TESTIMONY OF THE HONORABLE LEON E. PANETTA

BEFORE

THE COMMITTEE ON FINANCE, U.S. SENATE

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Mr. Chairman and Distinguished Members of the Finance Committee:

I am honored to have this opportunity to appear before you to share my thoughts on the subject of Economic Growth and Job Creation: Incentives for Investment.

There are two fundamental principles that must support whatever incentives for investment the Congress decides are necessary. These principles are drawn from my experience in the Congress as Chairman of the House Budget Committee and in the executive branch as Director of the Office of Management and Budget. But they are also influenced by my present experiences as a member of the Board of the New York Stock Exchange and Co-Chair of its Corporate Accountability and Listing Standards Committee.

The first principle is that there is no effective federal incentive for investment that can produce sustained economic growth and jobs unless it is at the same time accompanied by strong fiscal discipline.

The second principle is that at a time of great uncertainty over the consequences of a number of foreign and domestic crises, the key guideline for federal policy should be

to “do no harm.” In other words, do nothing that will add only greater uncertainty to an already nervous investment environment.

The danger you must avoid is that in the rush to judgment to find a temporary or permanent solution to kick starting a weak economy, you are willing to excuse exploding future deficits on the basis that somehow they are insignificant or can take care of themselves.

The lesson of the last 25 years is that deficits do matter and they will not be reduced without strong and unified action by the President and the Congress.

In the 1980s, the nation was looking at what OMB Director David Stockman predicted would be “deficits as far as the eye could see.” As a result of the Reagan tax cut, dramatic defense-spending increases, growing entitlement and discretionary spending and a slowing economy, deficits were projected to reach $200 billion by the end of the 1980s and escalate to $300 billion by the early 1990s, reaching $600 billion by the beginning of the new century.

The national debt was well on the way to quadrupling from less than $1 trillion to more than $4 trillion by 1992. The economy was being affected by high long-term interest rates, increased government borrowing, reduced capital for investment and ever-larger interest payments on the debt.

In a word, the deficit was out of control but neither political party had the political will or courage to directly confront the problem. Rather than making the tough budget decisions that had to be made, Congress passed budgets based on a combination of "smoke and mirrors" accounting, "rosy scenario" economic projections, funding shifts from one fiscal year to another to hide spending, and exaggerated savings from program reductions that few believed would be realized.

In the midst of the frustration over exploding deficits, Congress passed the Gramm-Rudman-Hollings bill that required an automatic "across the board" cut if certain deficit-reduction targets were not met. Congress, however, kept changing the targets for fear of what such arbitrary cuts would do.

None of these steps nor any of the hoped for economic benefits of the tax cut reversed the continuing growth in deficits.

In the end, it was finally recognized that the key to reducing the deficit was not procedural gimmickry or artificial legislative or constitutional mandates of one kind or another. Nor could one resolve conflicting priorities by putting the budget process on automatic pilot. Political leaders are elected to make hard choices, to set priorities and to discipline the budget.

In 1990, former President George Bush did exactly that in an historic budget agreement that achieved significant debt reduction, established caps on discretionary

spending, and implemented a "pay-as-you-go" discipline that required any new proposal for tax cuts or entitlement spending to be fully paid for. Without those vital budget disciplines, this nation would never have achieved a balanced budget.

In 1993, former President Bill Clinton pushed through his economic plan for $500 billion in deficit reduction over five years, continuing the budget disciplines put in place by the 1990 agreement.

Combined with the Balanced Budget Agreement of 1997, these efforts by former Presidents and Congresses sent a vital signal to the financial markets that strong fiscal discipline would be enforced. These credible efforts to reduce the deficit along with the actions of the Federal Reserve, corporate and business leaders helped produce the strongest economic growth and job creation in the history of the country.

Those are the facts. Those lessons should not now be ignored in favor of unproven and speculative theories that promote painless remedies for controlling the deficit. Many of you played important roles in the difficult decisions that had to be made. There is not a member among you that has not at one time or another criticized the dangers of uncontrolled deficits. You were right to do so. Nothing has changed that reality.

Deficits do matter. Increased government borrowing places a drag on the economy by reducing national savings, increasing long-term interest rates, crowding out

capital spending, reducing investment in capital stock to improve productivity, increasing the debt owed to foreign investors, jeopardizing the social safety net for retirees, reducing the future income and living standards of American households, and putting a tax burden on our children who ultimately will have to pay the interest on the debt. We have a responsibility to future generations to make sure that any incentive for investment is accompanied by strong fiscal discipline.

The second principle of "do no harm" makes clear that we must not add further instability to the economic outlook of the nation. As Chairman Greenspan pointed out yesterday, the business community is concerned about the consequences of a series of uncertainties that currently plague the nation. That is not to say that they are pessimistic about the long-term future of the country as it confronts these crises. But it is to say that they are increasingly worried about the growing number of problems that the nation must deal with in order to provide a more stable environment for investment and growth.

Consider the list of challenges: The potential for war in Iraq, the resulting turmoil in the Middle East, the impact on oil prices, the growing conflict with North Korea, the terrorism alerts that impact on business and consumer fears, the continuing concern over corporate scandals, the confused enforcement and regulatory environment affecting CEOs and boards of directors, the serious losses on future retirement income, the escalating foreign trade deficit, and the budget crisis looming over state governments that will reach $60 billion to $80 billion collectively. All of this combined with a volatile

stock market and high unemployment makes clear that we live in a more dangerous and unpredictable world.

To add to this the prospect of cumulative deficits over $2.1 trillion for 2002 through 2011, an $8 trillion fiscal reversal from the $5.6 trillion surplus projected in January of 2001, a national debt on course to exceed $10 trillion by the end of the decade, an extra $1.1 trillion in spending for interest on the debt, an unfunded liability for Social Security, Medicare and other retirement programs that OMB projects to be $24.8 trillion, and a tax cut agenda that could cost $.2.526 trillion over ten years and reduce state revenues by about $64 billion is all tantamount to creating even greater anxiety about our economic future.

Recognizing these realities and the principles that should guide any investment decisions, the following points should be considered in your deliberations:

1. Don't dig the deficit hole deeper. Any costs for an incentive package should follow the "pay-as-you-go" rules with budget offsets or, in the least, should provide a firm fiscal plan to fully pay for these additional costs.
2. Temporary is better than permanent. All economic stimulus measures, including tax cut and spending proposals, should be temporary and stimulative without harming the long-term budget outlook.

3. <u>Tax cuts should be targeted</u>. Less than nine percent of the ten year $670 billion tax cut proposed by the Administration would have an impact on this year. To be effective and fair, tax cuts should be targeted to consumers and working families likely to spend and businesses likely to invest and hire new workers now.

4. <u>States should be helped through their fiscal difficulties</u>. Any federal effort to promote growth and jobs could be undermined by states having to raise taxes, cut spending and layoff employees in order to balance their budgets. Support to the states for homeland security and sufficient funding for vital programs that serve the most in need could help the states through this difficult period so that federal and state governments are working together and not in opposition to one another.

In his State of the Union address, President Bush said: "This country has many challenges…we will not pass along our problems to other Congresses, other Presidents, and other generations." He was right. Unfortunately, his proposals fail to live up to that promise.

To enact permanent new tax cuts in the face of large new spending pressures such as the prospect of a costly war in Iraq, increased homeland security needs and a major prescription drug benefit is to live beyond our means and pass the IOUs to our children and grandchildren.

If incentives are to be provided that support economic growth and job creation, hard choices must be made that implement strong budget discipline and restore a sense of confidence in the economic stability and future of a very uncertain world.

That will require both leadership and sacrifice. That is the clear lesson of the past. It is the clear lesson of the present if we are to secure a strong economy and a strong democracy for the future.