Chairman Alan B. Krueger, Council of Economic Advisers
"The Economic Case for a Balanced Approach to Fiscal Policy"
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Remarks as Prepared for Delivery
Embargoed until Delivery

Thank you [Lynn Reaser] for your kind introduction. I'm delighted to deliver the lunch time address to the NABE Economic Policy Conference again this year. Some of you may recall that at last year's conference I spoke about the progress that we had made recovering from the worst recession since the Great Depression. In addition, I discussed the near-term outlook for the U.S. economy. I emphasized several "reasons to be cautiously optimistic about the economy going forward," despite uncertainty about government fiscal policy and the lingering effects of the financial crisis that were then, and continue to be, headwinds for the recovery.

As I am sure you are all aware, our economy has continued to recover over the past year. Real GDP has now grown for 14 consecutive quarters. While many developed economies have struggled to rebound from the global downturn, U.S. real GDP is 2½ percent higher than its previous business-cycle peak. Last year I told you that the Council of Economic Advisers' forecast was that 2 million payroll jobs would be added in 2012. Employment actually rose a bit more, by 2.2 million in 2012. And this rise was entirely accounted for by growth in the private sector, which – thanks to the resilience of the American people – has added more than 6.1 million jobs over the last 35 months.

Since I spoke here last year the economy has continued to show signs of healing from the Great Recession. In the past year the housing market appears to have finally turned a corner, with rising nationwide home prices, sales, and home construction. And new car sales reached their highest level in five years. All of these gains reflect the determination of American businesses, workers and families in the aftermath of the most painful recession of our lifetimes.

Nevertheless, there is still more work that needs to be done. Unemployment remains too high. The middle class continues to struggle with stagnant wages and persistent widening in inequality. Our nation's deteriorating infrastructure cries out for further investment.

And on top of everything else, political gamesmanship in Washington is creating uncertainty and inflicting unnecessary wounds on our economy, just as the recovery is gaining traction. The prime example of this problem, of course, is the sequester – Washington-speak for severe budget cuts – which officially went into effect last Friday. As Goldman Sachs economist Alec Phillips observed, "Sequestration is poorly timed, less efficient than most other forms of deficit reduction, and does little to address long-term imbalances that stem from demographic shifts and the excess growth of health spending compared to revenues."

Given the ongoing debates over the Federal budget, the main theme of my remarks today will be the economic case for a balanced, responsible approach to deficit reduction – which has always been the Administration's position. A critical point—one which others have made, but frequently gets lost in the public conversation over fiscal policy—is that the Federal budget is not an end in itself. The Federal budget is simply the means through which we, as a nation, seek to achieve our economic objectives. As President Obama eloquently stated in his State of the Union Address last month, the North Star guiding our course as a country must be a growing economy that creates good, middle-class jobs. This requires taking steps to make sure that America is a magnet for good jobs that pay decent wages, and that workers have the skills needed to fill those jobs. We must also address the Federal budget deficit, because if we do not put the budget on a sustainable course, we will ultimately not be able to achieve our objective of growing the economy and creating good middle-class jobs.

President Obama has repeatedly called for a balanced approach to deficit reduction. His plan for a balanced approach includes raising additional revenue from those who are most able to contribute, reforms to our entitlement programs so that they will be around for generations to come, and smart reductions in spending that preserve key investments in education and training, research and national security. One thing that is often overlooked is that before the sequester, we have made substantial progress toward reducing the deficit in a balanced way, achieving over $2.5 trillion of the $4 trillion in deficit reduction needed to stabilize our finances over the next decade. We're more than half way there. And we have done this in a balanced way, cutting over $2 in spending for every $1 in new revenue.

My theme today is that a balanced approach to deficit reduction is good economic policy, justified by considerations of *both* efficiency and fairness. Deficit reduction that balances spending cuts, entitlement reform and loophole closing is also in the interest of the macroeconomy and economic growth. Economists should reject the position that says no revenues can be raised from closing unjustified tax loopholes in order to finish the job of stabilizing our finances and strengthening our economy.

The Economics of Balanced Deficit Reduction

As economists, we are naturally accustomed to viewing the world through the prism of costs and benefits, and weighing the costs and benefits on the margin. The proper economic approach to deficit reduction would be to implement policies to the point that they equate the net marginal cost of raising an additional dollar in tax revenues against the net marginal cost of an additional dollar in cuts to programs such as education, research, and defense. This is balance. In principle, optimal fiscal policy would weigh the (at most very small) cost to the economy of reducing loopholes in the tax code, such as the carried interest provision, against the (significant) benefits foregone from cutting Head Start, research by the NIH, border security, and other government functions, as well as entitlement reform. Balance means that we do some of each.

Can anyone believe that it is less distortionary to preserve every loophole and deduction in the tax code in order to cut more deeply the number of children who can go to Head Start or the amount of research that NIH can conduct? I don't think there is much question that it would be more efficient if we eliminated some of the tax expenditures that our wealthiest and most well-connected citizens and businesses take advantage of to enable more children to attend Head Start and to allow NIH to conduct more life-saving medical research.

Compare this approach to the alternative, which says that all of deficit reduction must occur from reductions in government programs, and not a dollar more would be raised from closing tax loopholes. Does anyone believe that on the margin it is more costly to trim back one dime of the trillions of dollars in deductions and loopholes that mar the tax code than to spare one more child a chance at pre-school education, or spare one more grant to a top medical researcher from being cut, or spare one more border patrol agent from being furloughed?

A balanced approach to deficit reduction is not only economically more efficient, it is also more fair. As President Obama said on Friday, it is not fair to "ask middle-class families, ask seniors, ask students to bear the entire burden of deficit reduction when we know we've got a bunch of tax loopholes that are benefiting the well-off and the well-connected…. The American people don't think it's fair and don't think it's right."

<u>Revenues and Outlays</u>
Economists across the political spectrum support policies that will limit the distortionary effects of our tax system. These loopholes don't support economic growth and job creation, so eliminating them is of little, if any, cost to the economy. Additional revenues could be raised in the context of tax reform, in which certain tax expenditures are limited or eliminated altogether. This would simplify the tax code, reduce the ways in which our tax system distorts economic decisions, and achieve that elusive but very popular goal of "broadening the base."

With respect to outlays, it cannot be stressed enough that rising health care costs and an aging population are the key drivers of our long-term budgetary challenges. As a result, to stabilize our long-term finances reforms to mandatory entitlement programs are needed. These reforms would ensure that Medicare and Social Security are solvent for future generations. Importantly, these programs can be made solvent through sensible reforms that protect the most vulnerable. For instance, the reforms that were included in the Affordable Care Act, which the President signed into law in March 2010, have already extended the life of the Medicare Trust Fund to at least 2024. Going forward, the budgetary challenges posed by the Medicare program will be largely contingent on the pace of health care costs.

<u>Timing</u>
A balanced approach to addressing our fiscal challenges must also recognize the importance of timing. The recovery is still fragile. Weak growth in Europe and Asia are limiting our exports. Consumption remains constrained as households are still recovering from the loss of $16 trillion of wealth from the financial crisis despite the rebound in equity markets and firming of home prices.

In the near-term, fiscal policy at all levels of government—Federal, State, and local—should remain focused on supporting the ongoing economic recovery. At the same time, we should take steps to address the deficit in a balanced way in the intermediate and long term.

<u>The Sequester is Poorly Timed and Badly Targeted</u>
Before the sequester, I used to say that we faced two risks when it comes to the government budget. One the one hand, we can lower the deficit too much and too soon, jeopardizing the

recovery. And on the other hand, we run the risk of lowering it too little and too late, creating uncertainty and requiring sharper adjustments later on.

Sadly, the sequester adds a third risk – we can cut the near-term deficit in a dumb way that short changes the future without addressing our long-term budget problems. That is, the sequester forces us to cut spending that supports key investments in education, research, security and infrastructure without addressing our long-run problems. As Bill Hoagland, a former Republican staff director of the Senate Budget Committee recently put it, the sequester eats into "the seed corn of the future." This hurts future generations and doesn't ease the burden of debt they will inherit.

The sequester was not designed as a means to address our budgetary challenges. Rather, it was agreed upon—in the context of avoiding national default, you might recall—as a mechanism to force Congress to come up with a bipartisan solution to our fiscal imbalances. The Congressional "Super Committee" was supposed to come up with a bipartisan and balanced agreement. Unfortunately, the "Super Committee" was unable to pass a plan – even though they had the blunt instrument of the sequester as their "sword of Damocles" and fast track authority. As a result, the sequester was automatically enforced and went into effect last week.

These indiscriminate, across-the-board spending cuts pose a threat to the ongoing economic recovery. You can't take $85 billion out of the federal budget in the remaining 7 months of the fiscal year without hurting the economy and job growth. According to the Congressional Budget Office, the sequester is expected to shave 0.6 percentage point from real GDP growth and lower employment by about 750,000 jobs through the end of this year. Most of these lost jobs will be in the private sector, as businesses feel the ripple effects of government cutbacks.

These cuts will not be felt immediately and uniformly across the country, but the longer they remain in place, the greater the damage will be to our economy. And they will be felt more profoundly and more quickly in some areas than in others. In northern Virginia, for example, it is estimated that federal spending drives 37 percent of the economy (source: Center for Regional Analysis). As federal workers are furloughed a month from now and contracts are cut, families will have less money to spend, and that will ripple throughout the economy. As the President said last week, the sequester is "a slow grind that will intensify with every passing day."

And what do we, as a nation, get in return for this self-inflicted wound? Yes, the sequester reduces spending. But because it largely bypasses mandatory spending programs and doesn't make structural reforms, these automatic cuts do little to address the primary drivers of our longer-term fiscal challenges. The sequester is the antithesis of smart, balanced fiscal policy. It jeopardizes the current recovery at a time when policymakers should be focused on growing the economy and investing in our nation's future. Indeed, Bob Solow warned last week that instead of reinvigorating our economy, "we're heading into an ill-advised, across-the-board austerity program."

President Obama's Plan

President Obama has already put forward a balanced plan that would not only put an end to the sequester but also put our country on a sustainable fiscal footing for a decade. And we have already made big strides toward achieving that plan.

To recap where we are: as a result of the Budget Control Act of 2011, the American Taxpayer Relief Act of this year and earlier actions, President Obama has already signed into law more than $2.5 trillion in deficit reduction over the next 10 years. Most of this deficit reduction—around $1.4 trillion— is from cuts to discretionary programs. More than $600 billion in additional revenues will be generated as a result of the American Taxpayer Relief Act, which was part of the "fiscal cliff" negotiations at the start of this year. The interest savings from these spending cuts and additional revenues amount to roughly $500 billion over 10 years. You sum this up and it is $2.5 trillion toward the $4 trillion goal needed to stabilize our finances.

As a result of this legislation and our recovering economy, you can see from this chart **[slide 1]** that government spending is coming down relative to the size of the economy and revenues, which had fallen to their lowest point since 1950, are growing and projected to grow further. Of course, the difference is the deficit as a share of GDP, which is shown in the next chart **[slide 2]**. (I like this chart because it shows the decline in the deficit relative to GDP independent of the baseline.)

The Federal budget deficit as a share of GDP has already fallen by 3.1 percentage points over the past three years. This represents the *fastest* three-year pace of deficit reduction since the late 1940s. And the next chart **[slide 3]**, which shows CBO projections under current law, shows that the deficit will continue to fall at its fastest post-war pace this year and next, but then rise to 3.8 percent of GDP by 2022.

Although this path inflicts much near-term pain, it does not stabilize our finances. To stabilize the debt relative to the size of the economy we need the deficit to stay at or below 3 percent of GDP. That is why we had a target of $4 trillion over 10 years. So we are most of the way there, but we need to finish the job. And the sequester, which is included in current law, does not finish the job. In fact, it makes the job harder by slowing growth this year and next and distracting from the real driver of our deficit problems – health care costs for an aging population.

President Obama has offered a balanced approach to get our deficits to a sustainable level. It is frustrating to hear claims that the President hasn't proposed a plan to end the sequester and stabilize our finances. He has. Repeatedly. In fact, it's posted on the White House website. You can easily find it by Googling "White House" and "sequestration plan". Here's what you get **[slide 4]**.

And if you click on the links you can find the specifics of the President's last offer to Speaker Boehner last year. This is shown on the next slide **[slide 5]**. This is a balanced plan that stabilizes the debt relative to GDP at a manageable level, ends the sequester, and strengthens the ongoing recovery. On the revenue side, consistent with the Administration's FiscalYear 2013 Budget, the President has proposed to limit the value of itemized deductions to 28 percent for the wealthiest taxpayers and to close other loopholes. This would result in savings of close to $600 billion over ten years. Last December, Speaker Boehner said he was open to $800 billion or $1 trillion in new revenues as part of tax reform that closes loopholes and deductions. Now he says that we got our revenue. Not a dime more. Subtracting the $600 billion in taxes collected by allowing the Bush tax cuts on the top 2 percent to expire under ATRA, that would leave $400 billion in revenue based on his last offer.

As far as spending cuts go, the President has proposed an additional $930 billion in spending cuts that address the main drivers of our deficit. The President has proposed health savings of $400 billion— which by the beginning of the next decade is in line with the amount proposed by the bipartisan Simpson-Bowles commission. Furthermore, the President has offered to use the superlative Consumer Price Index as a more accurate way of measuring cost-of-living adjustments to Federal programs. And the President has offered an additional $200 billion in discretionary spending cuts beyond those required in the Budget Control Act. These are not easy cuts for a Democratic President to propose. President Obama has shown a commitment to doing the hard things needed to stabilize our finances.

Including interest savings, all of these tax and spending changes would result in about $1.8 trillion in additional deficit reduction and stabilize our nation's finances over the next decade in a balanced way. The President has also proposed a temporary growth initiative of investing $50 billion toward fixing our nation's roads and highways to support the recovery in the near term. Research by Ned Gramlich and others has found that spending on maintenance of existing infrastructure has a very high return, and will help to put construction workers back to work right away. Pursuing a growth agenda today is important because, as we saw in the 1990s, and as many developed countries are learning the hard way, nothing restores fiscal balance faster than economic growth to which everyone can contribute and from which everyone can benefit.

You can see from the next slide **[slide 6]** that the President's plan would reduce the deficit below the 3 percent of GDP threshold and keep it there through the end of the next decade.

Counting saved interest spending on the outlay side, the $2.5 trillion in deficit reduction that President has already signed into law is comprised of nearly a 3-to-1 ratio of spending cuts to additional revenues. If the sequester remains in place, this ratio would be pushed well out of balance to around 4 to 1, and our intermediate and long-term deficit problems would still remain. If Congress were to pass the President's proposal, however, the ratio of spending cuts to additional revenues would be brought back into balance at around 2 to 1 and we will have stabilized our debt and deficits relative to the size of the economy for a decade, and made strides in addressing the long-term drivers of our budget deficit.

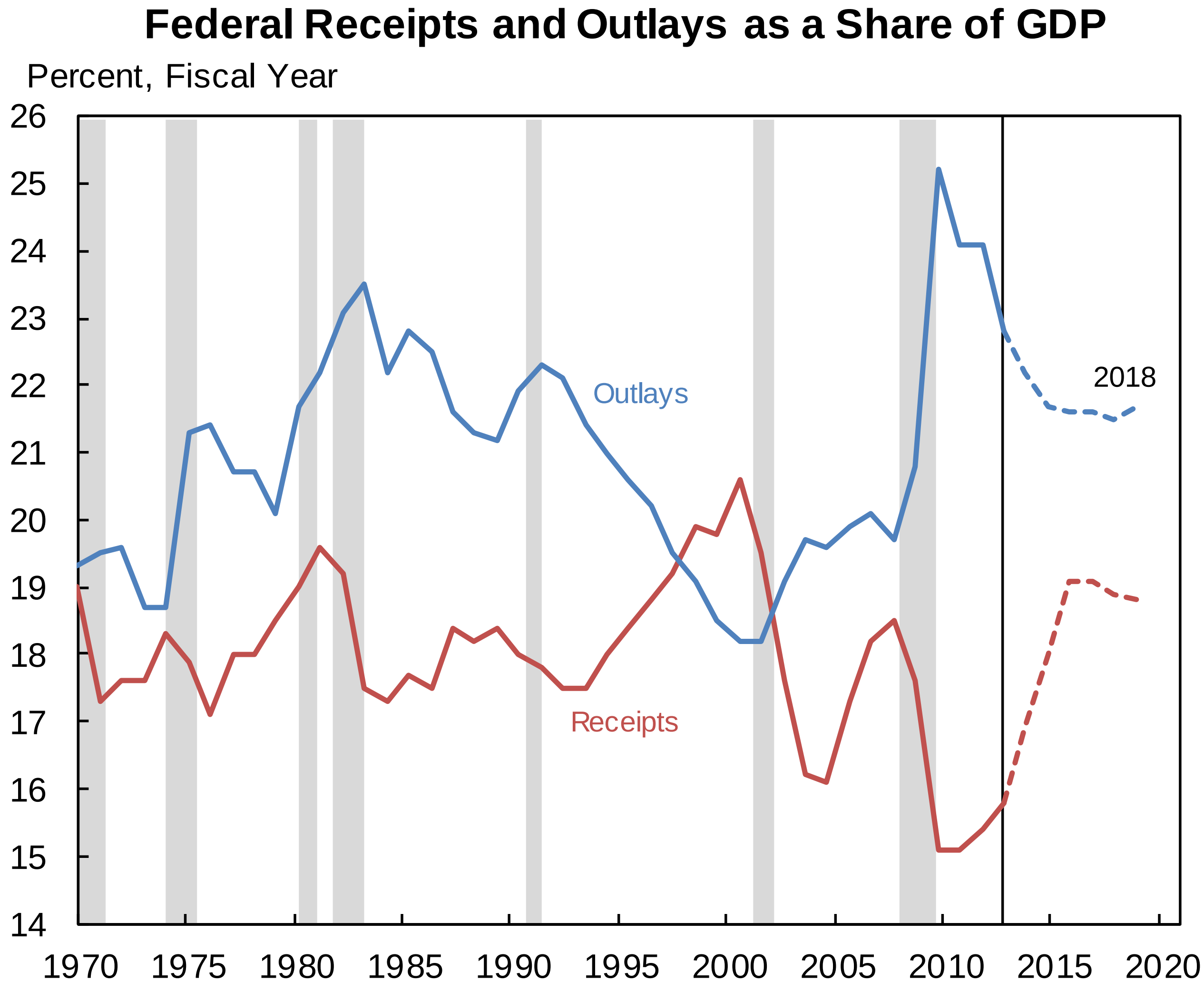
Conclusion

Let me conclude by telling a story. A long time ago, President Kennedy called over to the Council of Economic Advisers late one night with a question. His call was eventually transferred to a young senior economist named Robert Solow. According to Bob, President Kennedy said, "I always forget the difference between fiscal policy and monetary policy. Which is the one I get to control?" Solow responded that the Fed is responsible for monetary policy and the President handles fiscal policy. (In fact, Solow told me that he advised that you can think of M – for McChesney Martin – for monetary policy.)

Now, of course, the President doesn't have full control over fiscal policy. Both Houses of Congress must pass legislation, which the President can sign or veto. This is how our system works. President Obama has made it clear that he is willing to work with the Congress to find a balanced solution to our fiscal challenges. Unlike others at the table, he did not retreat from his final offer in the fiscal cliff negotiations. He has kept on the table a balanced plan to deficit reduction that makes responsible reforms to slow the growth of health care spending for an aging population—the single biggest driver of our long-term debt—and saves hundreds of billions of dollars by getting rid of tax loopholes and deductions for the well-off and well-connected.   But he has never said it is my way or the highway. He has kept his offer on the table, in the hopes that we can reach a bipartisan solution that reforms our tax code and entitlements and puts us on a sustainable fiscal course. There are many ways to reach a balanced solution.

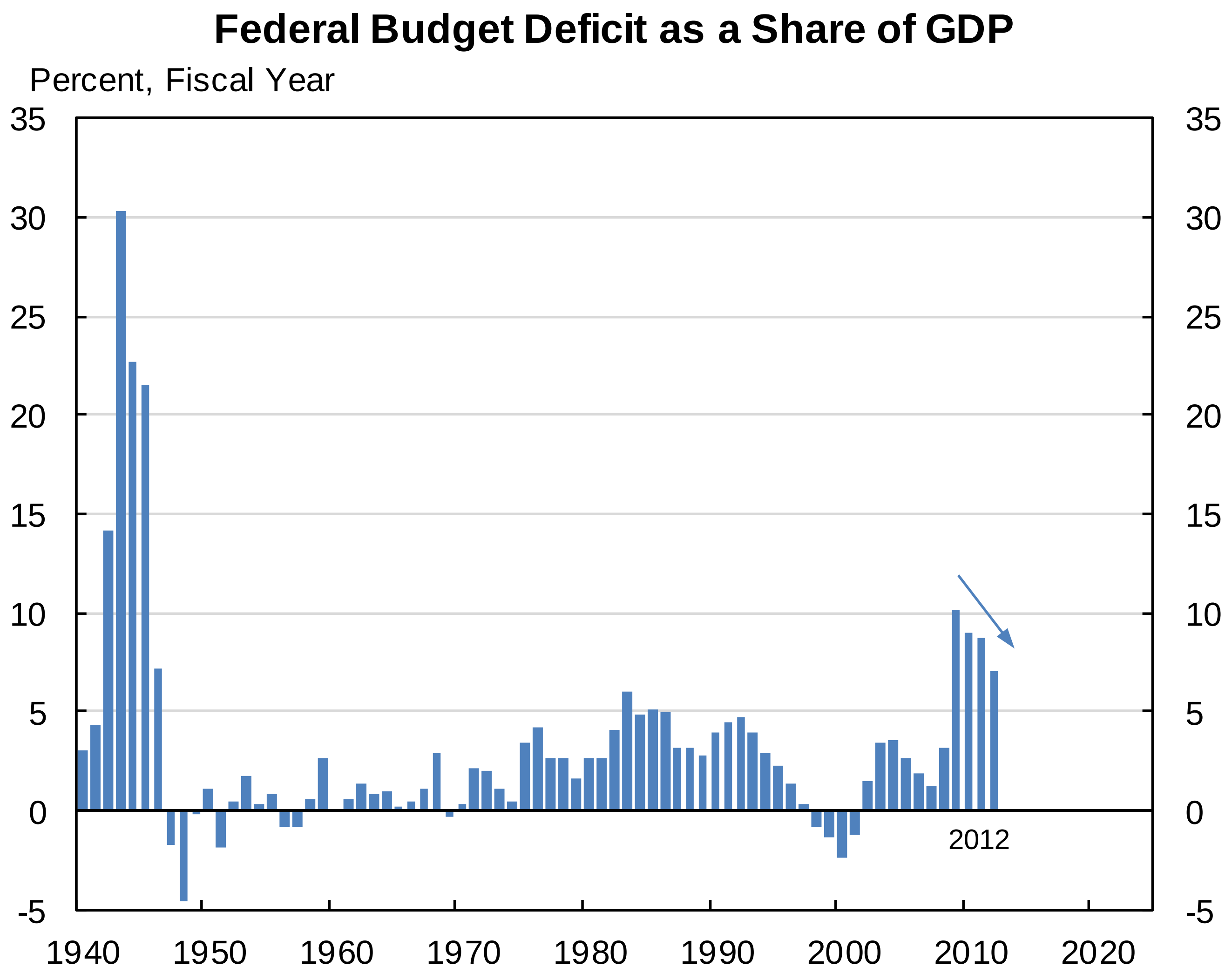
If we follow our "North Star" of growing the economy and the middle class, we will end up with a balanced plan that supports the economy in the near term while we take steps to address our long-term budget deficit. That is the ultimate test that we must apply to government policy. Thank you very much.

Revenues are Projected to Rise and Outlays to Fall, But a Deficit Remains



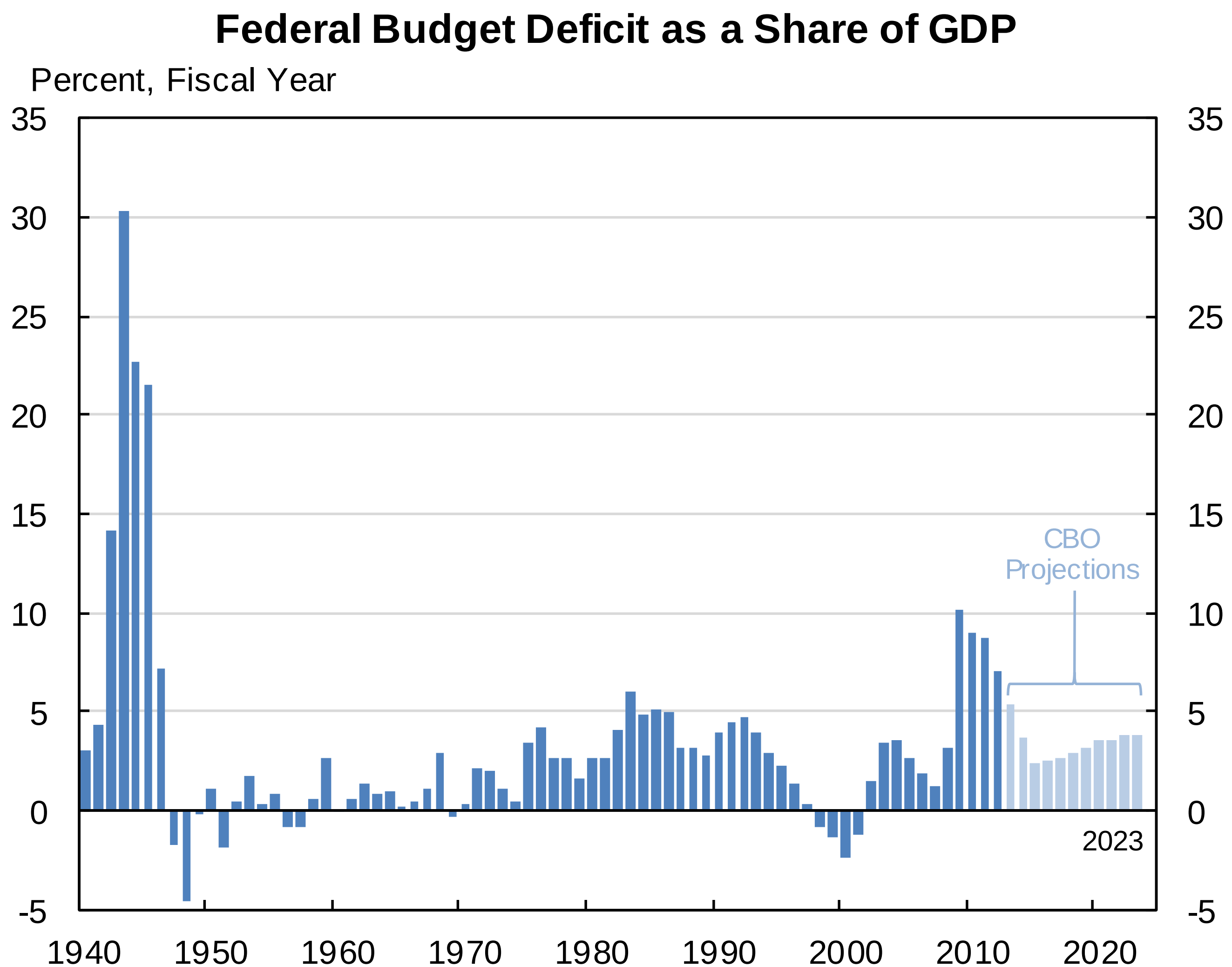
Note: Shading denotes recession.
Source: Office of Management and Budget; Congressional Budget Office.

The Federal Deficit Has Fallen Faster Over the Past Three Years Than at Any Time Since the 1940s



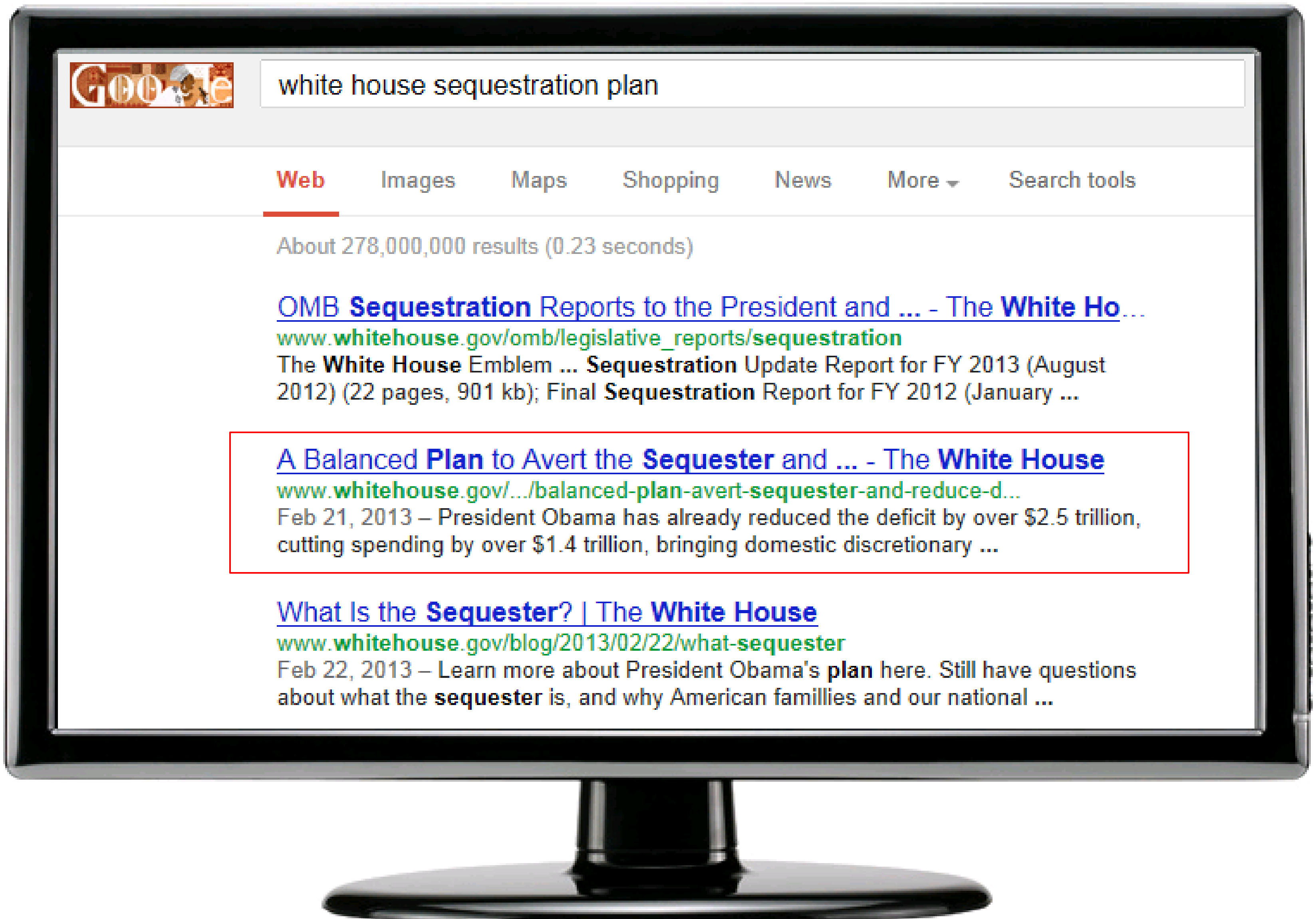
Source: Office of Management and Budget; Congressional Budget Office.

Under Current Law the Federal Deficit is Projected to Decline at a Fast Pace but not Stabilize Finances



Source: Office of Management and Budget; Congressional Budget Office.

Where is the President’s Plan for Averting the Sequester?



Note: Google search conducted on March 4, 2013.

The President's Balanced Approach to Reducing the Deficit

The President's Plan: \$4 Trillion of Deficit Reduction Including the Last Offer to Speaker Boehner (in \$ billions)	
THE PRESIDENT HAS SIGNED INTO LAW MORE THAN \$2.5 TRILLION OF DEFICIT REDUCTION	
Spending cuts to discretionary programs enacted over the past two years (not counting war savings)	**\$1,400**
New revenue from wealthiest in fiscal cliff deal	**More than \$600**
Interest savings	**More than \$500**
Subtotal, Deficit Reduction to Date	**More than \$2,500**
THE PRESIDENT'S LAST OFFER TO SPEAKER BOEHNER IS STILL ON TABLE: MORE THAN \$1.5 TRILLION IN ADDITIONAL DEFICIT REDUCTION	
Spending Reductions	
Even split between defense and nondefense discretionary savings	**\$200**
• Non-defense discretionary spending	\$100
• Defense discretionary spending	\$100
Health savings – could be achieved by:	**\$400**
• Reduce payments to drug companies	\$140
• Reduce hospital payments such as reimbursement for patients who don't pay	\$30
• Encourage efficient care after a hospital stay	\$50
• Encourage beneficiaries to seek high value health care and ask the most fortunate to pay more	\$35
• Medicaid, Pay-for-Delay, IPAB, program integrity	\$25
• Other health savings	\$120
Non-health Mandatory Savings – could be achieved by:	**\$200**
• Eliminate certain subsidies for agriculture	\$30
• Reform Federal retirement programs	\$35
• Reform postal service and TSA passenger security fees	\$40
• Strengthen solvency of UI trust fund	\$50
• Other savings including spectrum fees, sales of excess property, & program integrity	\$45
Spending savings from superlative CPI with protections for vulnerable	**\$130**
Subtotal, Total New Spending Reductions	**\$930 + \$200 interest**
Revenue	
Limit tax deductions to 28% for the wealthiest and close other loopholes	**\$580 (+\$100 from CPI change)**
Temporary Growth Measures	
Immediate investments in infrastructure	**-\$50**
TOTAL DEFICIT REDUCTION	
Deficit Reduction to Date	**More than \$2,500**
New Deficit Reduction	**\$1,800**
Total Deficit Reduction	**More than \$4,300**

The President’s Proposal Stabilizes Our Nation’s Finances Over the Next Decade