of logic, one could say that all of the borrowing is going to go to pay for the cost of food stamps. I would not say that that is an expenditure we should not make. For sure, the President has said all of the dollars in the budget are ones that he believes we should be spending.

Senator GRAHAM. Yes. To go back to my family example, I am not suggesting that the family does not need to eat and buy groceries. But I am suggesting that maybe the second spouse is going to have to take another job to pay for those necessities, that you are not going to be going to the bank to borrow to pay for the ongoing expenses of maintaining the family.

I am suggesting that that is not a bad principle for the Federal Government, that we ought to borrow for those things that are clearly identified as priorities and which will have a long-term benefit to the country.

Things like keeping the national parks open. It is a highly desirable thing to do, but you should not be borrowing money to do something as recurrent and basic as keeping the national park system in place.

So I am trying to distinguish as to how much of the \$750 billion is going to go for the three priorities that the President has outlined as opposed to how much is going to go for other things, with-

out denigrating the value of those other things, just questioning whether they should be financed by borrowing.

Secretary O'NEILL. I would say every penny of what is going to be borrowed is going to be used for high-priority spending, not a single penny for something that is not important.

But it causes me to make another point. We believe that being in deficit is not a desirable thing to do. The President has said over and over again, but for the attacks of September 11 and the recession that we found ourselves in, and the national emergency to deal with the needs of homeland security, he would not want or consider being in a deficit position.

Beyond that, we are convinced that you do not get where we want to be as a society by anything but a continuous rate of positive economic growth, which will then produce the revenues that we need to pay for all of the things that we need and want in our society.

So this is very much a budget that is fashioned against the backdrop of having to do things that were required by the war conditions and homeland security, while at the same time trying to put ourselves into a position that we will see a return to high rates of real growth, which then will cause the deficits to disappear and we will be back in positive territory.

Senator GRAHAM. Are you saying it is not possible to identify what our expenditures are going to be on the war, securing the homeland, and stimulating the economy, and thus make some connection between what those three priorities are going to be and the amount of borrowing?

Secretary O'NEILL. I can do this. I can give you a precise set of numbers for those three priorities which are overwhelmingly larger than the amount we are talking about financing with deficit financing.

If I remember right, the budget authority number for defense spending this year was \$369 billion.

Senator GRAHAM. But I heard an account from a Defense Department official, when asked the question, how much are we spending per month additionally on the war in Afghanistan, and his number, I think, was \$1.2 billion. So while we have an enormous budget for the Defense Department, the additive component that relates to the war on terrorism is a relatively small percentage of that.

Secretary O'NEILL. As a matter of incremental accounting, that is right. But if we had to account for all the money that is effectively being deployed in the form of training the military so that they could go, so that we could have a standing Army that was ready to go and an Air Force that was ready to go, and amortizing that cost over today's period as you would in the private enterprise, the amount of money that we have got pointed at Afghanistan is, I do not know, \$100 billion or something like that.

The reason why we have all of this defense spending on a continuous basis is so that when we have a need to go to Afghanistan, we can do it. It is true on a simple accounting basis that the incremental costs on a day-to-day basis, because the people are there instead of in their home bases in the United States, is maybe only \$1.2 billion, but the cost associated with maintaining that standing force is, nevertheless, a very big number.

Senator GRAHAM. I would be interested in getting, in follow-up, data on what your assessment is of those three areas: the war on terrorism, securing the homeland, and stimulating the economy.

Secretary O'NEILL. All right.

Senator GRAHAM. This leads me to a concern which goes back to the statement that was in the 2001 Presidential budget, which inferred that the first thing we were going to do was to meet our spending priorities, the second thing was to pay down the debt, then if we had anything left over, we would reduce taxes.

Is that still the formulation of the President's priorities?

Secretary O'NEILL. Yes. Again, subject to the reservation the President made for the last two or three years, that under normal conditions he would not want to see the Federal Government running in a deficit position.

But he was pressing enough to know, even two or three years ago, that he should not hold the country to that standard in the case of a war, or a national emergency, or an economic recession. He was right. As we look back now, I think as the Congressional Budget Office looks back now, people have not changed their mind about what would have been if not for September 11, and if not for the depth of the recession that we had. But circumstances and conditions changed.

That does not mean that the value structure of what we are trying to accomplish has changed, it means conditions have changed and we need to accommodate those conditions so we can get ourselves back on a fast economic growth track which will put us back into surplus territory. We can again be looking at the prospect of paying down debt held by the public.

Senator GRAHAM. I agree with what the President has said. As one who has been a strong supporter of efforts to eliminate the flood of deficits that the country experienced and get us into a position that we could begin to deal with reducing our debt for a variety of reasons, but particularly to get ready for that big wave of retirees that we are soon going to face, I think we have to be careful not to allow emergent and urgent conditions such as wars, recessions, and need to defend the homeland to become the cover for indolent and permissive fiscal practices.

Secretary O'NEILL. I could not agree with you more, Senator.

Senator GRAHAM. The fourth question that I had, was looking 10 years downstream, what is the administration's strategy for positioning ourselves to get ready for this tidal wave of retirees?

I note that at the end of the 5-year budget that we are talking about now, we will break the 50 million mark in terms of number of retirees. Then by the next 5 years, we will be up close to 55 million retirees.

What is the administration's strategy to deal with this, and how is this \$750 billion debt increase consistent with that strategy?

Secretary O'NEILL. Well, first of all, Senator, let me say, I share your view that this is inevitable. The demographics tell us that we are going to have a very substantial increase in the population that is collecting Social Security benefits as we go toward 2020.

The numbers become even more striking when you get to 2030 and you see the effect of our population aging, thank goodness. Those in the working population have an ongoing obligation to

make sure that those who have been promised Social Security benefits will receive them.

One thing is very clear to me. There is no one in Washington, I think, who has any doubt that we are going to meet the obligations to Social Security beneficiaries.

One of the reasons I say that to you is because I worry, with people watching hearings in the Capitol and not understanding some of the nuances about all of our concern and consideration about ensuring that we do take care of our obligation to Social Security beneficiaries, that might alarm some people who are not sophisticated about these things.

So I would say as a declaration: we are all committed to the idea that Social Security beneficiaries will be protected. As the President has said over and over again, beneficiaries should have no doubt they are going to receive their benefits.

Now, more directly to your question. It is very clear that we are going to have to figure out a way that we can both honor our obligations to Social Security beneficiaries and pay for those benefits in a way that does not become a surprising mountain in front of the working population 15 or 20 years from now.

It is the reason why the President formed the Social Security Commission last year and invited some of the smartest people in the country to look at these questions. They worked through the middle of November and have issued a report.

I think they point the way, in terms of saying we need to figure out a way that we can give people an opportunity to get a higher rate of return on their investment.

There is, conceptually, I think, a way out there that it is possible to not only meet the obligation of Social Security beneficiaries, but begin turning our attention to an idea that I think has a lot of merit, which is to, in the forward period, accomplish an objective in our society that every American is a wealth accumulator.

I would differentiate that from someone who works a long time and then has an expectation of getting a check from the government, indirectly from people who are currently working, to a notion that says we are rich enough as a society that we can begin to contemplate the possibility that every American, when they get to be 65, will own a very substantial block of money that is not held by the government, does not belong to the government, is really owned by individual Americans, every individual American, that they can use as they wish and pass on to their children.

As we work on this issue, it is useful to have a vision of what could be and not be stuck with the idea that we simply have to eat our spinach and accept the conclusion that I do not think is necessarily true, that this problem, as it has been characterized, that the future of Social Security beneficiaries rising is an insurmountable one.

But it will take lots of work and it will take lots of educational process. I think it will take great leadership by members of Congress to talk clearly with people in their individual States and help them understand what the choices are as we try to deal with these issues here in Washington.



Senator GRAHAM. Well, we will have another discussion at another time on how we should be looking at our National responsibilities for the financing of retirement.

My own feeling is, the United States, unlike a number of the countries which are frequently cited as models for reform, relies on a three-legged stool for retirement. Two of those legs are already significantly what I would call entrepreneurial.

They require a great deal of the individual retiree in their pre-retirement life, both with respect to their individual savings, and increasingly, as employer-based pensions shift to defined contribution models as opposed to defined benefit plans, with respect to their employment-based pensions.

I did not intend to bring this into this discussion, but it is apparently inevitable. As in the Enron case, there is a great deal of risk that the beneficiaries bear.

My feeling is that it is appropriate for there to be risk in the savings and the employer pension side, which today represents over half of the retirement income for most Americans. But Social Security should continue as a defined benefit. It should be the stable foundation under retirement planning. That is a debate that we will have at another time.

But I infer from your comments that it is your feeling that if we can make the sorts of changes that you suggested in Social Security, that we can generate enough additional income in the Social Security trust fund or individual accounts held by the Social Security beneficiaries to avoid the necessity of substantial additional public funds going into Social Security.

So, this whole debate is essentially irrelevant because we will not be looking to public finance to meet the needs of these 69 million Americans.

Secretary O'NEILL. Well, Senator, let me say this. You are, without a doubt, one of the most expert people in the country on this subject. Everyone knows that—

Senator GRAHAM. Do I have your permission to clip that last sentence and use it for the most personally aggrandizing means? [Laughter.]

Secretary O'NEILL. Please do. I think I am not exaggerating when I say everyone acknowledges your great expertise and understanding of these issues.

Let me answer your question in this way, to be careful. The system we have had since 1935, I think, is a wonderful creation and it has been a great credit to the United States that we have had this system in place.

It was designed as a system for the benefits to be paid by the current working population for people who were already retired. I think it served us very well when we had a relationship between workforce and the retired population that was, on the one hand, very large in terms of the number of people who were supporting very few people who were receiving benefits.

But, as you know, with the aging of our population and the maturation of the system, we have gotten to a point where we are going to have very few workers in relative terms providing current revenue to pay a swelling group of beneficiaries.

I suspect when Franklin Roosevelt and his associates were doing this back in 1935, they figured we in 2002 would figure out some way to deal with what was clearly a system that would not do well with this change in the demographics.

Yet, at the same time it seems clear to me that we are a very wealthy society now and that it is possible to have a different kind of a system that is built on the idea of wealth accumulation instead of income transfers between generations.

But then to the critical point. In order to go from one to the other, we are going to have to figure out a way, together, that we can pay for the transition cost from one system to another system.

At the moment, if one wanted to measure that you would say, in accounting terms, the unfunded liability that exists for our population going forward may be \$10 trillion, or something. It is not an insignificant amount of money.

One of the tasks of policy people here in Washington, and then of members of Congress like yourself, is to figure out how we accommodate this transition so that no one is hurt in the process and we move ourselves up to a different level of how our society works.

Senator GRAHAM. I agree with what you have just said.

I am going to ask one question, then make a closing comment. And, Mr. Secretary, we thank you for your generosity of time.

My question is, if you were to assume that we will try to meet these pending Social Security—and of course Medicare is the other Siamese twin of this—responsibilities at the current level of spending as a percentage of GDP, at the current level of taxation as a percentage of GDP, and without financing it through borrowing, what kind of an annual return over current rates in Social Security would you have to receive to be able to do that?

Secretary O'NEILL. It is a very big number, and I will get it for you. It is a knowable number and I will get you a number for the record. It is 50 percent or so. It is a very big number.

Senator GRAHAM. You mean, we have to have 50 percent a year return on the Social Security funds in order to be able to meet these obligations?

Secretary O'NEILL. As you know better than I do, right now the number, on a combined basis, is 12.7 for a traditional case.

Senator GRAHAM. No, no. I am not talking about increasing the tax. I am saying, if we are going to keep taxes at their current level, and we are going to keep spending by government, including Social Security benefits, at its current level in terms of percentage of GDP and not increase borrowing, then the only changeable variable is rate of return.

The theory of some is that we can inject enough growth into the Social Security accounts that they will grow fast enough, that the combination of that additional growth in the accounts, plus the amount which the government is currently able to commit to Social Security, will cover the benefits in future years.

I would like to know what it is going to take in terms of that increased growth inside the accounts to be able to accomplish that.

Secretary O'NEILL. All right. Good. We can do that for you.

Again, as you know, this is a very important point. Compound interest is very important. The sooner that you start dealing with

compound interest, the better off you are going to be because the numbers grow to meet the problem.

Senator GRAHAM. And that is the segue to my final comment.

One of the reasons that I, frankly, have concerns about a \$750 billion increase in the national debt limit is the fact that I think that takes the pressure off dealing with these issues.

Every month we delay in dealing with this, it is going to make the problem that much more difficult. I wish we had dealt with this 20 years ago. It would have been a relatively manageable problem.

I believe that if we have to periodically go back and take the castor oil, which raising the debt limit clearly is, then we are more likely to remain cognizant of the big picture. You do not like to write a letter as you did and we are not going to look forward to what we know will be our obligation to make some increase of the national debt.

But I do not want to make it too easy on us by having an increase that is so large that we will not be forced to give attention to these issues for another two or more years.

So, that is another part of being Scotch, is that you like to wear a shirt with some burs on it so that you will not get too comfortable.

Mr. Secretary, I thank you very much and look forward to continuing this discussion. I want to say, the President is very fortunate to be served by a man who is as thoughtful on these issues and articulate as yourself.

Secretary O'NEILL. Thank you very much, Mr. Chairman.

Senator GRAHAM. Thank you, sir.

The second panel, as previously indicated, will be Mr. Bruce Bartlett, Mr. Robert Bixby, and Mr. Gene Sperling. I thank each of you for your participation today. I would like to call on each of you in turn for your opening statement. I would appreciate if you could compress that to 5 minutes, then the full statement will be submitted for the record.

Mr. Bartlett?

**STATEMENT OF BRUCE BARTLETT, SENIOR FELLOW,  
NATIONAL CENTER FOR POLICY ANALYSIS, WASHINGTON, DC**

Mr. BARTLETT. Thank you, Mr. Chairman. Thank you for the opportunity to testify this morning on the question of raising the debt ceiling.

I would like to make three main points. First, the debt subject to limit is a declining portion of the Federal Government's total indebtedness. Second, the debt held by the public is a declining portion of the debt subject to limit. Third, there is no evidence that changes in any measure of debt have a significant impact on interest rates.

The national debt and the debt ceiling have been controversial since the founding of our Nation. It is well-known that the Founding Fathers, with the conspicuous exception of Alexander Hamilton, viewed the national debt with great alarm. To them, avoiding debt was not merely a matter of economics, but of morality.

Hamilton's great insight was that the debt could serve a positive role in developing U.S. capital markets. He reasoned that there was a lot of money sitting around under mattresses because there

were no investment opportunities that did not involve excessive risk.

Government bonds, Hamilton thought, could draw this idle wealth and liquidity into the economy by offering people a risk-free return on their saving. That is why Hamilton told Robert Morris that, "A national debt, if it is not excessive, will be to us a national blessing."

Hamilton was exactly correct. History shows that his assumption of State debts and creation of the first national debt was a milestone in the development of the U.S. capital market. New York quickly developed into a world-class financial center with a rapidity that is hard to imagine without a government bond market as its foundation.

The existence of a domestic capital market makes all the difference in the world as to whether public debts are dangerous or benign. The main reasons why, historically, national debts have gotten nations into trouble is because they had to borrow on foreign markets, which meant that gold or foreign exchange was needed to service the debt, or because they could not borrow the necessary funds domestically and debased their currencies to finance it, leading in some cases to hyperinflation.

Obviously, having a large domestic liquid market for Treasury bonds avoids both these problems. Thanks to Hamilton's genius, the U.S. has always been able to borrow all of the money needed to finance its debts, even during wartime, without resorting to foreign currency-denominated debt or the printing press.

Nevertheless, concerns about national indebtedness have remained a powerful force in American politics for more than 200 years. One way Congress tries to keep a lid on debt is by having a limit on how much the Treasury may borrow.

The debt limit which we are discussing today came about almost accidentally during World War I. Prior to that time, Congress individually authorized each specific bond issue. But with the second Liberty Bond Act of 1917, Congress chose instead to give the Treasury general borrowing authority subject to an overall limit established by law.

As this committee well knows, raising the debt limit is always politically contentious, time-consuming, and expensive to the Treasury. For these reasons, many economists have argued over the years that the debt limit should be scrapped. Congress has within itself any number of other means for controlling the government's debts. In any case, the debt limit has not proven to be an effective brake on Federal indebtedness.

I would argue that the case for elimination of the debt limit has been strengthened by the vast growth of off-budget government borrowing. Quasi-Federal agencies such as Fannie Mae now have debts that almost equal the national debt. There are other forms of government indebtedness as well that are not covered by the debt limit, and therefore tend to escape scrutiny.

This brings us to the politically sensitive question of surpluses associated with the Social Security trust fund. As this committee well knows, the debt limit applies to the gross Federal debt, which includes the debt held by the public plus the debt held in trust for Social Security and other purposes.

Thus, even if the Federal Government was still running a surplus, it would be necessary to raise the public debt limit from time to time to accommodate the need to place more Treasury bonds into various trust funds.

Now, there are many people in Congress on both sides of the aisle who sincerely believe that these trust fund assets are real and have a meaningful impact on the Federal Government's ability to pay promised benefits.

Hence, the question of whether Social Security surpluses are being used, or even stolen, some say, to pay non-Social Security-related bills is one of great political importance.

It seems to me that the use of trust fund assets is of no more importance than the use to which a bank makes of funds one deposits in a savings account or certificate of deposit.

Therefore, to claim that excess revenues from the Social Security system are being misused when they are, in effect, being used by the Treasury to reduce borrowing from the public simply misses the point.

No Social Security recipient's current or future benefits are affected in any way. Benefits will not be larger or more secure if the Social Security trustees invested excess revenues and financial assets other than U.S. Treasury securities.

The truth is, the Social Security trust fund is really nothing more than an earmarking or accounting device. It is more akin to budget authority than a true trust fund.

It simply gives the Federal Government legal permission to use general revenues to pay Social Security benefits when Social Security revenues are insufficient to pay current benefits. That day will come in about 10 years.

Therefore, I have great difficulty in worrying about whether excess Social Security revenues are temporarily used to finance other government expenditures. All that matters economically is how much the Federal Government either draws out of private financial markets when it must borrow to finance deficits, or how much it adds to private financial markets when it runs a surplus. The government's internal accounting as to whether such surpluses or deficits are on-budget or off-budget is economically irrelevant.

I will stop there.

Senator GRAHAM. Thank you, Mr. Bartlett.

[The prepared statement of Mr. Bartlett appears in the appendix.]

Senator GRAHAM. Mr. Bixby?

**STATEMENT OF BOB BIXBY, EXECUTIVE DIRECTOR, THE  
CONCORD COALITION, WASHINGTON, DC**

Mr. BIXBY. Thank you very much, Mr. Chairman.

Mr. Chairman, I am here representing the Concord Coalition, which is a bipartisan organization dedicated to fiscal responsibility. Your former colleagues, Warren Rudman and Bob Kerrey serve as our co-chairs.

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 of 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 extensions such as the one proposed by the administration should be approved until Congress and the President agree on a new fiscal policy. We would prefer a plan to balance the budget, excluding Social Security within a reasonable time, using prudent economic and fiscal assumptions.

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. The numbers demonstrate a startling turn-around.

Last year, we were debating whether or not we were going to pay off the national debt too fast, and this year we are debating how fast we need to raise the debt limit.

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 a little over \$1 trillion over 10 years, and the payment in 2011 would be just \$20 billion.

This year's budget projects net interest payments of \$1.79 trillion over the same 10-year time frame, with the 2011 payment at \$159 billion, meaning that it would not fall by very much over the coming decade.

While the Concord Coalition is as strong an advocate of balanced budgets and debt reduction as there is, we recognize that there are times when a deficit is an appropriate response to pressing national needs. This well may be true in the short term, but the temporary need for deficit spending should not be taken as an excuse to abandon fiscal discipline, which is still needed.

Turning to the administration's request, under current projections both OMB and CBO project that the level of gross Federal debt will exceed the debt limit as soon as next month, as the Treasury Secretary just said. Defaulting on the 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 the year 2004.

Under the CBO baseline, which does not account for the President's policies, the new debt limit would be hit sometime in fiscal 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, and that is all that really needs to be done at this time.

Raising the debt limit by too much would only tempt more election-year spending or tax cuts than would be prudent in the absence of some larger agreement to control fiscal policy.

The statutory debt limit is the only mechanism left to provide a sense of fiscal discipline. 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 the pay-as-you-go requirements expire this year.

The need to pry open the so-called Social Security lock box, 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 fear of causing a so-called raid on the trust funds.

As a result, open-ended budgeting may be back. Rather than setting priorities, making hard choices, it will be very tempting to fall back on old habits like cutting taxes, increasing spending, eating up the Social Security surplus and running up the debt.

It is a dangerous path to follow when, looming just beyond the 10-year budget window is the huge unfunded retirement and health care costs of the coming baby boom generation.

The problem is not that we may have to run a short-term deficit in response to both recession and military conflict. The problem is that politicians may once again get comfortable with the idea of spending the Social Security surplus or running deficits larger than we need, which simply amounts to paying for the government services we demand by sending the bill to our kids.

Today's major budgetary decisions, including the debt limit decision, should 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 unfunded retirement and health care costs associated with the coming senior boom. The challenges of an aging society include fiscal pressures that cannot be remedied simply by assuming that renewed economic growth will follow a period of brief deficits.

I will end there.

Senator GRAHAM. Thank you, Mr. Bixby.

[The prepared statement of Mr. Bixby appears in the appendix.]

Senator GRAHAM. Mr. Sperling?

**STATEMENT OF GENE SPERLING, VISITING FELLOW,  
BROOKINGS INSTITUTION, WASHINGTON, DC**

Mr. SPERLING. Thank you, Mr. Chairman, for inviting me to testify today.

In my testimony I am going to focus on what was your first chart, which is the debt held by the public or the external debt, because I feel that the gross debt, in some ways, does not accurately measure what the drain is.

On the other hand, it is too small to reflect what our true contingent liabilities are for the future, which, as Secretary O'Neill said, can be as high as \$10 trillion for Social Security alone.

Over the past 20 years, we have had two dramatic swings in the path of the external debt. From 1970 to 1981, the percentage of

debt as a percentage of GDP stayed within a fairly narrow band, between 24 and 29 percent.

The first major swing we had was in the 1980's, in which debt as a percentage of GDP rose from 25.8 percent to 48.2 percent. What was more disturbing than the virtual doubling of the debt as a percentage of GDP was the projection for the remainder of the decade.

In 1993, the Congressional Budget Office projected that the debt as a percentage of GDP for the year we are dealing with, fiscal year 2003, would be 77.6 percent. That was the projection of the debt as a level of GDP in 1993.

Fortunately, the second major swing was a positive one in which, because of the 1993 Deficit Reduction Act, the various bipartisan agreements to focus on a balanced budget, our strong economy, and the decision to save surpluses for Social Security, we saw our country by the year 2000 see the debt as a percent of GDP fall to 35 percent of GDP, and with an expectation that America could be debt-free within a decade.

As you will recall, we actually last year faced the debate of whether or not we were going to pay down the debt too fast, something that seems like an extremely good problem to have 1 year later.

As you mentioned, the situation a year later shows a third swing, which is going from a path of making America debt-free to a path that I see has very little prospects at the moment for debt reduction over the next decade. Even under the administration's own projections, the external debt falls from only \$3.5 trillion to \$3 trillion by 2010.

If one includes more realistic budget accounting, I believe for Medicare, non-defense discretionary spending, and fixing the Alternative Minimum Tax, it is not clear that the external debt that we once feared we would pay off too quickly will even fall at all by the end of 2010.

Now, why does it matter? Some have suggested that deficits and debt do not affect long-term interest rates. Yet, that defies basic laws of supply-and-demand, as well as recent experience in the United States.

It follows that, in the basic law of supply and demand, that where there is a greater supply of capital to meet a given demand, the price of capital in terms of interest rates will be lower.

In the United States, we have seen that the main contribution to net national savings has been the improvement in our Federal fiscal position. If you look over between 1993 and 2000, we saw that our net national savings grew from 3.5 percent to 6 percent. The entire reason that net national savings grew in our country, Mr. Chairman, was because of the improvement in our fiscal situation. Private savings actually declined significantly. But, on the Federal side, we went from a 4.7 percent of GDP deficits to a 2.2 percent surplus, a 6.9 percent swing.

Now, what does that translate into? In the year 2000, that would translate into a \$680 billion swing. Nobody could suggest that the Federal Government, going from being a borrower to actually crowding in or contributing to national savings by a tune of \$680



billion in a single year, would not have a positive effect on long-term interest rates.

As one of my colleagues, Peter Orzag, has written, if one looks at the Federal Reserve, CBO, OMB, statements by the Under Secretary of Treasury John Taylor and Marty Feldstein in their academic positions, the fact is that the overwhelming amount of people who have been in major policy positions all agree that long-term deficits and debt do have a significant effect on long-term interest rates.

I will just quickly mention the last point, sir. What matters most is the generational responsibility. Are we, as Mr. Bixby said, saving more now to meet the problems of the future generation?

There we have to look at whether we are saving by lowering our external debt to help meet that burden, and that really should be the fundamental economic issue that we deal with and that most meets the name of this subcommittee, which is debt reduction and long-term growth.

Thank you.

[The prepared statement of Mr. Sperling appears in the appendix.]

Senator GRAHAM. Thank you very much, gentlemen. I would like to ask a series of questions to all three of you. I would just ask for responses in the order that you spoke initially.

The first is would you recommend approval of the administration's request for a \$750 billion debt increase? If not, what would be your recommendation and what would be the rationale upon which your recommendation is predicated?

Mr. Bartlett?

Mr. BARTLETT. My view is that the debt limit does not serve a very useful purpose. I think it would be a better idea simply to dispense with it. Having said that, I think it is desirable to have as few situations in which the Treasury bumps up against the debt limit as possible, because it creates some concerns in capital markets and is very costly to the Treasury. So I think that more, rather than less, is better, economically speaking.

Senator GRAHAM. So you would recommend approval of the administration's request?

Mr. BARTLETT. Yes.

Senator GRAHAM. Mr. Bixby?

Mr. BIXBY. I would modify it before approving it. I think \$750 billion is perhaps a bit large. If you will look at the President's budget, it would require \$150 billion or so to get through fiscal year 2002, and raising it by about \$500-some billion to get through fiscal year 2003.

I would prefer a short-term extension, enough to get through fiscal year 2002. The reason why, is that there is no clear, agreed-upon fiscal policy goal right now. The one thing that the debt limit does do, is it forces a reconsideration at some point of what past policies have led to.

So while it is not in and of itself an effective firewall—there are very few effective firewalls that you can come across—it is a precipitating event. You have to do something about it.

So, extending the limit by too much in an era where we no longer have an agreed-upon fiscal policy goal and where we do not know

how long deficits may extend for, I think would be taking a risk. So, I think we should all be Scotch and follow the advice of keeping a lid on the debt limit.

Senator GRAHAM. So would your recommendation be approximately \$150 billion, and the rationale is that is what is required to get through this current fiscal year?

Mr. BIXBY. Somewhere around there, \$150 billion to \$200 billion. You do not want to have it so tight that you have to revisit the issue every couple of months and you are causing a debt crisis. I would like to time it so we would have to be having this discussion again next year at this time.

Senator GRAHAM. Mr. Sperling?

Mr. SPERLING. Mr. Chairman, I guess I come to this question with somewhat mixed views.

First of all, I believe that it would serve our country and our National discussion better if the discussion focused on external debt or debt held by the public, because I think that would more communicate to people what is the degree of debt we are using.

Secretary O'Neill could not answer your question on how gross debt would affect how what the expenditures are, because it is mixed in too much with the Social Security and Medicare trust funds.

If the debt limit focused on external debt or debt held by the public, then one could have a much more clear discussion on how much we are borrowing and why.

There would be a greater way to communicate to the public that a very large reason why the external debt does not come down is due to the specific policies of the administration, most specifically the tax cut that was passed last year and the additional \$600 billion to \$800 billion of tax cuts that they are calling for right now.

So, again, I would have somewhat of a different focus. I guess that I do not have an opinion on whether it should be exactly \$750 billion. I agree with Mr. Bixby that you do not want to have it so short that it creates any doubt in financial markets that this is the safest form of bond in the world. So, I guess I am dealing in a second-best world where this would not be the limit I would have.

In light of that, I think it is important to use this process to educate the American public on what has happened to our debt situation in the last year and how undesirous that is for our National savings rate and for saving to meet the generational baby boom crisis that we do face.

So, I think, one, it would be wise to use this as a way of bringing up issues related to why the external debt has gone up, whether we should be restoring things like pay-as-you-go or other budget principles that I think have served us well.

So I think this should be used as a discussion and I think it may be helpful in the current context to have that discussion every year and a half or couple of years or so.

But having been through the experience that we did in 1995 in the Clinton administration, I also have to say that I do not believe those discussions should ever get to the point where someone is taking actions that would threaten potential default, or even create that impression in the world markets.

Mr. BARTLETT. Could I just say something?

Senator GRAHAM. Yes, Mr. Bartlett.

Mr. BARTLETT. I think Mr. Sperling is exactly correct about the focus being on debt held by the public. That is what really matters. How much is the Treasury taking out of capital markets? How much is it putting in in its fiscal policy?

But I would just add a footnote, which is often forgotten. The Federal Reserve is treated budgetarily as part of the public. So about \$600 billion of the debt held by the public is effectively not actually held by the public. It is held by the Federal Reserve, which is part of the government. When it buys Treasury bonds, for all intents and purposes, they are extinguished. They serve no purpose after that.

As you know, the Federal Reserve gets interest on that debt, then turns around and gives it back to the Treasury at the end of the year. So, it is kind of just a circular process that may or may not serve any useful purpose.

Mr. SPERLING. Mr. Chairman, if I could add a footnote, too. I actually think, as I mentioned in my written testimony, that the gross debt is both too small and too large. It is too large in that, at \$5 trillion, \$6 trillion, it is larger than we are actually borrowing from the public, which is \$3.5 trillion. So in that sense, I think that is important to focus on.

On the other hand, it is too small, because what you really want to do is educate the public on what our contingent liability is for Medicare and Social Security. So, in that sense, gross debt is far too small.

Perhaps we would educate the public more by saying, how much are we borrowing now? Are we crowding out from private sector and having an effect on interest rates on one hand, but then have a larger number which is letting people know before they decide to consume as opposed to save now, that we face a \$10 trillion-plus contingent liability for the Social Security and Medicare benefits that people hold dear?

Mr. BIXBY. I would add my footnote to this. I agree with what Mr. Sperling said about the gross debt being both too small and too large in that sense. It would be good to educate the public about the differences between the debt.

We have a grassroots organization. I used to be field director of the Concord Coalition. I can tell you, people get very confused when everybody is talking about the debt going down, which it did, the publicly-held debt, but the gross debt continues to go up. Somebody thinks that there is a scam going on. So, it is important to maybe use this process to distinguish between the two types of debt.

I would not make any changes in the way we do the debt limit right now precipitously. Until the public is educated about these things, you may not want to move too quickly.

Senator GRAHAM. I think you make a persuasive case. Each one of you have recommended some changes in the way in which we report in order to accomplish desirable objectives.

My concern at this point in time, is there is value in consistency of reporting so that people do not feel as if we are changing and we are now going to allow a field goal to count for five points in-

stead of three points, and change the character of the game while the game is at a particularly critical point.

But I will look forward to receiving published articles from each of you from your various academic and intellectually-based institutions on what we should do when we get to that time of tranquility so we can look at changing the rules of the game.

A second question. Mr. Sperling, you almost got off not being quantifiable. I am going to put you down, unless you tell me to the contrary, for a number at the top end of what Mr. Bixby had said, which was \$150 billion to \$200 billion. I am going to put you down for \$200 billion, unless you want to enter a different one.

Mr. SPERLING. Mr. Chairman, I think that my view on how great it should be would probably be related to what else the administration was doing.

If they were, I think, willing to show other efforts to show that they were being focused on the debt and willing to consider continuing some of the budget rules, I would feel much more comfortable with moving towards their numbers.

If they do not, then I think it justifies doing something that is less than that as a way of continuing to be able to bring up the issue of whether we are doing enough to bring down the debt.

Senator GRAHAM. This is really the fourth question, but I am going to ask it now in case we should be squeezed for time. I am very focused on the implications of this chart.

What would be your recommendation as to what the administration and Congress should be doing together to best prepare the Nation for this demographic mountain that we are going to be climbing in the next 20 years?

Mr. BARTLETT. I think the most important thing we should be trying to do, is making it easier for people to save for their own retirement. It appears that nothing is likely to happen in the near-term on reforming the Social Security system itself. But as you pointed out, there is this three-legged stool. The other parts of the stool are very much affected by Federal income tax and other tax policies.

I would like to see more generous contribution limits for Individual Retirement Accounts, 401(k)s, anything along those lines that would help people save for their own retirement so that they are not as totally dependent upon Social Security as people are.

I think one of the problems with the three-legged stool idea is that for many people there is only one leg. We really need to help build up those other two legs.

Senator GRAHAM. Well, I would agree with that. But your comments suggest that this is a contractual obligation that the U.S. Government has with 46,352,000 of our citizens, and soon to be 69,316,000 of our citizens. What should we be doing to prepared for this contractual obligation? You are not suggesting that we abandon this.

Mr. BARTLETT. No, no. I am assuming we will meet all of our contractual obligations. I would hate for us to do what the easy thing is, which would be simply to raise the Social Security payroll tax rate.

As you know, the way the Social Security trustees calculate it is as a percent of payroll. I think—correct me if I am wrong, Gene—

about a 2 percentage point increase would be enough to pretty much keep the system in balance for the 75-year projection period.

But the Social Security tax is a very regressive, burdensome tax. I would hate to see us raise that. I think we need to find other methods. That is what I had hoped would come out of the Social Security Commission's deliberations. But it just appears that the idea of moving toward some kind of private system is just too controversial. Therefore, we have to think of something else.

Senator GRAHAM. Mr. Bixby, what would be your suggestions of what we should be doing today to get ready to meet this contractual obligation?

Mr. BIXBY. Well, I think that is the big question. I mean, that is the challenge of our age, really. No pun intended. It is the challenge of these times and why issues of the national debt are so important, more important than they might be otherwise, because we have been presented with a bunch of new challenges this year.

But they come on top of these old challenges that we already have, which is represented by that chart, the baby boomers' retirement and what it will cost to fund them.

Our organization has been preaching for years that there are two things that the country really needs to be doing. One, is increasing net national savings in response to this coming burden.

Second, is looking at Social Security and Medicare programmatic reform with an eye towards controlling the long-term growth. That is the controversial part because nobody really wants to do that.

Frankly, in Medicare it is going to be awfully difficult because there you have got a program that is both underfunded in its current form, and lacking in a major element, which is a prescription drug benefit. Adding that will make the program even much more costly, which means Social Security reform, I think, is all the more important.

So we would do two things. One, increase the national savings, which is where debt reduction comes in and why debt reduction is so important, unusually important, at this particular time in our Nation's history. This is why I think we should try, after this initial period of responding to the emergencies of last year, to get back to a level where we are being able to pay down the debt again.

Second, we really have to reengage on the Social Security reform issue. I know administrations have made attempts. I know our organization worked with the Clinton White House. Gene Sperling and I worked on that. Nothing came out of it in terms of a particular reform plan. Debt reduction is a good first step, but it will not be complete until we have some programmatic reform as well.

Senator GRAHAM. Mr. Sperling?

Mr. SPERLING. Mr. Chairman, if I flunked the test for being non-specific on the exact amount of debt limit, I will now pass on being very specific on what I think we ought to do.

First of all, people from the administration often talk about how we might possibly find money for transition to a more pre-saved Social Security system as opposed to the purely pay-as-you-go plan, as if that was mysterious as to where one might find those resources. We very much had a path in which we had a substantial

possibility of having such resources and a very specific choice was made.

It was a choice to use those resources for a consumption-oriented, a very large consumption-oriented tax cut, as opposed to using those for savings to deal with the generational crisis.

Now, let me be very specific. When you asked before, what does one have to raise in terms of dealing with Social Security, as Mr. Bartlett said, if you look at it as a percentage of payroll, it is 1.86 percent. That does not mean one should raise taxes by that, that is just one measure for how much one would have to raise in an ongoing way to make Social Security solvent.

Another way to look at it, is that we would have to come up with another 0.7 of GDP dedicated to Social Security on an ongoing basis. The tax cut that was just passed will end up taking 1.6 percent of GDP.

In other words, we had enough resources, however you want to do a plan, as the administration wanted to do or as some Democrats might want to do, there were enough resources.

If we had just been willing to commit half, half of what we committed to the tax cut that was just passed, we had the resources to deal with Social Security solvency. I believe that Social Security reform was set back terribly by the passage of that.

Now, what I will do, is I will give a specific proposal. If we were to protect all marginal rate tax cuts for 98 percent of Americans, but simply freeze the tax cut in 2004 and 2006 at just the top two brackets, not do the PEP and PEAS, which just affects high-income taxpayers, and take the estate taxes——

Senator GRAHAM. For the record, would you de-mystify PEP and Pease?

Mr. SPERLING. Yes. That actually may be difficult for me to do without notes. They did not give the full personal exemptions that high-income taxpayers, taxpayers making below \$150,000, received. In addition, rather than repeal the estate tax, I would let it increase the unified exemption to \$4 million per couple. Now, taking those small steps and then dedicating that money to a Social Security reserve would be enough to close 50 percent of the 75-year solvency gap.

So, in other words, I believe one could protect 98 percent of the marginal rate tax cut for all Americans, still give the top 2 percent a sizeable tax cut, though not as large, still increase the estate tax exemption but not repeal it, and just with those modest steps we could close 50 percent of the Social Security gap.

Or we could use that money to do something that I believe in, which is to have individual accounts on top of Social Security, as President Clinton proposed in USA accounts, where we could ensure that all Americans are being savers and wealth accumulators. Either of those things would be modifying a consumption-oriented tax cut to saving to meet the baby boom entitlement.

That modest proposal I put forward would be the equivalent of closing half of our Social Security gap. We still would have to do some of the tough things that Mr. Bixby was referring to, but it is quite stunning, I think, how much a modest modification of that tax cut could have such a large effect on closing the Social Security solvency gap.

Mr. BIXBY. Could I add a footnote on something I should have mentioned?

When we look at debt, a lot of that debt is the debt held by government accounts, a lot of it is Social Security. That debt is like a balloon payment. It will begin to come due around 2016 when the cash flow turns negative for Social Security.

One reason it is so important to keep a lid on fiscal discipline now, is that the government is going to have to be in a good, strong position in 2016 and thereabouts to start redeeming those bonds, which it will have to do in cash.

So, we do not want to work ourselves into a situation now where we are already in a big deficit hole and then we have to start redeeming the bonds in the Social Security and Medicare trust fund. I just wanted to make that point about the two debts and the relationship.

Senator GRAHAM. Yes. I used the analogy of the family with a teenaged child within a few years of college. Let us say you have a family income of \$50,000 and you are spending \$50,000, and you have got \$5,000 of credit card debt.

You had better start, one, paying that debt off, and two, getting some space between your current expenditures and your revenue so that you can absorb the cost that is coming when that child reaches college age.

Well, that is sort of, in my judgment, a rough equivalent of what we are facing as a Nation, getting ready not to send our 18-year-old to college, but to send our 65-year-old to Social Security retirement.

Gentlemen, I want to thank you very much for your very thoughtful comments and contributions. If there are further questions that emerge from my colleagues or in our review of the record, I would like to hold open the possibility that we could ask for some further analysis of the positions that you have presented here today.

But on behalf of the committee, I might close with my own editorial. In this business of life, almost every choice which is circumscribed and individual is positive. We would all like to take long vacations. Many of us would like to work fewer hours. Many of us would like to enjoy the benefits of a higher lifestyle.

But in the reality of the world, those all become trade-offs. How hard you are willing to work affects, for most people, what kind of a lifestyle you can sustain.

Applying those principles to the Federal Government, it seems to me we have been making a series of discrete decisions, all of which are easy to say, yes, we should do that. This debt limit forces us to look at decisions in a relative context where there are real consequences and trade-offs required. You cannot have spending levels, you cannot have erosion of your tax base and not avoid an accumulation of further national debt.

So, I believe that we should not be able to avoid the consequences of the interrelationship of these decisions by putting the debt limit in such large numbers that we can essentially forget it for a long cycle of Congress. Maybe by the time we get back to it, all the people who thought about it the last time have gone.

So, I tend to favor, not primarily for economic reasons but for political discipline reasons, that we have a debt limit that does not endanger our National financial standing in the world's capital markets, but also keeps a sufficient leash that we are constantly reminded there are real consequences of this decision to take on another \$750 trillion of national debt.

Thank you very much. The hearing is adjourned.

[Whereupon, at 11:50 a.m. the hearing was concluded.]



## APPENDIX

### ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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#### PREPARED STATEMENT OF BRUCE R. BARTLETT

Mr. Chairman, thank you for the opportunity to testify this morning on the question of raising the debt ceiling. I would like to make three main points. First, the debt subject to limit is a declining portion of the Federal Government's total indebtedness. Second, the debt held by the public is a declining portion of the debt subject to limit. And third, there is no evidence that changes in any measure of debt have a significant impact on interest rates.

The national debt and the debt ceiling have been controversial since the beginning of our Nation. It is well known that the Founding Fathers, with the conspicuous exception of Alexander Hamilton, viewed the national debt with great alarm. To them, avoiding debt was not merely a matter of economics, but of morality.<sup>1</sup>

Leaving aside the moral question, there were two good arguments against borrowing in the early years. First, most of the Federal Government's revenue in those days was raised by regressive taxes such as tariffs. Since, then as now, most bonds are owned by wealthy people, the national debt involved a redistribution of income from the poor to the rich.

Second, the U.S. capital market was small and weak in those days. This meant that it was very hard for the government to borrow only from domestic sources. Most borrowing of significant size had to be done on international markets in London and Paris. Hence, there was a legitimate concern about Federal borrowing leading to foreign indebtedness, which could lead to foreign intervention in U.S. affairs.

Hamilton's great insight, however, was that the debt could serve a positive role in developing U.S. capital markets. He reasoned that there was a lot of money sitting under mattresses because there were no investment opportunities that didn't involve excessive risk. Government bonds, Hamilton thought, could draw this idle wealth and liquidity into the economy by offering people a risk-free return on their saving. That is why Hamilton told Robert Morris that "a national debt, if it is not excessive, will be to us a national blessing."<sup>2</sup>

Hamilton was exactly correct. History shows that his assumption of state debts and creation of the first national debt was a milestone in the development of the U.S. capital market. New York quickly developed into a world class financial center, with a rapidity that is hard to imagine without a government bond market as its foundation.<sup>3</sup>

The existence of a domestic capital market makes all the difference in the world as to whether public debts are dangerous or benign. The main reason why, historically, national debts have gotten nations into trouble is because they had to borrow on foreign markets, which meant that gold or foreign exchange was needed to service the debt, or because they could not borrow the necessary funds domestically and debased their currencies to finance it, leading in some cases to hyperinflation.

Obviously, having a large, domestic, liquid market for Treasury bonds avoids both of these problems. Thanks to Hamilton's genius, the U.S. has always been able to borrow all the money needed to finance its debts, even during wartime, without re-

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<sup>1</sup> See Lewis H. Kimmel, *Federal Budget and Fiscal Policy, 1789-1958* (Washington: Brookings Institution, 1959), pp. 7-25.

<sup>2</sup> Hamilton spelled out his views on this matter at great length in his First Report on the Public Credit in 1790, and his Second Report on the Public Credit in 1795.

<sup>3</sup> See John Steele Gordon, *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt* (New York: Walker & Co., 1997); Edwin J. Perkins, *American Public Finance and Financial Services, 1700-1815* (Columbus: Ohio State University Press, 1994); Forrest McDonald, *Alexander Hamilton: A Biography* (New York: W.W. Norton, 1979).

sorting to foreign currency-denominated debt or the printing press. For this reason, it has often been said that we really owe the debt to ourselves.<sup>4</sup> As Franklin D. Roosevelt put it:

“Our national debt after all is an internal debt owed not only by the Nation but to the Nation. If our children have to pay interest on it they will pay that interest to themselves. A reasonable internal debt will not impoverish our children or put the Nation into bankruptcy.”<sup>5</sup>

Nevertheless, concerns about national indebtedness have remained a powerful force in American politics for more than 200 years. Andrew Jackson was so concerned about the debt that he paid it off and abolished the Bank of the United States in order to make it harder for the Federal Government to borrow in the future. Even now, there are many Members of Congress who have vowed never to vote for an increase in the national debt.

One way Congress tries to keep a lid on debt is by having a limit on how much the Treasury may borrow. The debt limit, which we are discussing today, came about almost accidentally during World War I. Prior to that time, Congress individually authorized each specific bond issue. But with the Second Liberty Bond Act of 1917, Congress chose instead to give the Treasury general borrowing authority, subject to a limit established by law.<sup>6</sup>

Within the limit, the Treasury can use whatever methods it chooses to borrow funds from the public. In recent years, it has moved away from long-term borrowing and even eliminated the 30-year bond, in favor of shorter-term securities. It has also established indexed bonds whose principal rises with inflation. The latter is an excellent example of what Alexander Hamilton did. By leading the way with an innovative security, the Treasury has helped create a private market for indexed bonds that are very valuable to policymakers and long-term investors.<sup>7</sup>

As this Committee well knows, raising the debt limit is always politically contentious, time-consuming and expensive to the Treasury. When the debt limit is not raised in a timely fashion, it must take actions to assure that the government's bills are paid that are costly in both monetary and political terms. Even if it creates the tiniest hint of doubt in bondholders' minds that they may not get their interest payments exactly when due, it can add a risk premium to Treasury bond issues that will require higher interest rates than necessary. It can also force changes in the timing of government spending that will increase the cost of government purchases and contracting. In the past, these efforts have been large enough to negatively affect the economy as a whole.

For these reasons, many economists have argued over the years that the debt limit should be scrapped. Congress has within itself any number of other means for controlling the government's debts. In any case, the debt limit has not proven to be an effective brake on Federal indebtedness.

I would argue that the case for elimination of the debt limit has been strengthened by the vast growth of off-budget government borrowing. Quasi-Federal agencies such as Fannie Mae now have debts that almost equal the national debt.<sup>8</sup> At the end of fiscal 2001, debt held by the public equaled \$3.3 trillion. The combined debt of all government-sponsored enterprises was \$3.1 trillion.<sup>9</sup> These agencies are, of course, free to borrow whatever funds they need without limit. Indeed, there is strong evidence that they have increased their borrowing in recent years in order to meet the demand for government securities no longer being supplied by the Treasury, owing to budget surpluses.<sup>10</sup>

There are other forms of government indebtedness as well that are not covered by the debt limit and therefore tend to escape Congressional scrutiny. They are de-

<sup>4</sup>It should be noted that foreign ownership of the publicly held debt has risen to 35 percent, about twice its 1991 percentage. However, most of the increase resulted from purchases of Treasury bonds by foreign central banks, which use them as backing for their currencies, rather than foreign individuals. In any case, all of such bonds are denominated in dollars, eliminating the principal concern over foreign borrowing.

<sup>5</sup>Address to the American Retail Federation, May 22, 1939.

<sup>6</sup>Marshall A. Robinson, *The National Debt Ceiling: An Experiment in Fiscal Policy* (Washington: Brookings Institution, 1959).

<sup>7</sup>Theo Francis, “Treasury Inflation-Protected Securities Shine,” *Wall Street Journal* (May 25, 2001). TIPS, as they are called, give the Federal Reserve valuable information about market expectations of inflation.

<sup>8</sup>Actually, they exceed it because debt held by the public includes that held by the Federal Reserve. At the end of October, the Fed owned \$544 billion of Treasury securities. If one subtracts this amount from the debt held by the public, GSE debt is significantly greater.

<sup>9</sup>*Budget of the United States Government, Fiscal Year 2003: Analytical Perspectives* (Washington: U.S. Government Printing Office, 2002), p. 203.

<sup>10</sup>Gregory Zuckerman and Patricia Barta, “Fannie Mae Sells \$11.5 Billion in Bonds, Fueling Its Efforts to Become Benchmark,” *Wall Street Journal* (August 2, 2000).

tailed in the *Financial Report of the U.S. Government*, issued annually by Treasury's Financial Management Service. The most recent is for fiscal year 2000.

According to the *Financial Report*, at the end of fiscal year 2000, the Federal Government owed \$2.8 trillion in future pension and health benefits for veterans and Federal employees. However, this figure pales in comparison to the unfunded liabilities of the Social Security and Medicare systems. The Federal Government owes \$3.7 trillion just to current retirees for Social Security and another \$2.4 trillion for Medicare.

Taking into account future retirees and putting all the Social Security system's debts into present value terms, there is an unfunded liability of \$3.8 trillion for Social Security, \$2.7 trillion for Medicare Part A and another \$6.5 trillion for Medicare Part B. In other words, the Federal Government would need to have \$13 trillion in the bank today, earning interest, to pay all of the Social Security commitments that have been made, over and above future revenues under current law.

This brings us to the politically sensitive question of surpluses associated with the Social Security Trust Fund. As this Committee well knows, the debt limit applies to the gross Federal debt, which includes the debt held by the public plus the debt held in trust for Social Security and other purposes. Thus, even if the Federal Government were still running a surplus, it would be necessary to raise the public debt limit from time to time to accommodate the need to place more Treasury bonds into various trust funds.

According to the Congressional Budget Office, the assets in the Social Security Trust Fund alone will rise by \$163 billion in the current fiscal year and \$179 billion next year. So even if the Federal budget were balanced, the debt limit would have to rise to accommodate this increase. Including other trust funds, such as that for highways and airports, gross debt would rise by \$223 billion this year and \$236 billion next year even if the budget was balanced.<sup>11</sup> The on-budget surplus would have to be at least this great in order to avoid the necessity of raising the debt limit. The growth of trust fund assets is so great that by 2005 they will exceed the debt held by the public; that is, more of the gross Federal debt will be held internally than externally.

Now, there are many people in Congress, on both sides of the aisle, who sincerely believe that these trust fund assets are real and have a meaningful impact on the Federal Government's ability to pay promised benefits. Hence, the question of whether Social Security surpluses are being used—or even stolen, some say—to pay non-Social Security-related bills is one of great political importance.

It seems to me that the use of trust fund assets is of no more importance than the use to which a bank makes of funds one deposits in a savings account or certificate of deposit. We don't expect the bank to take our greenbacks and leave them lying around in a bank vault gathering dust. If they did that, where would they get the income with which to pay us interest? We don't claim that the bank is stealing our money for some nefarious purpose when it loans our savings to a local businessman to expand his business. That is simply how banking works.

Therefore, to claim that excess revenues from the Social Security system—those over and above what are needed to pay current benefits—are being misused, when they are, in effect, used by the Treasury to reduce borrowing from the public, simply misses the point. No Social Security recipient's current or future benefits are affected in any way. Benefits will not be larger or more secure if the Social Security trustees invested excess revenues in financial assets other than U.S. Treasury securities.

The truth is that the Social Security trust fund is really nothing more than an earmarking or accounting device. It is more akin to budget authority than a true trust fund. It simply gives the Federal Government legal permission to use general revenues to pay Social Security benefits once current Social Security revenues are insufficient to pay current Social Security benefits. That day will come in about 10 years.

It really makes little difference, substantively, whether there is \$1.3 trillion in "assets" in the Social Security trust fund or \$13 trillion. It wouldn't change the basic problem, which is whether or not there are sufficient revenues from the Social Security tax to pay Social Security benefits. Indeed, the late Herb Stein once suggested, only half in jest, that the Treasury should just create out of thin air \$10 trillion in new securities and deposit them in the Social Security trust fund. Since no additional borrowing from the public would take place and since no additional debt would be incurred, it would have no economic effect whatsoever. The Treasury

<sup>11</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003–2012* (Washington: U.S. Government Printing Office, 2002), p. 14.

would simply be converting an implicit debt into an explicit one.<sup>12</sup> The net effect would only be to extend the date by which general revenues could legally be used to pay Social Security benefits.

Therefore, I have great difficulty in worrying about whether excess Social Security revenues are temporarily used to finance other government expenditures, in some sense. All that matters, economically, is how much the Federal Government either draws out of private financial markets when it must borrow to finance deficits, or how much it adds to private financial markets when it runs a surplus. The government's internal accounting, as to whether such surpluses or deficits are on-budget or off-budget, is economically irrelevant.

Furthermore, the whole question of whether the Federal Government runs surpluses or deficits—at least of the magnitude that we have seen since World War II—is far less important to financial markets than is commonly imagined. According to the Federal Reserve's Flow of Funds Accounts, there was almost \$19 trillion in debt outstanding last year—household, business and government. The net addition to this total by the Federal Government would have to be much larger than has been seen in the last 50 years or is contemplated in the future to have any meaningful impact—more than a few basis points—on the level of market interest rates.

I realize that it is an article of faith among many Members of Congress from both parties that deficits raise interest rates significantly, thereby slowing growth, and that surpluses lower interest rates, thus raising growth. However, there is almost no scientific evidence to support this view. Of course, one can always find anecdotal evidence to support any point of view, and for brief periods it may well appear that Federal financing is having an impact on interest rates one way or another. But academic economists, with no ax to grind and writing in peer-reviewed journals, have failed to find a consistent relationship.<sup>13</sup>

In conclusion, I would urge this Committee to seriously consider abolition of the debt limit. I think it is an ineffective tool for controlling the growth of Federal indebtedness. The portion of the debt covered by the debt is a small and declining share of the government's total indebtedness, including GSE debt and the unfunded liabilities of pension and health commitments. I think that the time spent debating the debt limit would be better spent in oversight and reform of these other government liabilities.

I will end by reminding the Committee that debts of any size cannot be viewed in isolation. They must always be viewed relative to income and assets. In the case of the Federal debt, I believe that the appropriate measurement is debt as a share of the gross domestic product.<sup>14</sup> What this means is that efforts to raise GDP will do more to make current and future debts bearable than anything Congress does to pay down the debt by cutting appropriations or keeping current tax revenues above current outlays. In other words, economic growth is more important to reducing the burden of the debt than explicit debt repayment.

This last point is crucial, in my opinion. It means that raising taxes, even if it reduces the on-budget debt, may be counterproductive if it causes growth to slow from what would otherwise be the case. Although I wouldn't deny that debt repayment, viewed in isolation, is beneficial to growth, I believe its impact is small. Any measure that caused private saving to rise by an equal amount would have the same beneficial effect. And as I noted earlier, if deficits have a small impact in raising interest rates, then surpluses must have an equally small impact on reducing them. In any case, whatever the Federal Reserve does swamps the impact of either deficits or surpluses.<sup>15</sup>

<sup>12</sup> Herbert Stein, "How to Solve Almost Everything," *New York Times* (February 3, 1999).

<sup>13</sup> Studies finding little, if any, impact from deficits on interest rates include Douglas W. Elmendorf and N. Gregory Mankiw, "Government Debt," Finance and Economics Discussion Series 1998-09, Federal Reserve Board (January 1998); Paul Evans, "Are Government Bonds Net Wealth? Evidence for the United States," *Economic Inquiry* (October 1988), pp. 551-566; idem, "Do Budget Deficits Raise Nominal Interest Rates?" *Journal of Monetary Economics* (September 1987), pp. 281-300; idem, "Interest Rates and Expected Future Budget Deficits in the United States," *Journal of Political Economy* (February 1987), pp. 34-58; Gregory P. Hoelscher, "Federal Borrowing and Short-Term Interest Rates," *Southern Economic Journal* (October 1983), pp. 319-333; Charles Plosser, "Government Financing Decisions and Asset Returns," *Journal of Monetary Economics* (May 1982), pp. 325-352.

<sup>14</sup> The great historian Thomas Babington Macaulay, after a long study of England's debt, concluded, "The power of a society to pay its debts is proportioned to the progress which that society has made in industry, in commerce, and in all the arts and sciences which flourish under the benignant influence of freedom and of equal law." *The History of England from the Accession of James I* (Philadelphia: J.B. Lippincott, 1868), vol. IV, p. 265.

<sup>15</sup> Economists generally believe that inflationary expectations have more impact on long-term interest rates than any magnitude of federal borrowing. For a standard textbook discussion, see

In worrying about whether our National debt is excessive, therefore, I would urge this Committee to give more attention to those provisions of our tax system that are hindering growth than to the nominal size of the debt.<sup>16</sup>

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PREPARED STATEMENT OF ROBERT L. BIXBY

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.

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Robert D. Auerbach, *Money, Banking, and Financial Markets*, 2nd ed. (New York: Macmillan, 1985), pp. 358–383.

<sup>16</sup>It is worth noting that regardless of what one thinks of the economic impact on the debt, the way it is calculated is a poor measure of it. For example, inflation alone will pay off about \$90 billion of the debt this year alone. For a discussion of such issues, see Robert Eisner, *How Real Is the Federal Deficit?* (New York: Free Press, 1986); Robert Heilbroner and Peter Bernstein, *The Debt and the Deficit* (New York: W.W. Norton, 1989).

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 increase 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 to 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 sus-

tained 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 1990's 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 well as firms. When interest rates are low, households are better able to 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. *Reaffirm the fiscally responsible goal of balancing the budget without using the Social Security surplus.* 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. *Recognize that the post-September 11 environment requires a careful examination of budgetary priorities.* 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.

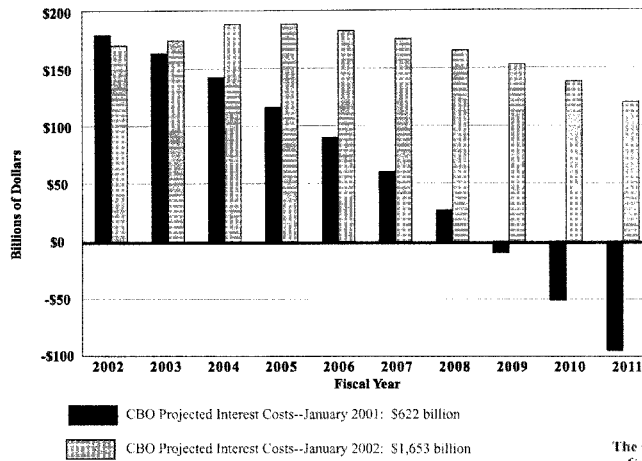
3. *If it is decided that an economic stimulus bill is needed, it should be carefully designed to have its maximum effect in the very near future, minimize costs in later years, and provide the most bang for the buck.* Back loaded options, whether tax cuts or spending increases, are not the right method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

visions 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.

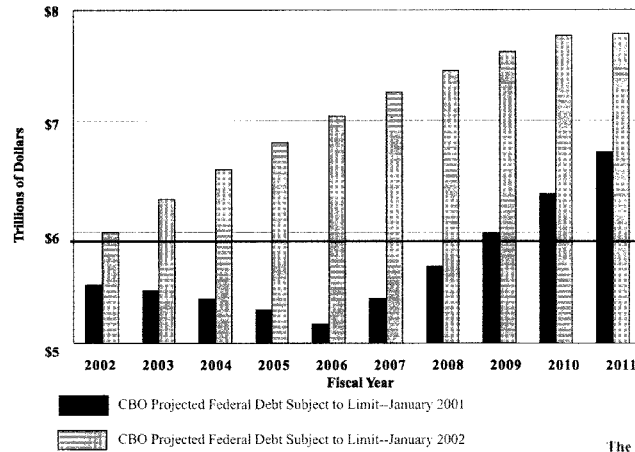
**Change in Net Interest Payments Since Last January**  
**Fiscal Years 2002-2011**



Source: CBO



### Change in Debt Subject to Limit Since Last January Fiscal Years 2002-2011

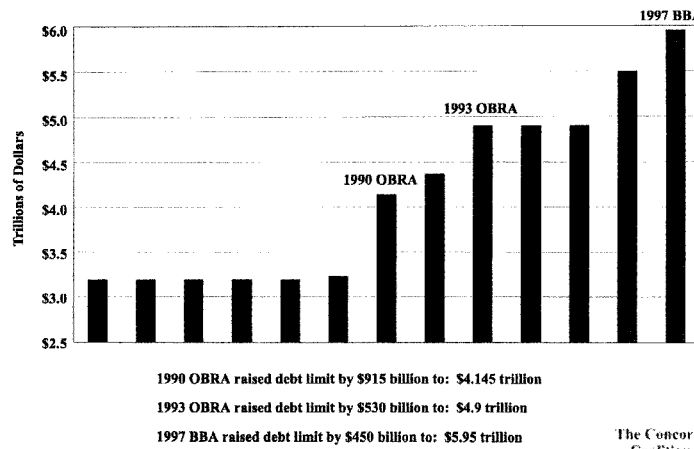


Source: CBO

Statutory Debt Limit: \$5.95 trillion

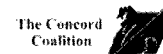


### Changes in the Statutory Limits on Federal Debt Since 1990 Major Increases Usually Accompany Budget Agreements



1990 OBRA raised debt limit by \$915 billion to: \$4.145 trillion  
 1993 OBRA raised debt limit by \$530 billion to: \$4.9 trillion  
 1997 BBA raised debt limit by \$450 billion to: \$5.95 trillion

Source: OMB



PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Over the past 4 years, the Federal Government has collected more in taxes than it has spent on programs. As a result of these surpluses, the government has been

able to repay \$453 billion in Federal debt held by the public. Despite this substantial debt reduction, the total amount of Federal debt went up in each of the past 4 years. These seemingly contradictory events are the reason we are here today. Under current law, there is a statutory limit on the amount of debt that can be issued by the government. This limit—which now stands at \$5.95 trillion—applies to Federal debt that is guaranteed as to principle and interest by the U.S. Government. This debt is essentially comprised of two major categories—debt held by the public and debt held by government programs.

The amount of debt held by the public is determined by the government's annual cash-flow. When total spending exceeds total taxes, the government has a budget deficit. To finance this deficit, the government borrows from the public by selling debt (bills, notes, and bonds). When taxes exceed spending, the government has a surplus. The government uses this surplus to repay the debt held by the public. That's exactly what's happened over the past 4 years. In theory, borrowing from the public reduces the amount of money that would otherwise be available for other investments, while paying down the debt increases the amount of money available for other investments. However, the link between government debt and other investment is not dollar-for-dollar. For example, if the government raises taxes to reduce its debt, businesses and individuals might reduce their investment to pay the additional taxes. The amount of debt held by government programs is determined by law. Certain programs, such as Social Security and Medicare, have been designated as "trust fund" programs. Unlike other programs that rely on general revenue, trust fund programs are funded by dedicated taxes or earmarked receipts. Whenever a trust fund program collects more than it spends, the surplus is invested in government debt (special issue securities).

Contrary to popular belief, the debt held by the trust funds reflects neither the amount borrowed nor the amount owed by the government. A large and growing share of the debt held by the trust funds is the result of the interest earned by the trust funds. But, the government credits interest to the trust funds by issuing more debt. No money is required to pay interest and no money is borrowed from the trust funds. The amount of debt held by the trust funds creates an obligation and imposes a limitation. The government has an obligation to redeem the debt when needed to pay for trust fund activities. But, once the debt is gone, trust fund spending would be limited unless the debt is restored. Since Congress is unlikely to allow the trust funds to redeem all of their debt—and thus become insolvent—it is impossible to say how much trust fund debt the government will have to redeem in the future. Hopefully, today's hearing will allow us to examine these issues more closely and determine whether or not we need to find a better way to measure the Federal debt.

Components of Federal Debt (Billions of Dollars)

Fiscal Year	Held by Public	Held by Government	Total Debt
1997	\$3,773	\$1,597	\$5,370
1998	\$3,722	\$1,757	\$5,479
1999	\$3,633	\$1,973	\$5,606
2000	\$3,410	\$2,219	\$5,629
2001	\$3,320	\$2,450	\$5,770

PREPARED STATEMENT OF HON. PAUL O'NEILL

Mr. Chairman, and Members of the committee last December, just 3 months to the day after the tragic events of September 11, I wrote to Congress requesting an increase in the statutory debt ceiling by \$750 billion. Yesterday I sent another letter, repeating this request with a revised projection that the debt ceiling will be reached in late March. Failure to enact a permanent increase in a timely manner would only serve to undermine confidence in our government and in our economy.

Last August, we forecast that the debt ceiling would be reached in late 2003. Since then, war, recession and national emergency have intervened. This year's surplus has been eroded by the economic downturn and the response to the September 11 attacks.

While the timing of the need to increase the statutory ceiling is sooner than we had anticipated just 6 months ago because of untoward events, we've always known it would need to be raised at some point. Payroll taxes that the American people put aside and send to the Social Security trust fund result in an increase in the level of debt subject to limit because these funds are invested in special Treasury

securities. The same holds true collections for Medicare, highways, airports and other special purposes for which the government has established trust funds. Government account holdings of these special Treasury securities increase by more than \$200 billion each year. As these trust funds grow they push up the level of the Treasury's outstanding debt. Indeed, over time the growth of the Social Security trust fund is—and will continue to be—the most significant contributor to the increase in the level of the government's debt subject to limit.

The US Government has the premier position in world capital markets because there is no doubt the United States will honor its financial commitments. Legislative action on the debt ceiling is necessary to preserve the US position in world capital markets. Any delay could create uncertainty that would raise the cost of borrowing for US taxpayers. This is an unnecessary expense and, of course, any uncertainty added to the early stages of our economic recovery would be particularly unwelcome at this time.

I urge Congress to enact this increase in the debt ceiling quickly.

#### RESPONSES TO QUESTIONS FROM SENATOR GRAHAM

*Question 1:* How much does the Administration need for each of the following priorities—the war on terrorism, securing the homeland, and stimulating the economy over the period which will be covered by the increased debt ceiling?

*Answer:* The war on terrorism, homeland defense, and stimulus are not confined to specific initiatives only but are part of a comprehensive effort to which these are related. Overall, Defense will amount to \$328 B and \$366 B in budget authority in FY 02 and FY 03 respectively and Homeland security will amount to \$37 B in budget authority over FY 02–03. Nor do these figures include emergency spending already taking place. The Administration's FY03 Budget proposed to increase spending for defense, homeland security and stimulus by \$193 B in outlays in FY 02 & 03.

*Question 2:* Other than these three agreed-upon national priorities, for what other spending will the additional borrowing requested by the Administration be utilized?

*Answer:* As you know, it is impossible to separate the individual parts of government that are financed by a debt limit increase because it applies to operating the overall government. However, most of the anticipated rise in the debt subject to limit over the next several years stems from purchases of special Treasury securities for government trust fund accounts, including the Social Security Trust Fund. In FY2002 and FY2003, slightly over \$500 billion in such Treasuries will be issued for this purpose. This reflects the net increase of government trust funds balances and small special fund balances.

*Question 3:* How much additional borrowing will be utilized in FY2002; FY2003; FY2004 and beyond?

*Answer:* The budget projects that debt subject to limit will rise by \$366 billion in FY2002, and \$390 billion in FY2003.

*Question 4:* What is the Administration's projection of the country's balance of payments status over the period of this debt ceiling increase? (p.16) Please indicate with some quantification what that effect will be on the value of the dollar? (p.18)

*Answer:* Reliable balance of payments forecasts have been particularly difficult to make during the past months, in the face of uncertainty about the economic impact of the September 11 terrorist attacks and the strength of the recovery. Private sector forecasters generally expect that the U.S. current account deficit will widen to around \$450 billion in 2002 and to slightly over \$500 billion in 2003. Foreign exchange rates are determined by many forces in the foreign exchange markets, not by current account developments alone.

*Question 5:* What are the economic assumptions upon which the Administration's projection of the trade surplus or deficit is predicated? (p.16)

*Answer:* Administration forecasts are based on assumptions of the FY 2003 budget. These assumptions are provided, with comparisons to other forecasts, in the attached Table 2–1 and Table 2–2 from Analytical Perspectives of the Budget of the United States Government for Fiscal Year 2003. Real GDP is forecast to grow 0.7 percent in 2002 (on a year average basis) and 3.8 percent in 2003 while the consumer price index is forecast to rise 1.8 percent in 2002 and 2.2 in 2003.

*Question 6:* Do you think that two years from now the dollar will be stronger or weaker? (p.18)

*Answer:* Treasury does not have a prediction of the foreign exchange value of the dollar nor believe it is possible realistically to make such a prediction. Treasury efforts, rather, remain focused on promoting the efficient performance of the U.S. economy.

**Table 2-1. ECONOMIC ASSUMPTIONS<sup>1</sup>**  
(Calendar years; dollar amounts in billions)

	Actual 2000	Projections											
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>Gross Domestic Product (GDP):</b>													
Levels, dollar amounts in billions:													
Current dollars	9,873	10,197	10,481	11,073	11,681	12,321	12,962	13,614	14,299	15,020	15,775	16,569	17,404
Real, chained (1996) dollars	9,224	9,313	9,382	9,739	10,101	10,462	10,802	11,136	11,462	11,838	12,204	12,583	12,973
Chained price index (1996=100), annual average	107.0	109.5	111.7	113.7	115.3	117.3	120.0	122.2	124.5	125.8	129.2	131.6	134.1
Percent change, fourth quarter over fourth quarter:													
Current dollars	5.3	1.9	4.7	5.6	5.5	5.4	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Real, chained (1996) dollars	2.9	-0.5	2.7	3.8	3.7	3.5	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Chained price index (1996=100)	2.4	2.4	1.9	1.7	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Percent change, year over year:													
Current dollars	6.5	3.3	2.8	5.6	5.5	5.5	5.2	5.0	5.0	5.0	5.0	5.0	5.0
Real, chained (1996) dollars	4.1	1.0	0.7	3.8	3.7	3.6	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Chained price index (1996=100)	2.3	2.3	2.0	1.8	1.7	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
<b>Incomes, billions of current dollars:</b>													
Corporate profits before tax	845	706	733	846	931	1,023	1,090	1,136	1,188	1,251	1,312	1,354	1,419
Wages and salaries	4,837	5,100	5,246	5,519	5,818	6,115	6,415	6,730	7,058	7,401	7,763	8,147	8,549
Other taxable income <sup>2</sup>	2,236	2,297	2,331	2,438	2,547	2,650	2,750	2,839	2,937	3,042	3,152	3,261	3,386
<b>Consumer Price Index (all urban):<sup>3</sup></b>													
Level (1982=66=100), annual average	172.3	177.2	180.5	184.5	188.7	193.2	197.8	202.6	207.4	212.4	217.3	222.3	227.4
Percent change, fourth quarter over fourth quarter	3.4	2.0	2.4	2.2	2.3	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3
Percent change, year over year	3.4	2.9	1.8	2.2	2.3	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3
<b>Unemployment rate, civilian, percent:</b>													
Fourth quarter level	4.0	5.5	5.8	5.4	5.1	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Annual average	4.0	4.8	5.3	5.5	5.2	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9
<b>Federal pay raises, January, percent:</b>													
Military <sup>4</sup>	4.8	3.7	6.9	4.1	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Civilian <sup>5</sup>	4.8	3.7	4.5	2.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
<b>Interest rates, percent:</b>													
91-day Treasury bills <sup>6</sup>	5.0	3.4	2.2	3.5	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
10-year Treasury notes	6.0	5.0	5.1	5.1	5.1	5.1	5.2	5.2	5.2	5.2	5.3	5.3	5.3

<sup>1</sup> Based on information available as of beginning of December 2001.  
<sup>2</sup> Rent, interest, dividend and proprietor's components of personal income.  
<sup>3</sup> Seasonally adjusted CPI for all urban consumers.  
<sup>4</sup> Percentages apply to basic pay only; 2002 figure is average of various rank- and longevity-specific adjustments; adjustments for housing and subsistence allowances will be determined by the Secretary of Defense.  
<sup>5</sup> Overall average increase, including locality pay adjustments.  
<sup>6</sup> Average rate, secondary market (bank discount basis).

**Table 2-2. COMPARISON OF ECONOMIC ASSUMPTIONS**  
(Calendar years)

	Projections											Average, 2002-12
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
<b>Real GDP (billions of 1996 dollars):</b>												
CBO January	9,398	9,782	10,146	10,471	10,804	11,145	11,498	11,850	12,216	12,590	12,973	.....
Blue Chip Consensus January (2)	9,410	9,742	10,069	10,401	10,738	11,075	11,425	11,791	12,168	12,557	12,959	.....
2003 Budget	9,382	9,735	10,101	10,463	10,802	11,156	11,482	11,838	12,204	12,583	12,973	.....
<b>Real GDP (chain-weighted): (1)</b>												
CBO January	0.8	4.1	3.7	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.0	3.1
Blue Chip Consensus January (2)	1.0	3.4	3.4	3.3	3.3	3.1	3.2	3.2	3.2	3.2	3.1	3.1
2003 Budget	0.7	3.9	3.7	3.6	3.5	3.1	3.1	3.1	3.1	3.1	3.1	3.1
<b>Chain-weighted GDP Price Index: (1)</b>												
CBO January	1.4	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.9
Blue Chip Consensus January (2)	1.6	1.9	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.1
2003 Budget	2.0	1.8	1.7	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
<b>Consumer Price Index (all-urban): (1)</b>												
CBO January	1.8	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.4
Blue Chip Consensus January (2)	1.7	2.4	2.6	2.7	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.5
2003 Budget	1.8	2.2	2.3	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3
<b>Unemployment rate: (3)</b>												
CBO January	6.1	5.9	5.4	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.4
Blue Chip Consensus January (2)	6.1	5.7	4.9	4.8	4.8	4.9	4.9	4.9	4.9	4.9	4.9	5.1
2003 Budget	5.5	5.5	5.2	5.0	4.9	4.9	4.9	4.9	4.9	4.9	4.9	5.1
<b>Interest rates: (3)</b>												
<b>91-day Treasury bills:</b>												
CBO January	2.2	1.5	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Blue Chip Consensus January (2)	2.1	3.4	4.3	4.7	4.8	4.8	4.7	4.7	4.7	4.7	4.7	4.3
2003 Budget	2.2	3.5	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.0
<b>10-year Treasury notes: (3)</b>												
CBO January	5.0	5.4	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.8	5.7
Blue Chip Consensus January (2)	5.1	5.0	5.7	5.7	5.7	5.7	5.6	5.6	5.6	5.6	5.6	5.7
2003 Budget	5.1	5.1	5.1	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2

Sources: Congressional Budget Office; Blue Chip Economic Indicators; Aspen Publishers, Inc.

(1) Year over year percent change.  
(2) January 2002 Blue Chip Consensus forecast for 2002 and 2003; Blue Chip October 2001 long run extension for 2004-2012.  
(3) Annual averages, percent.

*Question 7:* What are the Administration's fiscal and economic assumptions in arriving at the \$750 billion needed to cover our indebtedness? What are your expectations for short- and long-term interest rates?

*Answer:*

*Economic Assumptions*

The Administration's forecast for the U.S. economy was developed late last year as part of the preparation for issuing our FY-2003 Budget proposals. We assumed that the economy would grow by about 2-¾ percent on a fourth-quarter to fourth-quarter basis during 2002. (0.7 percent on a year-over-year basis) and accelerate to an annual rate of 3-¾ percent (both fourth to fourth and year over year) during 2003 and 2004. The attached table from the Analytical Perspectives document issued with the FY-2003 Budget provides additional detail on our forecast.

The yield on the three-month bill is expected to average 2.2 percent this year, rising to 3.5 percent next year and 4.0 percent in 2004. The assumption for the 10-year note is placed at 5.1 percent in each of those years.

*Fiscal Assumptions*

The fiscal assumptions are those contained in the FY-2003 Budget, discussed in answer to the first question. These include, among others, the President's proposals for defense and homeland security and an economic security plan.

*Question 8:* What is the Administration's strategy to deal with the next decade's tidal wave of retirees, and how is this \$750 billion debt increase consistent with that strategy?

*Answer:* The welfare of future retirees and the economy are inextricably linked. Future retirees will enjoy substantial benefits from a stronger economy today. A stronger economy produces more tax revenue to help us meet obligations to future retirees. A stronger economy also generates higher paying jobs, thereby allowing for a larger amount of resources to be saved for retirement. It also helps generate larger returns on the investments that millions of workers have made through 401(k) plans and other retirement plans. (The Administration's recent recommendations for reforming 401(k) plans will also help secure future retirement security.) We, therefore, view economic stimulus as a key ingredient of securing future retirement security rather than as a competing goal.

The linkage between retirement and economic security, however, also works in the opposite direction. Unless action is taken in a timely manner, retirement benefits that must be paid to future retirees have the potential to significantly impact the government's fiscal position. The Administration believes that the best action is to begin pre-funding some of these future obligations today rather than waiting until the time of reckoning is upon us, which will require much larger steps. Personal retirement savings accounts are the best way to set money aside today, removing the assets from future political debate.

*Question 9:* If you assume that direct Social Security and Medicare benefits and tax levels remain unchanged, and that the federal government will not increase debt to provide resources to fund these programs, what rate of return must be earned on Trust Fund assets, or, if created, individual retirement accounts in order to accumulate sufficient assets to meet these contractual obligations?

*Answer:* The President has publicly stated his opposition to investing Social Security Trust Fund assets into the private sector. Securing a better Social Security system for tomorrow requires a vision of Social Security as a wealth accumulation retirement system. As discussed in my answer to your last question, the best way to increase wealth is to establish funded personal accounts. Several plans currently exist in Congress for creating personal accounts. The bipartisan President's Social Security Commission proposed some ideas as well. I firmly believe that we need to have an open and honest debate on this issue. But we must also act in a timely manner.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

*Question 1:* In 1995 and 1996, there was a true debt limit crisis. Some members of Congress refused to pass a debt ceiling increase unless the President signed a bill that he strongly opposed. The President would not do that, and the debt ceiling was not raised. Secretary Rubin had to use legal but unprecedented actions to avoid default by the Treasury.

What are the consequences if Congress and the President fail to enact a debt ceiling increase by the deadline for action?

*Answer:* The actions taken to avoid hitting the debt limit in 1995-1996 were:

- On October 17:

- Treasury announced a cut in the October 23 auction of 13-week bills in order to stay under the debt limit on October 31.
  - Treasury suspended issuance of additional amounts of Treasury bills to Federal Reserve Banks as agents for foreign and international monetary authorities (“foreign add-ons”).
  - Treasury suspended the issuance of State and Local Government Series Treasury securities (“SLGS”) other than on subscriptions received by October 17.
  - On October 18, Treasury suspended awards of foreign add-ons to Treasury notes sold to the public.
  - On November 1, Treasury called back approximately \$2.3 billion of Treasury cash balances from seven large banks.
  - On November 6, Treasury postponed the auctions of 3- and 10-year notes that had tentatively been scheduled for November 7 and 8, respectively.
  - On November 8, Treasury postponed the auction of 52-week bills that had tentatively been scheduled for November 9.
  - On November 15, Secretary Rubin authorized not reinvesting fully the assets of the Government Security Investment Fund (G-Fund) and redeeming a portion of the assets of the Civil Service Retirement and Disability Fund (CSRDF).
  - On December 29, Treasury was unable to issue securities to the CSRDF to enable it to invest \$14 billion it received that day in interest payments.
  - On February 14:
  - Secretary Rubin amended his November 15 determination authorizing the redemption of a portion of the assets of the CSRDF to permit the redemption of an additional portion of such assets.
  - The Federal Financing Bank (the “FFB”) exchanged approximately \$8.6 billion of its assets, consisting of debt obligations of the U.S. Postal Service and the Tennessee Valley Authority, for an equivalent amount of Treasury securities held by the CSRDF. An exchange between FFB and Treasury allowed Treasury to cancel such Treasury securities.
  - Secretary Rubin authorized suspending the reinvestment of the dollar-denominated assets of the Exchange Stabilization Fund.
  - On March 25, Treasury postponed the auctions of 2- and 5-year notes that had tentatively been scheduled for March 27 and 28, respectively.
  - On March 27, Treasury postponed the auction of 52-week bills that had tentatively been scheduled for March 28.
- On March 28, Congress passed H.R. 3136, which increased the statutory debt limit from \$4.9 trillion to \$5.5 trillion. On March 29, President Clinton signed H.R. 3136 into law as Public Law No. 104–121.

*Question 2:* In light of the impending retirement of the baby boomers, don’t you agree that it would be very important to save the Social Security and Medicare surpluses in order to reduce debt held by the public?

*Answer:* Reducing the publicly held debt is a very important goal. However, the Administration believes that fighting the war on terror, defending the homeland and reinvigorating our economy remain near-term priorities. Once these important challenges are met, the FY2003 budget projects that the publicly held debt will resume its decline. Indeed, the burden of debt on the economy will continue to fall over the next five years—publicly held debt as a share of GDP is projected to fall from 34% this year to 25% by FY2007.

It is important to note that debt reduction alone will not solve our long-term fiscal challenges—real entitlement reform is needed if we are to shore up our fiscal long-term outlook.

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PREPARED STATEMENT OF GENE B. SPERLING

I. INTRODUCTION:

Thank you Mr. Chairman for inviting me to testify today to the Senate Finance Subcommittee on Long-term Growth and Debt Reduction.

In my testimony I will discuss my views on the relationship between the path of debt reduction, economic growth and our ability to be ready to meet the baby-boom retirement challenge.

In my testimony I will focus on the path of debt held by the public—what is sometimes called external debt. I will not focus on the gross debt—which is the figure that the debt limit legislation is tied to—because the gross debt is simultaneously too large to describe what the government is actually borrowing from the private sector, and too small to describe our true contingent liabilities in meeting our long-term commitments to Medicare and Social Security.



Gross debt overestimates how much government fiscal policy is affecting our national savings rate and the amount of capital available to the private sector, because it includes both the debt held by external sources and “internal government transactions and bookkeeping . . . debt held by government accounts,”<sup>1</sup> which does not have a direct impact on the supply of capital available to the private sector.

On the other hand, the gross debt figure represents only a fraction of the full contingent liability we face for long-term Medicare and Social Security.

Therefore for the remainder of the testimony below, when I refer to paying down the national debt I will be referring to what is known as the debt held by the public.

## II. THE PATH OF DEBT REDUCTION—THE THREE DRAMATIC SWINGS:

Over the last 20 years we have experienced two dramatic swings in the path of national external debt, and are now on the verge of an unfortunate third swing. From 1970 to 1981, debt as a percentage of GDP stayed within a narrow band of 23.8% (1974) to 27.9% (1970). As the external debt quadrupled from \$789 billion in 1981 to \$3 trillion in 1992, however, the level of debt as a percentage of GDP also rose from 25.8% in 1981 to 48.2% in 1992.<sup>2</sup>

More disturbing than the doubling of the debt as a percentage of GDP were the rising projections over the next decade. In 1993, the Congressional Budget Office (CBO) 10-year baseline projected that deficits would rise from \$290 billion in 1992 to \$653 billion in 2003, and that debt as a percentage of GDP would rise from 53.3% in 1993 to 77.6% in 2003.<sup>3</sup>

Fortunately, the second major swing in the path of debt reduction prevented these disturbing projections from taking place. Starting with the 1993 deficit reduction act and continuing with the bipartisan goal of a balanced budget, the bipartisan 1997 Balanced Budget agreement and President Clinton’s policies of saving the surpluses for debt reduction and potential Social Security reform, America went from massive deficits to surpluses. Moreover, the debt as a percentage of GDP declined to 35% in 2000, less than half of the level of 73.8% projected by CBO in January of 1993. While there were many causes of the strong economic performance of the 1990s—including the widespread dissemination of information technology, corporate restructuring, wise monetary policy and increased savings through fiscal discipline—the decision to save as opposed to consume the surpluses meant that in early 2001 both the CBO and the Office of Management and Budget (OMB) were projecting 10 year unified surpluses of \$5.6 trillion.

We are now on the verge of the third swing in the path of external federal government debt as a percentage of GDP. Last year the path of debt reduction was so promising that there was a serious debate as to whether we were on too fast of a path in paying off the national debt. In one year our situation has changed dramatically. Even under the Administration’s own economic and budget assumptions, the debt will fall from only \$3.5 trillion to \$3 trillion by 2010, compared to last year’s estimate of below \$900 billion for the year 2010.<sup>4</sup>

Yet, with more realistic budget and accounting assumptions the debt situation is even worse. For example, the Administration assumes nearly \$500 billion in savings based on budget assumptions with few if any specific savings. The Medicare baseline is assumed to be \$313 billion below the CBO baseline based only on the assumption of record low growth. Furthermore, the Administration assumes \$167 billion in nondefense discretionary cuts below inflation over 10 years with few specifics and even fewer believers that this is a tenable path particularly in light of new homeland security needs. Replacing these assumptions with more conservative assumptions, the Administration’s budget would likely face a deficit over the 2003–2007 period. When one assumes likely fixes to the alternative minimum tax—estimated to reach 39 million taxpayers under the Administration’s own assumptions by 2012—it is very likely that we will see no cumulative debt reduction during the entire first decade of the century.

## III. WHY DEBT REDUCTION MATTERS:

Over the last few months, there have been increasing claims within the Administration and among some conservative economists that the degree of public debt and

<sup>1</sup> CRS Report for Congress, “Surpluses and Federal Debt, March 1, 1999.

<sup>2</sup> Congressional Budget Office, “Historical Budget Data”, *The Budget and Economic Outlook: Fiscal Years 2003–2012*, Table 11: Surpluses, Deficits, Debt, and Related Series 1960–2001, January 31, 2001.

<sup>3</sup> Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994–1998*, Table 2–4, January 1993.

<sup>4</sup> Congressional Budget Office, *The Budget and Economic Outlooks: Fiscal Years 2002–2011*, “Labor Productivity in the Nonfarm Business Sector,” Table 1–4, January 2001.

deficits do not have a clear impact on long-term interest rates. Yet this position defies the basic laws of supply and demand, recent experience with savings in the United States, and even the positions of well known Republican economists.

**1. Fiscal Discipline and Debt Reduction has Been Vital to Improving America's Weak Savings Rates:** It follows basic laws of supply and demand that where more supply of capital exists to meet a given demand, the price of that capital in terms of interest rates will be lower. In the United States over the last decade the main contribution to net national savings has been the improvement in our federal fiscal position. Instead of borrowing to meet the costs of high deficits and "crowding out" private sector capital, the decade ended with the government "crowding in" private sector investment by paying down debt and adding to the pool of savings available to private sector investment and homeownership. For example, net national savings nearly doubled from 3.5% in 1993 to 6% in 1999 and 2000. Yet, during that time, net private savings actually declined from 8% to 3% in 2000. *Therefore, the full reason that net national savings nearly doubled, as opposed to declining, was that the federal government went from dissavings and deficits of 4.7% of GDP to a surplus of 2.2% of GDP—a swing of 6.9% of GDP.* Between 1993 and 2000, the swing of 6.9% of GDP is the equivalent of making \$680 billion additional capital available to private sector. To argue that deficits and debt are irrelevant to long-term interest rates, one would have to argue that an additional \$680 billion in the supply of capital has no impact on the price of that capital—a highly dubious proposition.

**2. Debt and Deficits Do Impact Long-term Interest Rates:** As Brookings Senior Fellow Peter Orszag has written in previous documents, all of the models used by the Federal Reserve, the CBO and OMB assume that sharp movements in deficits or debt reduction have a significant impact on long-term interest rates.<sup>5</sup> Furthermore, publications by Martin Feldstein—former Chairman of the Council of Economic Advisors (CEA) under President Reagan, and John Taylor—current Undersecretary of the US Treasury and former Stanford economics professor, and the CEA of the Reagan and first Bush administrations have all recognized this relationship. Indeed, the former President Bush's CEA explicitly stated in 1990 that "economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction is credible, can lower interest rates as financial markets participants observe that the government will be lowering its future demand in the credit market."<sup>6</sup> In 1984, the CEA again wrote: "Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the recovery. . . ."<sup>7</sup>

Some have tried to downplay the impact of deficits on interest rates by stating that interest rates did not drop in 1999 when surpluses were rising and have not skyrocketed this year when the surplus were plummeting. But such observations ignore the demand side of the supply and demand laws. We expect the price of capital to fall when there is low demand for capital in times of recession, and we expect such interest rates to rise when there is great demand for capital in boom times. The right issue, therefore, is whether fiscal policies have made interest rates higher or lower than they otherwise would have been in differing economic times. A Goldman Sachs analysis published on April 14, 2000 asked the right question in discussing how, given the high level of investment demand, interest rates would have been different under the scenario of large deficits. The Goldman Sachs analysis concluded that "According to the model the swing in federal budget position from a deficit of improvement in the general government position—has lowered equilibrium bond yields by a full 200 basis points." This estimated 200 basis points impact would save an owner of a \$150,000 home as much as \$3,000 a year in mortgage costs.

The virtuous cycle of fiscal discipline during the late 1990's had the positive effect of keeping interest rates from rising significantly during the investment boom of the late 90's. Similarly, the sudden turnaround in our fiscal situation over the last year has been a negative factor in preventing long-term interest rates from falling as much as they might have during the period of economic weakness we have witnessed during this past year.

Consider the following: Since the beginning of 2001, 1-year interest rates have fallen over 300 basis points from 5.11% to 2.08%. Normally, one would expect long-term interest rates to have fallen at least half as much. Yet, as the long-term surplus has deteriorated, 30-year interest rates have risen from 5.35% to 5.36%. The

<sup>5</sup>Peter R. Orszag, "The Budget and the Economy," Testimony before the U.S. Senate Budget Committee, page 5, January 29, 2002.

<sup>6</sup>Council of Economic Advisors, *Economic Report of the President*, page 64, February 1991.

<sup>7</sup>Council of Economic Advisors, *Economic Report to the President*, page 62, February 1984.

negligible spread between 1-year and 30-year interest rates that existed in January 2001 rose by approximately 300 basis points by January 2002.

What explains this failure of long-term interest rates to fall even half as much as short-term rates? A perception of a strengthening economy alone cannot explain why long-term interest rates did not even fall as much as short-term rates. Greenspan stated that “some of the firmness of long-term interest rates probably is the consequence of the fall of projected budget surplus.”<sup>8</sup> Goldman Sach’s chief strategist Abby Cohen stated that “the reason is that many investors are concerned about the long-term implications of the change in fiscal policy . . . the very large tax cut that was implemented just a few months ago really puts us toward the edge of . . . losing all of the surplus that we might have enjoyed.”<sup>9</sup>

**3. National and Economic Security:** While President Bush is correct in arguing that exceptions should be made to fiscal discipline rules in case of war and recession, it is important to recognize the importance of fiscal discipline to preparation for unexpected national crises. For example, can we doubt that the United States was better prepared to deal with the dual crises of terrorism and recession when we were starting from a position of surpluses as opposed to facing the \$589 billion deficits that were projected for 2002 by the CBO back in 1993?

A strong fiscal position can also help ensure our economic security. Certainly, the improvements in the fiscal position gave the Federal Reserve more flexibility to ease rates and provide global stimulus during the Asian Financial Crisis. Furthermore, debt reduction is a wise policy in light of our large current account deficits. As Fred Bergsten, Director of the Institute for International Economics wrote in February 26, 2001, “it would be the height of folly” to assume that we can forgo savings for tax cuts that will likely make our current account situation more precarious.<sup>10</sup> On the other hand, increased national savings would allow us to adjust in a gradual process so that if there was a modification in the supply of foreign borrowing, it would not lead to a shortage of capital and higher interest rates that would deter productive investment.

**4. Generational Responsibility:** Integral to the argument for increased focus on debt reduction is the importance of the current generation being willing to forego some current consumption in favor of savings so that we are not simply passing on the burden of meeting the baby-boom retirement challenge to the next generation. While key investments in education and training and well-targeted incentives for greater productive investment can also be key to enhancing productivity, increasing savings through debt reduction increases the capital pool and therefore investment and productivity that can help the smaller number of workers support the larger number of future retirees without oppressive tax increases or spending cuts.

As a Congressional Research Service report in April 2000 stated: while “future generations of Americans bear the major part of the burden [of deficit and debt],” budget surpluses “crowd in interest-sensitive private sector spending, meaning that future generations inherit a larger privately owned capital stock and higher levels of income. If the budget surplus is used to reduce the national debt future generations tend to gain. Alternatively, if the surplus is used for cutting taxes, a large share of the gain accrues to the current generation.”<sup>11</sup>

Therefore, even in the absence of a specific plan to dedicate surpluses to enhancing Social Security solvency, the type of policies implemented by President Clinton to at least save surpluses for debt reduction furthered the cause of generational responsibility by putting savings and future productivity ahead of consumption-oriented tax cuts and spending.

The impact on savings can also be seen by considering what revenues committed to the recent tax cut could mean toward reaching the goal of 75 year Social Security solvency. The sense is often created in both the public and policy circles that finding the savings to shore up Social Security solvency is beyond reach. But the fact is that had our nation been willing to commit just half of the revenues committed to the tax cut to Social Security solvency, we could have reached Social Security 75 year solvency. This is not to say that Social Security reform should be done simply by committing surpluses to the Social Security Trust Fund, but it does give a sense of the difference that a greater commitment to savings and debt reduction could mean toward meeting the babyboom retirement challenge.

<sup>8</sup> Alan Greenspan, “The Economy,” Remarks at the Bay Area Council Conference, San Francisco, January 11, 2002.

<sup>9</sup> Face the Nation, CBS, January 6, 2002.

<sup>10</sup> C. Fred Bergsten, “This Tax Cut Could Too Hurt Us,” *Washington Post*, page A19, February 26, 2001.

<sup>11</sup> CRS Report for Congress, “The National Debt: Who Bears Its Burden?,” April 7, 2000.

## IV. WHAT TO DO:

A renewed commitment to debt reduction should not be seen as a call to put all worthy investments in education, reducing child poverty, or providing incentives to productive investment on hold. It does mean, however, that such priorities need to be melded with tough choices that can return us to a path of debt reduction. The first step would be to renew some of the effective budget controls that are soon due to expire. Second, there are options for protecting a significant tax cut for all Americans while still freeing up some resources that can be saved for debt reduction and Social Security reform.

A proposal I put forward in *The Washington Post* on July 31, 2001,<sup>12</sup> demonstrated that if we simply froze the tax cut for the top 2% of taxpayers (i.e., those affected by the 38.6 and 35% rates), maintained the current law on high income exemptions, doubled the estate tax exemption instead of fully repealing it, and then committed those funds to a Social Security Reserve Fund, we could close half of the 75 year Social Security solvency gap and most likely pay down significant debt while increasing savings in the process. The marginal tax rate cuts for approximately 98% of American taxpayers—average families making about \$200,000 and over in adjusted gross income—would be fully protected. Meanwhile, lessening the tax cut for the top 2% would help ensure that the widespread benefits of increased national savings reached all Americans, while ensuring that eventual Social Security reform does not fall unnecessarily hard on tens of millions of future Social Security recipients of modest means.

Thank you.

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<sup>12</sup>Gene Sperling, "Fiscal Chutzpah," *Washington Post*, July 31, 2001.

