



Designing a Framework for Economic Recovery and Fiscal Sustainability

President Obama and the new Congress face distinct but related fiscal policy challenges over the short and long term. Swift action is necessary both to address immediate needs and develop an “exit strategy” to ensure that our response to the current crisis does not have adverse unintended consequences over the long term.

The most immediate challenges are the recession and the frozen credit markets. Addressing these challenges calls for a loosening of fiscal policy and higher deficits than would be acceptable under more normal circumstances. And yet, hovering over the short-term challenges is an unsustainable long-term fiscal policy driven on autopilot by rising health care costs and an aging population. Without a firm commitment to long-term fiscal discipline, any actions taken to revive the economy in the short term will be of fleeting value.

Deficit spending is an appropriate policy response to the current recession, but only for policies designed to stabilize the economy during the downturn. Committing to large and persistent deficit spending beyond the recession — even for apparently worthy purposes — would be detrimental to longer-term economic growth through reduced national saving. It would also contribute to the fragility of short-term economic recovery by undermining the attractiveness of U.S. Treasury debt to global investors, thus threatening our nation’s access to affordable credit.

The rapid effort to pass economic recovery legislation seems to indicate that the Obama administration and Congress recognize the dangers of inaction in the face of the country’s severe economic downturn. While the details are being hammered out through the legislative process, it appears that policymakers are looking at a total package cost of around \$825 billion, to be split between spending (two-thirds) and tax cuts (one-third). Unfortunately, numerical goals such as these often begin to drive policy choices at the expense of strategic considerations. Whether on the spending or tax side of the budget, the effectiveness of the policies in the package is more important than the size. Rather than setting a top-line goal and then rushing to fill it with policies that add up to the desired amount, great care should be taken to ensure that the policies are designed to meet critical needs. In that regard, the Obama administration and Congress should pursue a recovery strategy that combines:

1. Deficit spending in the short term on policies that will quickly stimulate consumption, create jobs, or provide assistance to cash-strapped households;
2. Critical public investments over the longer term that will ultimately increase our nation’s productive capacity; and

3. A long-term fiscal sustainability strategy focused on reforming health care, Social Security and the tax system.

To do the first effectively, deficit-financed policies must have a clearly countercyclical purpose and be effective at producing those benefits during, not after, the recession. To accomplish the second goal, deficit financing of longer-term investments should be evaluated through the normal budgetary process and designed to pass a cost-benefit test that accounts for debt service. To do the third effectively, the long-term cost of government commitments must be scaled back and sufficient revenues must be raised to pay for them.

This suggests a three-part sequencing of action that frontloads deficit-financed economic stimulus in immediate legislation, evaluates long-term investments through the upcoming FY2010 budget process, and begins to impose long-term discipline through a process to be determined at the fiscal responsibility summit recently called for by President Obama.

Strengthening the economy over the next four years requires a careful balance of two very different economic policy strategies. In the short term, we need to increase consumption to generate the kind of activity that will put some of our economy's idle capacity to use. Over the longer run, however, we need to stimulate savings and invest in physical and human capital to increase the capacity of the economy. The tricky part is accomplishing a smooth transition between the two imperatives.

With that strategy in mind, here is a list of suggested principles to guide action by policymakers:

1. Fiscal stimulus must be timely, targeted, and temporary to ensure “bang for the buck” and limit damage to the long-term outlook.

The objective of fiscal stimulus is to immediately inject funds into the economy to prop up consumption and avoid a deep recession. Because this policy would be deficit-financed, it would increase government debt and decrease national savings. Thus, the federal government's immediate actions will likely run counter to the longer-term goal of promoting economic growth through more adequate saving and investment. If properly designed, however, fiscal stimulus need not have an adverse impact on economic growth over the long term, and long-term discipline need not have an adverse impact on economic activity in the short term. We don't need to sacrifice one to achieve the other, but we need to be clear about the trade-offs.

Tax cuts or public spending increases that are intended to stimulate demand in the short term should be “timely, targeted, and temporary” to maximize the economic bang for the buck. Policies that are not likely to generate much additional, immediate consumer and business spending do not constitute effective stimulus and should not be considered in the context of “emergency” legislation. Appropriate policies to include in stimulus legislation should target dollars to those households and businesses that are currently most constrained and hence most likely to spend the cash flow from the stimulus. There should be no commitment to permanent deficit-financed policies that would place ongoing demands on the federal budget beyond the period when demand-side stimulus is needed, because the deficits would undermine longer-term economic goals.

As CBO Director Douglas Elmendorf recently testified before the House Committee on the Budget:

“Those higher deficits... tend to slow economic growth in the long term if they are allowed to persist, because they tend to reduce capital accumulation and the upward trend in the economy’s capacity to produce. Given the large projected shortfall of federal revenues relative to outlays in the medium term and long term, any policy designed to provide short-term fiscal stimulus will have to reckon with long-term consequences. Increases in spending and decreases in taxes that are intended to be temporary may be difficult to reverse later. Moreover, even if taxes and noninterest spending return to their baseline levels, the additional debt service from the period of larger deficits will—unless offset by greater fiscal discipline later—crowd out some amount of future growth.

In addition to their negative long-term effects, policies that substantially worsen the fiscal outlook can have negative short-term effects as well. The nation currently benefits greatly from the fact that investors worldwide tend to flee to U.S. Treasury securities in times of trouble. That tendency provides an important advantage in times of crisis, helping to increase liquidity and decrease interest rates. If investors lost confidence in the government’s debt as a safe haven because of deterioration in the long-term fiscal outlook, the U.S. economy would lose that advantage, perhaps permanently.”¹

2. Distinguish between short-term fiscal stimulus and long-term fiscal investment.

President Obama has stated that the economic recovery legislation “is not just a short-term program to boost employment. It is one that will invest in our most important priorities like energy and education, health care and a new infrastructure that are necessary to keep us strong and competitive in the 21st Century.”² These are important goals, yet the budgetary calculus for longer-term fiscal investments is fundamentally different from that of short-term stimulus.

Former CBO and OMB director Alice Rivlin explained in recent congressional testimony, “Since a sustained program of public investment in productivity-enhancing skills and infrastructure will add to federal spending for many years, it must be paid for and not simply added to already huge projected long-term deficits. That means either shifting spending from less productive uses or finding more revenue.”³

These are the kind of trade-offs that are best dealt with in the regular budget process and not in the context of emergency legislation designed for speed rather than deliberation. As Rivlin observed, “A large combined package [of stimulus and investment] will get attention and help

¹ CBO, Statement of Douglas W. Elmendorf, Director, *The State of the Economy and Issues in Developing an Effective Policy Response*, House Committee on the Budget, January 27, 2009, p.23.

² Radio address, January 24, 2009.

³ Testimony of Alice Rivlin, Senate Budget Committee, January 21, 2009, p.5.

restore confidence that the federal government is taking action – even if part of the money spends out slowly. But there are two kinds of risks in combining the two objectives. One is that money will be wasted because the investment elements were not carefully crafted. The other is that it will be harder to return to fiscal discipline as the economy recovers if the longer run spending is not offset by [spending] reductions or new revenues.’’⁴

The “spend out,” or budgetary cost, of the various proposals matter, but they should matter in terms of how the costs compare with the benefits. With short-term stimulus, the costs of deficit spending should be compared to the benefits on GDP and employment. With longer-term investments, whether deficit spending is justified depends on whether the longer-term economic benefits of such spending outweigh the longer-term costs. And with deficit financing of those longer-term initiatives, those costs include the adverse effects of deficits on national saving, the costs of debt service that will be incurred with compound interest, and the risk to the short-term stability of the U.S. economy from increased borrowing.

Over the longer run, the strength and resiliency of the U.S. economy will depend on our ability to increase national saving. We cannot simultaneously encourage both consumption and saving — they are opposites. We can, however, encourage consumption in the short term without reducing saving over the longer term by maximizing economic bang for the buck over the short term and not committing to deficit-financed spending over the longer term. And we can deficit spend today in *smart* ways so that the budgetary cost is minimized and the economic benefit maximized, by targeting spending on programs that provide immediate assistance during the recession without contributing to ongoing costs.

In addition, to help pay for long-term investments and to ensure public trust that new money is not being wasted, every effort should be made to identify savings from eliminating wasteful and unnecessary programs and increasing the efficiency of other government programs as well as eliminating narrowly targeted tax breaks that add to the complexity of the tax code without producing meaningful economic benefit. Such provisions divert resources from more pressing national needs and increase public cynicism about the fairness of the federal budget. Similarly, there is the potential for increased revenues by closing the “tax gap” — the difference between taxes that are legally owed and the revenues that are actually collected.

3. Fiscal policy must be put on a sustainable path for the long term.

Official sources and independent analysts of diverse perspectives are united in warning that our nation’s overall fiscal policy is unsustainable. Beyond the current crisis looms the growing cost of Medicare and Social Security. The deficits projected under current law, and their adverse effect on savings, investment and economic growth, are very real. The bottom line is that current spending promises cannot be financed at today’s level of taxation. No amount of fiscal stimulus will change that because it is a structural, not a cyclical, problem. A realistic strategy will require reductions in promised benefits, higher revenues, or a combination of both.

⁴ Ibid., p.5.

Getting our nation's long-term finances in order is not only critical for the longer-term health of our economy; it is crucial for the shorter-term stability of our economy as well. While our nation has endured higher levels of public debt as a share of our economy in the past—reaching 121 percent of GDP by the end of WWII—those past debts were financed almost entirely by American investors. Foreign investors now hold about half of the outstanding federal debt, and over the past eight years, about 70 cents of every additional dollar of federal debt has been borrowed from abroad. Our international creditors cannot lose faith in the American government's ability to honor their loans, or our nation as a whole could suddenly be faced with the ultimate "credit crunch" as the true lenders of last resort become less and less interested in lending to us—causing rapid increases in interest rates and a plummeting dollar which would deepen the recession and slow the recovery.

4. Health care reform must reduce the growth in costs.

Achieving a sustainable fiscal policy will require us to slow the growth rate of health care costs. Medicare costs are projected to grow much faster than the economy, and faster than can be reasonably supported in the budget. If President Obama, with the help of Congress, can agree on meaningful Medicare reforms, it may well lead the way to necessary reforms of the broader health care system.

Much of the current talk in Washington about health care policy has focused on expanding health care coverage. While this is an important goal, it would not, by itself, lower health care costs or their rate of growth. Yet, expanding coverage, as a politically popular reform, might provide the momentum for other health care reforms that could slow cost growth--and it will be crucial for these two to develop together and be linked.

Ultimately our nation must decide what level of health care we wish to provide as an entitlement and how much we are willing to pay for it. Costs are not rising because of the proliferation of completely useless medical services. They are rising because medical science can do more for more people—and because what it can do is often very expensive yet always in demand, even if the benefit is incremental or nonexistent.

To control these costs we need better information about the benefits we receive from new procedures and technologies, and we need to come to grips with the need to set limits once we have such information. Investing in Health IT and comparative effectiveness research represents an important first step. However, spending on such investments needs to be carefully planned and tied to a commitment to use the information to improve health care quality *and* reduce health care costs. The initial investment alone does not automatically lead to either, but does immediately increase costs.

5. Social Security must be reformed to ensure its long-term viability and generational fairness.

The demographic and fiscal challenges facing Social Security in the years ahead are well known. Over the next 30 years, Social Security will place a mounting burden on the budget and the

economy. By 2035, the program's projected annual cost of \$1.4 trillion (adjusted for inflation) will equal 6.3 percent of GDP--an increase of roughly 50 percent.

Any Social Security reform plan should be designed to meet three fundamental objectives — ensuring Social Security's long-term sustainability, raising national savings, and improving the system's generational equity.

It is true that the Social Security trust fund shows a positive balance through 2040. However, trust fund solvency is a misleading measure of the program's long-term viability. Social Security cannot be viewed in isolation from the overall federal budget. The trust fund is simply an accounting device keeping track of the program's claims on general revenues with "assets" consisting of Treasury IOU's. It says nothing about how society will meet the growing fiscal burden reflected in those trust fund balances. The key point is that the trust fund assets are also promises to spend future tax dollars. What matters fiscally and economically is Social Security's cash balance—that is, the annual difference between outlays and earmarked tax revenues. Social Security will begin running annual cash deficits in 2017. Thus, the existence of trust fund balances on paper does not change the fact that Social Security will place growing pressures on the rest of the budget and future taxpayers as well as the economy as a whole.

6. Tax reform must ensure adequate revenues while improving efficiency and fairness.

Low rates of taxation generally encourage economic activity by raising the returns to work, saving and investment. Tax policy, however, should not be considered in isolation from spending decisions. If taxes fall too far below spending for too long, the resulting deficits will eventually cancel out whatever positive economic effect there may be from low taxes.

In the current climate of trillion-dollar deficit spending, policymakers need to avoid the temptation to include tax cuts in the recovery package that are likely to be ineffective as short-term stimulus while adding to the federal debt. The goal of maximizing economic bang for the buck in the short term, while contributing positively to national saving and economic growth over the longer term, must be applied to tax cuts as well as spending.

Revenues were already insufficient to cover federal spending *before* the current economic downturn, leaving a gap averaging around 2 ½ percent of GDP over the past 40 years. But the latest CBO report shows a loss of more than \$2 trillion in revenues in the 10-year baseline budget outlook (FY2010-FY2019) due solely to deterioration in the economic outlook. This is even before accounting for the cost of any tax cuts that may be part of the economic recovery plan, or the cost of extending any part of the 2001 and 2003 tax cuts, which under current law expire at the end of 2010. The Concord Coalition's "plausible baseline" (based on CBO estimates) shows that if all expiring tax cuts are extended, revenues as a share of GDP will fall to 17 ½ percent over the next ten years, while spending as a share of GDP will grow to 24 percent, producing a deficit of 6 ½ percent— *before* any new spending or tax cuts considered as part of "economic recovery" policy.

In the final analysis, revenues must be sufficient to pay for the cost of government. Debt is not a painless alternative to taxation. Given the severe upward pressures on federal spending associated with the aging of the population and rising health care costs, it is clear that even with the best efforts to control entitlement spending, the federal government will need to look to the tax side of the budget to provide at least part of the solution to the long-term fiscal gap.

President Obama and the 111th Congress will face an “action forcing event” regarding tax policy almost immediately: the expiration of the 2001 and 2003 tax cuts on December 31, 2010. The expiration of the tax cuts combined with a recovering economy should force policymakers, faced with the reality of a growing fiscal shortfall, to seek a more sustainable revenue policy going forward. Ideally, they will reform the federal tax system in ways that improve economic efficiency, enhance revenues and achieve the desired degree of progressivity at the same time. Increasing revenues as a share of the economy need not discourage economic growth. To the extent that the tax system can be made more efficient by broadening its base—through closing loopholes, reducing tax entitlements and newly taxing activities that generate social costs—marginal tax rates on productive activities would not have to rise by as much.

7. The budget process must improve transparency and accountability.

The federal budget is suffering from a lack of transparency and accountability similar to the private sector institutions the government has been forced to rescue. In recent years official budgets have used a number of scoring tactics that understate likely expenses and overstate likely revenue. It is becoming increasingly difficult to know where the budget is headed, even in the short-term, by looking at official documents.

Equally concerning, the budget process is stacked against long-term accountability. A five or 10-year budget window may have been adequate when most federal spending was appropriated annually. It is insufficient now that so much of the budget consists of entitlement programs on autopilot.

Budget rules alone will never be able to solve the nation’s fiscal problems. Enforcement mechanisms can bring greater accountability to the budget process and help provide elected officials with the political cover to make the tough choices necessary to reduce the deficit. Pay-as-you-go rules (PAYGO) for all tax and entitlement legislation and discretionary spending caps for appropriations are proven tools for fiscal discipline. These enforcement rules, first enacted in 1990 in the Budget Enforcement Act (BEA), were an important part of constraining deficits in the early 1990s and getting the budget back into balance. The lesson to be learned from the overall success of the BEA is that budget process can be an important tool in achieving strategic long-term goals.

The administration has expressed a desire to address the long-term budget outlook and implement PAYGO rules. The Director of the Office of Management and Budget Peter Orszag noted this in a recent letter to House Appropriations Chairman Obey:

“Finally, we need to recognize that this recovery and reinvestment plan is an extraordinary response to an extraordinary crisis. It should not be seen as an opportunity to abandon the fiscal discipline that we owe each and every taxpayer in spending their money – and that is critical to keeping the United States strong in a global, interdependent economy. Although it is not feasible to avoid any spillover whatsoever of the recovery package on out-year spending, the Administration believes that the package should minimize such effects on out-year spending as much as possible. Furthermore, the President is committed to paying for any of the temporary tax cuts included in the recovery plan that he would like to make permanent, and will detail the manner of doing so in his budget submission.

Moving forward, we need to return to the fiscal responsibility and pay-as-you-go budgeting that we had in the 1990’s for all non-emergency measures. The President and his economic team look forward to working with the Congress to develop budget enforcement rules that are based on the tools that helped create the surpluses of a decade ago. Putting the country back on the path of fiscal responsibility will mean tough decision and difficult trade-offs, but for the long-term health of the economy, the President believes that they must be made.”⁵

Similar sentiments were included in a recent memo to President Obama signed by Concord Coalition executive director Robert Bixby and several other prominent budget experts. The memo encouraged the president to use his first budget submission to Congress (Fiscal Year 2010) as an opportunity to “set the stage both for steady economic growth and a sustainable fiscal future,” and suggested a few new budget process reforms, along with renewing commitments to PAYGO and discretionary spending caps:

“Once an agreement for tax and long-term spending reform is in place, it must be enforced by pay-as-you-go rules that require that all tax cuts or entitlement increases be financed by some combination of tax increases and entitlement cuts. Without such rules, a painfully negotiated agreement is likely to erode over time.

In addition, targets for entitlement spending and tax expenditures should be budgeted for the long run, say, 30 years. If unexpected events push spending or tax expenditures above targets, automatic triggers could be used to slow spending growth, increase revenues, or some combination of the two.”⁶

⁵ Letter to Chairman Obey on the American Recovery and Reinvestment Act from OMB Director Peter Orszag (January 27, 2009)

⁶ [*A Budget We Can Believe In*](#) (January 27, 2009), p.5.

8. Establish a bipartisan process.

Since the regular legislative process has thus far failed to confront the impending fiscal crisis, some have suggested that a new bipartisan commission be appointed. This could be a useful mechanism to break the gridlock, but only if it recognizes fiscal and political realities. The commission would need five elements to succeed:

- First, it must be truly bipartisan. Any perception that the commission's purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.
- Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.
- Third, all options must be on the table. If either side sets preconditions, the other side will not participate. This means that Republicans cannot take tax increases off the table and Democrats cannot take benefit reductions off the table.
- Fourth, the commission must engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. When people are armed with the facts and given the opportunity for honest dialogue, they are more likely to set priorities and make hard choices.
- Fifth, the commission's recommendations should be given an up or down vote in Congress, allowing for amendments that would not reduce the total budgetary savings. Absent that, the report would likely join many others on a shelf.

In an ideal world, we would not need another commission to tell us things most people in Washington already know. Moreover, elected leaders--not an appointed commission--must make the ultimate decisions. However, a commission with a broad mandate and no preconditions could provide a credible framework for Congress and the President. Bipartisan proposals by Senators Kent Conrad (D-ND) and Judd Gregg (R-NH) in the Senate and by Jim Cooper (D-TN) and Frank Wolf (R-VA) in the House could serve as a model in this regard.

9. Bring the public into the process.

Changing course will require substantial spending reductions from projected levels, equivalent increases in revenues, or — most likely — a combination of both. Neither party wants to be the first to propose such tough choices out of fear that the other side will attack them. Similarly, neither side wants to discuss possible compromises of their own priorities out of fear that the other side will take the concessions and run. Unfortunately, these fears are justified.

Because these choices are politically difficult, the active involvement of the American people is critical. Without greater understanding of the problem among the public, community leaders, business leaders and home state media, elected leaders are unlikely to break out of their comfortable partisan talking points--and unlikely to find solutions.

The Concord Coalition, The Heritage Foundation and The Brookings Institution have been working with Public Agenda and Viewpoint Learning on a project designed to provide insight into how attitudes evolve as people discuss difficult trade-offs with regard to long-term fiscal policy.

Based on several intensive day-long "Choice Dialogues," a report issued in December 2008 made the following observations:

- “They [the public] want leaders to provide an honest, straightforward assessment of the challenges facing the nation. They are increasingly suspicious of easy answers, and are more aware when they are being pandered to or spun; such tactics tend to reinforce mistrust.
- They do not expect leaders to provide all the answers – but they do expect leaders to give people the chance to wrestle with the tough choices and take citizens’ viewpoints seriously.
- They want to be challenged and play a role in problem solving: being asked to consider hard choices is not a poison pill.”⁷

The desire of citizens to be more engaged in the process was also highlighted in the “Stakeholder Dialogue” portion of the discussions when the participants sat down with elected leaders:

“What seemed to make the difference was not when a leader said something citizens wanted to hear, or when leaders seemed to have the answers. Instead, what seemed to make the most difference was when leaders in the room were honest about their own concerns, misgivings and uncertainties. It was then that citizens began to shift from being critics or petitioners to becoming part of a problem-solving team. After the first hour or two, outside observers at each of these sessions noted that it was very difficult to tell which of the participants was a member of the public and which was one of the elected or civic leaders, as they worked together to find solutions. In effect, trust crept in.”⁸

⁷ [*Changing Expectations: Americans deliberate our nation's finances and future*](#) (September 2008), p.5.

⁸ [*Changing Expectations: Americans deliberate our nation's finances and future*](#) (September 2008), p.14.

Conclusion

“Fiscally-responsible deficit spending” need not be an oxymoron. In the current debate about how to best engineer a strong and sustainable economic recovery, fiscal responsibility in the short run targets deficit-financing to only the most effective anti-recessionary policies. Over the longer term, fiscal responsibility means investing wisely in projects that will contribute positively to economic growth—and being willing to *pay* for those worthwhile projects over time. On both fronts, policymakers should not confuse the *size* of our economic problems with the *benefits* of various policy options. Cost is a poor measure of effectiveness.

The current temptation to throw federal money “out the door” as quickly and energetically as possible is perhaps understandable as a demonstration that the federal government is doing all it can for the American people in response to the economic crisis. But haste may make for a lot of waste, and many proposals being considered as part of the recovery plan are clearly designed to promote economic growth for the *longer* term, where haste is not necessary, and waste is not justified.