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THE ECONOMIC COSTS OF DEBT-CEILING BRINKMANSHIP

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRTEENTH CONGRESS

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THE ECONOMIC COSTS OF DEBT-CEILING BRINKMANSHIP

WEDNESDAY, SEPTEMBER 18, 2013

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 2:33 p.m. in Room 216 of the Hart Senate Office Building, the Honorable Amy Klobuchar, Vice Chair, presiding.

Representatives present: Brady of Texas, Campbell, Carolyn B. Maloney, Cummings, and Delaney.

Senators present: Klobuchar, Casey, Warner, Murphy, Coats, and Wicker.

Staff present: Corey Astill, Doug Branch, Hank Butler, Conor Carroll, Gail Cohen, Sarah Elkins, Connie Foster, Niles Godes, Colleen Healy, and Robert O'Quinn.

OPENING STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, A U.S. SENATOR FROM MINNESOTA

Vice Chair Klobuchar. Okay, thanks to everyone. I would like to call this hearing to order today. I am joined by the Chairman of the Committee, Mr. Brady, as well as a number of Members. I thank you for being here.

I would also like to welcome—maybe I will wait until they come in, some of our guests; I do not think they are here yet—here they come. We have a number of guests visiting us today from the Republic of Ireland and Northern Ireland. They are in the United States as part of the Boston College Irish Institute's Joined-Up Program. Thank you for being here. You are in for a treat, let me tell you.

We have a very important topic today. I would like to introduce our witnesses.

We have first of all Dr. Mark Zandi who is the Chief Economist at Moody's, where he directs economic research. Dr. Zandi was an advisor to the presidential campaign of Senator McCain and has provided economic advice to Congress for many, many years.

Secondly, The Honorable David Malpass is the President of Encima Global, an economic research and consulting firm based in New York. He served as Deputy Assistant Treasury Secretary under Ronald Reagan, Deputy Assistant Secretary of State under President George H.W. Bush, and Republican Staff Director of the Joint Economic Committee. That's the most important credential that you have.

[Laughter.]

We also have The Honorable David Marron who is an institute Fellow and Director of Economic Policy Initiatives at the Urban Institute. He served as a member of the Council of Economic Advisers under President George W. Bush, and as the Acting Director of the Congressional Budget Office. He was the Executive Director of the Joint Economic Committee under Chairman Robert Bennett. There we are, another former Joint Economic Committee staff member.

He recently served as a member of the Rivlin-Domenici Debt Reduction Task Force. We have actually had Alice Rivlin here to testify, so thank you.

Also, Dr. Daniel Mitchell is a Senior Fellow at the CATO Institute where he specializes in tax reform policy. He was previously a Senior Fellow with the Heritage Foundation and an economist on the Senate Finance Committee. He also served on the 1988 Bush/Quayle transition team and was Director of Tax and Budget Policy for Citizens for a Sound Economy.

You may think it interesting that we have four Republican witnesses here when I am chairing the hearing, but I think it goes to show this is a bipartisan issue and something that we have to come together on as a country, and there are differences among our witnesses, as we will soon see.

In the summer of 2011, the United States experienced some of the costs of a protracted debt-ceiling showdown. As Congress struggled to raise the debt ceiling, the Dow Jones Industrial Average dropped more than 2,000 points, and Standard and Poor's downgraded the U.S. credit rating. Consumer confidence also fell sharply.

During that debate, I heard from nearly 20 CEOs of major companies in my state urging Congress to set partisan divisions aside and reach an agreement to raise the debt ceiling.

The delay in lifting the debt ceiling and the resulting uncertainty meant that the Treasury had to pay higher yields than otherwise would have been necessary, costing taxpayers $1.3 billion.

After the 2011 debt-ceiling showdown, Federal Reserve Chairman Ben Bernanke told this Committee in very blunt language that "It's no way to run a railroad." He is right.

We now find ourselves in a similar situation: the Federal Government effectively reached its borrowing limit on May 19th, 2013. The Treasury Department has taken extraordinary measures since then to postpone default for several months.

Last month, Treasury Secretary Lew informed Congress that those extraordinary measures would run out in mid-October. In other words, we have about a month left to take action that will allow the U.S. Government to pay our bills—while we are at the same time of course facing, with the Continuing Resolution issue, potential government shutdown.

We should learn from our experience in 2011—and not repeat it. We have seen this show before, and it reminds me of like a bad rerun of "Three's Company." We don't have to have this happen. We can actually get this done.

There is broad agreement that a default would cause significant harm to the economy. It would disrupt financial markets, limit access to credit, and raise financing costs. It would also trigger a run

on money market funds and force the Federal Government to renege on commitments to individuals, businesses, and governments.

For consumers, higher credit costs would mean less borrowing for purchases of homes, cars, or other durable goods. Businesses could face difficulties accessing short-term financing.

A default would also require the Federal Government to suspend payments to creditors, program beneficiaries, and others. Delays in Social Security checks, Veterans benefits, and other programs would have a direct impact on millions of Americans and would negatively affect the economy by depressing consumer spending.

Because a default would cause significant harm to the economy, even the mere prospect, as we've learned from the past, even the mere prospect of a default can affect the decision-making of households and businesses and slow economic growth.

As discussed in the report that I released this morning on the costs of debt-ceiling brinkmanship, Congress has raised the debt ceiling more than 70 times since 1962, and voted on the debt limit 12 times since 2002. This is part of our responsibility.

It is also clear that Democrats and Republicans need to come together on a long-term budget plan and focus on smart, balanced solutions to reducing our debt. We have had many discussions about this right here in this Committee. I am in the group of Senators that wants to go big; that believes we need to take the principles from the Debt Commission report, as well as the Rivlin/Domenici report, and take those and put them into action. But the place to do that is not at the last minute on the debt-ceiling issue.

The Senate and House have each passed a budget. The President has been reaching out to Democrats and Republicans about the need to move forward on a budget deal. Many of my colleagues, including Senator McCain and Senator Collins, have joined Democrats to say we need to go to conference and agree on a budget that will allow us to address our fiscal challenges in a bipartisan way.

While we have to do more to move the Nation forward toward fiscal responsibility, it is important to note that Congress has already taken steps to reduce deficits by at least $2.4 trillion over the next 10 years.

But the vast majority of the savings to date comes from spending cuts. If sequestration continues, the ratio of spending cuts to revenue increases will be four-to-one, which is not the ratio even suggested by the National Commission on Fiscal Responsibility and Reform.

The Senate-passed budget also calls for a roughly even split between additional spending cuts and revenue increases.

In addition to addressing the budget and raising the debt ceiling, there are a number of actions Congress should take to make sure that our economy continues to grow.

One of them I will tell you is passing the Immigration bill: $160 billion in debt reduction over 10 years, around $700 billion in 20 years.

If you look at the Farm Bill, $24 billion reducing the debt over the last Farm Bill. You can go through a number of things that I think would make a difference for the economy and make things positive for the economy. Brinkmanship on the debt ceiling is not one of them. It will move us backwards and not forwards.

I thank you to our witnesses, and look forward to hearing from you.

Mr. Brady.

OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Chairman Brady. Vice Chair Klobuchar, our Distinguished Witnesses, and our Guests from the Republic of Ireland and Northern Ireland, welcome.

On this Committee we often jest that Minnesota's delegation tends to dominate the Joint Economic Committee. I just want to give warning: As an Irishman, I have brought my reinforcements today.

[Laughter.]

Vice Chair Klobuchar and I agree that political brinkmanship over raising the debt ceiling is costly to our economy. I just wish President Obama felt as we do. His declaration this past weekend, quote, "What I haven't been willing to negotiate, and I will not negotiate, is on the debt ceiling"—represents the inflexible brinkmanship that the American people deplore.

Despite the recent decline in the federal budget deficit, future projections are troubling. Add to that an ever-growing national debt, Medicare whose main Trust Fund runs empty within 12 years; and Social Security that had to borrow nearly $150 billion last year from foreign investors and the Fed, simply to make payments to our seniors. As Dr. Zandi noted in his testimony, " . . . the long term fiscal outlook remains disconcerting."

This bleak outlook hurts middle-class families and the 20 million Americans who cannot find a full-time job today in the weakest recovery since World War II.

That is why House Republicans have reasonably and prudently passed a bill to take default off the table and invited the President to sit down together—today—to find a bipartisan solution that puts Washington on a responsible fiscal path through pro-growth tax reform, ending wasteful spending, and taking substantive steps to extend the lives of Medicare and Social Security.

Children born today in America owe nearly $50,000 as their share of the national debt. In other words, they owe a Lexus to Uncle Sam. If Washington does not change its spending ways by the time they reach 13 years old, they will owe another Lexus. And when they graduate from college ready to begin their career, they will owe yet a third.

Of course young people do not buy luxury sedans for Uncle Sam. Instead, they pay the price for this generation's spending addiction through a sluggish economy with higher taxes and higher interest rates. So if they are able to find a job, they will have lower wages and keep less of their paycheck to pursue their American Dream.

For the first time in our history, we cannot be confident that the next generation of Americans will be better off than the current one. That is unacceptable.

Admittedly, the debt ceiling is an imperfect vehicle to control the growth of federal spending. I would prefer that Congress and state legislatures amend the U.S. Constitution to limit the growth of federal spending and require a balanced budget except during war or

emergencies. However, the debt ceiling remains an effective tool for Congress and the President to reach bipartisan consensus on measures to limit the growth of federal spending and reform entitlements.

Both parties, Democrats and Republicans, have used the debt ceiling as a responsible means to shore up America's financial house—the Omnibus Budget Reconciliation Act of 1990 came about through debt ceiling negotiations between Congressional Democrats and President Bush, and the Budget Control Act of 2011 came about through debt ceiling negotiations between House Republicans and President Obama.

It is irresponsible to give the White House another blank check. Instead, it is responsible to limit the growth of federal spending and secure the future of entitlement programs in exchange for raising the debt ceiling.

If now is not the time to tackle Washington's spending addiction, when is? Perhaps brinkmanship is just another word for a long over intervention.

One of today's witnesses, Dr. Mitchell, summarized good fiscal policy in a simple golden rule: Private output should grow faster than government spending. In other words, Main Street should grow faster than Washington. I agree.

Some advocates of "big government" claim that modest savings from the recent sequester are decimating government services and threatening economic growth. The reality is that since the recession ended, real federal consumption and investment spending has grown faster than real GDP—6.4 percent compared with 4.6. The sequester is merely asking this 500-pound Federal Government to lose 10 pounds.

What ails our economy is not too little government, but too much. Therefore, I will soon reintroduce the Maximizing America's Prosperity or the MAP Act to limit the growth of federal spending through a new, innovative spending cap—non-interest spending as a percentage of potential GDP.

Using non-interest outlays as the numerator in the spending cap forces Congress to limit what it can control—program spending—through appropriations bills and changes in entitlement legislation, but not what it can't—interest outlays—that are determined by past spending decisions and the Fed's monetary policy.

Using potential GDP as the denominator eliminates the boom and bust cyclicality in spending caps tied to GDP. The growth of GDP fluctuates with the business cycle, allowing blowout spending in boom years and then forcing deep cuts during recession. Using potential GDP provides a more stable, solid path for federal spending over time.

Vice Chairman Klobuchar and I might not agree on what's the right level for a spending cap, but we should be able to agree on the right metrics. And non-interest spending as a percent of potential GDP is that right metric.

I look forward to the testimony of today's witnesses.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 30.]

Vice Chair Klobuchar. Thank you very much, Chairman Brady. Why don't we begin with Dr. Zandi.

STATEMENT OF DR. MARK ZANDI, CHIEF ECONOMIST, MOODY'S ANALYTICS, WEST CHESTER, PA

Dr. Zandi. Thank you, Vice Chair Klobuchar, and Chairman Brady, and the rest of the Committee. I welcome the opportunity to be here today.

I am an employee of the Moody's Corp., but the views I express today are my own. I would like to make four points in my oral remarks:

First, the Treasury debt limit must be increased by the last two weeks of October. By my calculation, the day the limit will be breached is probably October 18th. That's a day when Treasury has to make a payment to Medicare and Medicaid providers.

It is of course very uncertain because of the timing and size of tax payments, so I do not know that for sure. I think the latest possible date that the limit has to be increased is November 1st. That is when a Social Security payment has to be made.

So in the last two weeks, it is very important that you raise the debt limit by that point in time.

The second point: If you do not raise the debt limit in time, you will be opening an economic Pandora's Box. It will be devastating to the economy.

Now let me first say, I would not take any solace in the fact that financial markets are not going to react up until the day that you need to raise the limit. As Senator Klobuchar has said, we have seen this show before. And each time the show ends with you signing on the dotted line just in time. Financial markets fully expect that you will do that this go-around. So I do not expect to see much going on in financial markets up until the time that the limit is going to be breached.

If you do not do it in time, confidence will evaporate. Consumer confidence will sharply decline. Investor confidence, business confidence, businesses will stop hiring, consumers will stop spending. The Stock Market will fall significantly in value. Borrowing costs for businesses and households will rise.

The other big hit to the economy of course is that the Treasury will have to eliminate its cash deficit and only spend what it is receiving in cash. By my calculation, in November that is about $130 billion. You annualized that, that is 9 percent of GDP. That comes right out of the economy. We will be in the middle of a very, very severe recession, and I do not see how we'd get out of it. There is no monetary policy response in the current context. We are already at a zero interest rate. I just don't see what policymakers will do.

So point number two is: You have to do something about the debt limit, D-day.

Point number three: To address the debt limit I would not add to the near-term fiscal austerity. We have a significant amount of austerity entrained. This year, you add up the effect of the spending cuts and the tax increases, it's about 1½ percentage points of GDP, that's the most fiscal drag this economy has had to digest since just after World War II during the War drawdowns.

So just for context, if fiscal policy was just neutral with respect to the economy, zero, given that the economy is growing 2 percent with the drag, we would be growing 3½ percent right now. So that is quite significant. That is a significant drag.

Now the drag will fade under current, last, next year, and the year after, but it is quite significant. I would not add to it in your attempts and efforts to address the debt limit. So that is point number three.

The final point, point number four, is that it is entirely appropriate and desirable for you to address our long-term fiscal problems. They are quite significant and daunting. Under current law, under reasonable economic assumptions, we are going to have a big problem a decade out. When you move into the 2020s and 2030s, the deficit will rise sharply and the debt load will become unsustainable. So it is very important for you to start focusing on that.

Now that may be a bridge too far in the current context because again you have to raise the debt limit by the last two weeks of October. So at the very least, I would be focusing on reforms to the budget process in terms of adopting things that will create transparency with respect to budgeting longer run things like adopting generational accounting, fiscal GAPP accounting. I would extend the budget horizon past 10 years so that we can start doing some entitlement reform and really see what the impact will be in the longer run.

And finally, I would repeal the debt limit. It is very counterproductive. And if you cannot manage that, there are some reforms to the debt limit that can be implemented to make this much more effective and a lot less destructive.

Let me finally say, I think our economy is on the verge of some very strong growth. The only missing ingredient is a decision, a reasonable decision in a timely way on the budget and the debt limit. If you can do that, we are going to be off and running.

Thank you.

[The prepared statement of Dr. Mark Zandi appears in the Submissions for the Record on page 32.]

Vice Chair Klobuchar. Very good. Thanks for ending on that good note, and the opportunities that we have.

Thank you.

Mr. Malpass.

STATEMENT OF HON. DAVID MALPASS, PRESIDENT, ENCIMA GLOBAL LLC, NEW YORK, NY

Mr. Malpass. Thank you very much. Hello, Vice Chairman Klobuchar, Chairman Brady, and Members of the Committee. Thank you for the invitation to testify on the debt limit. I will try to have some upbeat thoughts as I go along, as well.

The debt limit increase is a vital economic and legislative issue. The national debt already exceeds the Nation's annual output, and the Administration is now requesting that Congress increase the debt limit above $17 trillion.

As part of providing this increase, I think there should be an honest, national debate on federal spending priorities, and an agreement with the President on constructive spending restraint.

There is a huge economic upside for jobs, investment, the Stock Market, and the dollar if you could lower the federal spending path, or rewrite the debt limit to make it more effective.

The Federal Government is spending nearly $3.6 trillion every year, and is planning to increase spending rapidly in coming years, even with the sequester and the underfunding of national defense.

Some of the spending is successful and adds to the Nation's wellbeing, but another portion of the spending—several hundred billion dollars—is not successful enough to justify the taxes and debt used to pay it. This has created a spending and debt crisis that harms the economy and undermines investment and jobs.

The crisis is particularly acute because several categories of federal spending will need to increase over the next two decades as the Baby Boom ages and requires more government services.

Given this demographic and interest rate cycle, spending and debt should be at lower than normal levels now in order to prepare for the coming increases. In addition, the maturity of the national debt held by the private sector should be longer than normal. Instead, the Fed's bond purchases have materially shortened the effective maturity of the national debt, and both spending and debt are at record levels even though the demographic bulge is just beginning to hit the federal budget.

This leaves fiscal policy completely out of sync with long-term economic growth. The debt limit provides a good opportunity to address this crisis. In negotiating the next increase, Congress and the Administration should take steps to downsize current spending and slow future spending growth.

It is also vital to improve the allocation of spending. Less-successful government programs should be reduced in order to make room for new programs and for more spending on successful programs.

In my August 30th Wall Street Journal column I advocated a menu approach in which the various parties suggest numerous methods to reduce spending, and then negotiate a compromise.

I have advocated replacing the debt limit with legislation to establish continuous spending restraint that strengthens when the debt-to-GDP ratio rises above a ceiling. I was privileged to work for Senator Bill Roth on this Committee in 1990 when he wanted to create a 50 percent debt-to-GDP limit.

Unfortunately, the debt ratio is now more than double that, and it will take many years of continuous spending restraint to restore a more pro-growth debt level. In the ideal, there should be a downward glide path for the debt ratio. A new law would set gradually lower debt-to-GDP limits which, if exceeded, would require Congress and the Administration to reduce their spending commitments or face escalating procedural restraints on spending.

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. Austerity or fiscal consolidation encompasses two separate economic policies: government downsizing on the one hand, which causes more growth; and private-sector downsizing on the other hand, which causes recessions.

Many of the reform programs undertaken in Europe that have been labeled "austerity programs" were harmful because they were built on private-sector austerity not government downsizing. The austerity often took the form of higher value-added taxes, wealth taxes, and increases in government fees.

As the U.S. examines its options, it should aim to reduce ineffective spending. It drains the private sector because it requires new taxes or debt. An open Washington discussion of spending restraint, even a contentious one, using a menu of options as I've suggested would receive a very positive market reaction.

So in conclusion, the U.S. is stuck in a new normal of very slow economic growth, high unemployment, and falling median incomes. Federal spending and debt trends are weighing on growth and investment. The debt limit provides an opportunity to break out. The Administration and Congress should create a menu of constructive restraints and agree on a package.

Movement in this direction would create a very positive economic and market reaction. Changes made now, even if they take effect in several years, would bring immediate benefits by improving the debt outlook.

Thank you, very much.

[The prepared statement of David Malpass appears in the Submissions for the Record on page 43.]

Vice Chair Klobuchar. Thank you very much.

Dr. Marron.

STATEMENT OF HON. DONALD MARRON, INSTITUTE FELLOW AND DIRECTOR OF ECONOMIC POLICY INITIATIVES, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. Marron. Thanks. This is a real treat to be here. Vice Chair Klobuchar, Chairman Brady, and Members of the Committee:

Thank you for inviting me to discuss the debt limit. It is a particular pleasure for me to appear today before this Committee, since it gave me my start in public service a bit more than a decade ago.

I would like to make six basic points today:

First, Congress has to increase the debt limit. Failure to do so will result in severe economic harm. Treasury would have to delay billions, then tens of billions, then hundreds of billions of dollars of payments. Through no fault of their own, federal employees, contractors, program beneficiaries, and state and local governments would find themselves suddenly short of expected cash, creating a ripple effect through the economy.

A prolonged delay would be a powerful anti-stimulus that could easily push our economy back into a recession, as Mark said.

In addition, there is a risk that we might default on the federal debt. Now I should emphasize that I expect that Treasury will do everything in its power to make debt service payments on time, if it's pushed to the limit, but there is a risk that it won't succeed.

Indeed, we have precedent for this. In 1979, Treasury accidently defaulted on a small sliver of debt in the wake of a debt limit showdown. That default was narrow in scope, but financial markets reacted badly and interest rates spiked.

If a debt limit impasse forced Treasury to default today, the results would be much more severe. Interest rates would spike. Credit would tighten. Financial institutions would scramble for cash, and savers might desert money market funds. Anyone who remembers the financial crisis should shudder at the prospect of reliving such disruptions.

Second, Treasury doesn't have any super-extraordinary measures hidden away in a desk drawer if the debt limit is not raised in time. Pundits have suggested that Treasury might sidestep the debt limit by invoking the Fourteenth Amendment, minting extremely large platinum coins, or selling gold and other federal assets. But Administration officials have said that none of those strategies would actually work.

Third, debt limit brinkmanship is costly even if Congress raises the limit at the last minute. As we saw in 2011, brinkmanship increases interest rates and federal borrowing costs.

The Bipartisan Policy Center, building on work by the Government Accountability Office, estimates that that crisis will cost taxpayers almost $19 billion in extra interest costs. Brinkmanship also increases uncertainty, reduces confidence, and thus undermines the economy.

In 2011, for example, consumer confidence and the stock market both plummeted while measures of financial risk skyrocketed.

Finally, brinkmanship weakens America's global image. The United States is the only major nation whose leaders talk openly about self-inflicted default. At the risk of sounding like Vladimir Putin, such exceptionalism is not healthy.

[Laughter.]

Fourth, as this Committee knows well, our economy remains fragile. Now is not the time to hit it with unnecessary shocks.

Fifth, as the CBO confirmed yesterday, the long-run budget outlook remains challenging. Deficits have fallen sharply in the past few years, but current budget policies would still create an unsustainable trajectory of debt in coming decades.

Congress should address that problem, but the near-term fiscal priorities are funding the government and increasing the debt limit.

Finally, Congress should rethink the debt limit and indeed the entire budget process. Borrowing decisions cannot be made in a vacuum separate from other fiscal choices. America borrows today because this and previous Congresses chose to spend more than we take in—sometimes with good reason, sometimes not.

If Congress is concerned about debt, it needs to act when it makes those spending and revenue decisions, not months or years later when financial obligations are already in place.

When the dust settles on our immediate challenges, Congress should re-examine the entire budget process, seeking ways to make it more effective and less susceptible to dangerous after-the-fact brinkmanship.

Now I have completely failed at the challenge of saying something upbeat, so in conclusion let me say that I think actually all of these challenges are soluble with good spirit and working together. And thank you for inviting me to appear today.

[The prepared statement of Dr. Donald Marron appears in the Submissions for the Record on page 45.]

Vice Chair Klobuchar. Thank you very much.

Dr. Mitchell.

STATEMENT OF DR. DANIEL J. MITCHELL, SENIOR FELLOW, CATO INSTITUTE, WASHINGTON, DC

Dr. Mitchell. Thank you very much, Vice Chair Klobuchar, Chairman Brady, and other Members of the Committee:

I have five points I want to make. I am a centrist. I am between Mark's four points and Donald's six points.

First, it is very important to understand that our chief fiscal problem is excessive federal spending. Deficits and debt are undesirable, of course, but they are simply ways of financing government spending; and the other ways of financing government spending—higher taxes and printing money—they are also undesirable.

In other words, we should look at government spending on things that it is not very efficient at doing. That is sort of the underlying disease, and deficits and debt are symptoms, but so are higher taxes.

Second, the best way to gauge good fiscal policy, as Chairman Brady indicates, is to try to control government spending so it grows slower than private sector economic output. If you do that, you are shrinking the burden of federal spending as a share of GDP over time and you get a very positive self-reinforcing cycle in that ratio of government spending as a share of GDP where the numerator is shrinking and denominator is growing.

If you do not do that, if you allow government to grow faster over an extended period of time than the private sector, sooner or later—it might be 5 years, it might be 50 years—but sooner or later, you are going to wind up like Greece. Because it is a mathematical certainty that if government for a long period of time grows faster than the private sector, you get in trouble.

Why? The private sector is your tax base. And if government is always growing faster than the private sector, no amount of tax increases in the long run are going to solve the problem. And that is assuming that you identify fiscal balance as the problem rather than the overall burden of government spending.

Third, I want to say something very optimistic. It is possible to make rapid progress with even a modest amount of spending restraint. Consider what has happened in the past two years.

For the first time in five decades, the government spending in nominal terms has shrunk, where government spent less last year than the year before, and less that year than it spent before that. And what has happened during that two-year period? Well the burden of government spending has fallen from 24.1 percent of GDP to 21.5 percent of GDP. And for those who focus on red ink, it is worth noting that that period of fiscal restraint resulted in our deficit going from $1.3 trillion to $642 billion.

And indeed, if we maintain some sort of fiscal discipline going forward, it is amazing how quickly we can make progress. If government grows just 1 percent a year, we balance the budget in 3 years. If it grows 2 percent a year, we balance the budget in 4 years. And if we let government grow 3 percent a year, we balance the budget in 7 years.

Indeed, it is worth noting what happened in Canada in the 1990s. They had a 5-year period where government spending grew 1 percent a year—and this was mostly under a liberal party control in Canada at the time—in that 5-year period, they went from hav-

ing a 9 percent of GDP deficit at the start, to a small budget surplus at the end.

And it is worth noting that of course their economy grew faster, not slower, as the burden of government spending fell.

My fourth point is that an increase in the debt ceiling is not needed to avoid default; it is needed to avoid messy budgeting; it is needed to avoid some of the complications with payments to providers, state and local governments, and all those other things that Donald mentioned. But when you have annual interest payments of $230 billion, roughly, and annual tax revenues approaching $3 trillion, you do not need to be a mathematical genius to realize that the Treasury Department should be able to manage that and avoid default, even though, as I said, it would be a messy process for other parts of the budget.

Indeed, I even quote Donald in my testimony—but since he is here, let me go ahead and cite two other people: Stan Collender said, quote: " ... it's worth taking a few steps back from the edge" " ... a default wouldn't be automatic because payments to existing bondholders could be made the priority while payments to others could be delayed for months."

The Economist Magazine said, quote, "Even with no increase in the ceiling, the Treasury can easily service its existing debt; it is free to roll over maturing issues, and tax revenue covers monthly interest payments by a large multiple."

The only caveat would be if for some reason the Treasury Department did not want to pay interest on the debt, and I do not think that is realistic or likely at all.

My final point is that a fight on the debt limit might be worthwhile if it generates some sort of good fiscal policy outcome. And let's look at Greece as an example of what not to do.

There is nothing akin to a debt limit in that country. But imagine there was. And imagine that a group of lawmakers, say 15 years ago, dug in their heels and said, no, we are not going to allow more red ink. That probably would have caused a lot of turmoil at the time, but if the net result was to force Greek politicians to restrain the growth of spending over a multi-year period, then it is quite likely that the people of Greece would have been spared the economic and fiscal misery that they are suffering right now.

Let's close with an analogy. Yesterday's long-run fiscal outlook from CBO shows that a do-nothing or status quo approach guarantees fiscal chaos. In other words, we are in a car. We are heading toward a cliff. We do not know whether we are going to hit that cliff in 5 years, 25 years, but if we do not take steps now when it is relatively easy, we will eventually cause a crisis.

So I suggest that we should begin to steer away from the cliff, perhaps by adopting something similar to Switzerland's debt break, which is of course akin to Congressman Brady's MAP Act, to impose annual limits on the growth of government spending.

Thank you, very much.

[The prepared statement of Dr. Daniel J. Mitchell appears in the Submissions for the Record on page 53.]

Vice Chair Klobuchar. Thank you very much, Dr. Mitchell. I wanted to first touch on this concept that if we just let this go that we are okay.

I guess history for me means something. When you look back at what happened in 2011, costing taxpayers $1.3 billion because of the higher yields that had to be paid, and this is in our report; the fact that we had the Dow drop 2,000 points; the fact that we had our credit rating downgraded. And from what I have heard from these credit rating agencies, we can expect this to happen again at great peril to our economy.

Just as you have pointed out, Dr. Zandi, we have this possibility of actually gaining ground right now vis-a-vis the rest of the world.

So could you respond to some of the other witnesses here in terms of what they have said? And I think Dr. Marron also noted even a small lapse of the debt ceiling in a certain area created some major problems.

Dr. Zandi. Yes. I think the 2011 experience is obviously very instructive. I think the difference between the experience we are going to go through over the next few weeks and then, then investors really had no roadmap. They did not have the good sense of how Congress would behave and whether you would come together at the end and sign on the dotted line.

It came pretty close, and it did create a lot of angst, and markets fell, and confidence eroded, and it is costing us even to this day in the form of a higher interest rate.

But in the current context, I think people and investors are fully anticipating that at the end of the next few weeks when we reach that day of reckoning when there is no way for the Treasury to use extraordinary measures to navigate around the limit, that you are going to act. And that is why you are not seeing anything in financial markets. That is why stocks prices——

Vice Chair Klobuchar. Do any of the witnesses think that the President will sign a bill, or the Senate will pass a bill that either defunds Obamacare or delays the funding of Obamacare? Because that is what is attached to the House CR, one of them, and then to the—right now, to the debt ceiling proposal.

Dr. Zandi. Right.

Vice Chair Klobuchar. And so that is my concern, when we talk about brinkmanship, is that that is what is there right now. And I completely understand using a discussion of the debt ceiling as a way to talk about our debt, and I have been supportive of the efforts of the Gang of Eight, and these other groups, and have supported their work and would like to move forward, and thought that Speaker Boehner and the President were not that far apart in their negotiations at the end of the last year, which would have meant we would have had a much more long-term approach to debt reduction than the kind of band-aid we got at the end of the year.

I just wanted to turn, Dr. Marron, to——

Mr. Malpass. Madam Chairman, you asked what could the Senate do, and I think the Senate could respond to the House with alternative versions of spending restraint.

The House is looking at it saying we do not want to spend money on this. And so it is incumbent on the Senate to come back and say, okay, we disagree with that, but we would like to see reductions in spending in this other area. So that you get a negotiation process going.

The market would respond very favorably to that, if your response was one of reasonable offers of spending reduction.

Vice Chair Klobuchar. Well I think when you look at the CR, there is not a set number right now on the CR. And I think that negotiations on that number could occur. But the issue is that we are not even there because what we have been told is we cannot get this bill unless we defund Obamacare.

And I just wanted to go to one last point here, Dr. Marron, about the business community. You work with the business community, and I was remembering back in 2011, a coalition of nearly 500 business leaders wrote to Congress and the President urging Congress to put aside our differences and come together for the good of the country and the debt limit.

The letter said: A great nation, like a great company, has to be relied upon to pay its debts when they become due. And then it went on to discuss the negative effects on business.

I personally, as I mentioned, some of our most conservative CEOs sent a letter saying: I know there may not be an agreement on how to do this. We think this has to be done in terms of the long-term debt, but the debt ceiling is not the place to play games in terms of the effect it is going to have on our employees and our businesses.

Could you address the business concerns?

Dr. Marron. Sure. I mean, so I absolutely agree. The United States Federal Government has the full capability of paying its bills as due. And we ought to be carrying out our obligations to the beneficiaries who are relying on them.

We ought to be a good business partner to the businesses that rely on us to pay them for the services they provide to the Federal Government. And for all those reasons, we have the capability. It is in our own interest, and it is the moral thing to do. For all those reasons, I think we ought to be sure that we pay all our obligations on time.

Vice Chair Klobuchar. Okay. Very good. I stayed within my five minutes, I'd like to point out to the entire Committee——

[Laughter.]

Next, Chairman Brady.

Chairman Brady. Thanks. Thank you all for testifying today. You are well respected. The points were really well made, and we appreciate it and it is very timely.

So let me ask a question: Does anyone believe the President's and the Senate Democrats' position that we will pass a debt ceiling limit without any checks or balances on spending, does anyone here believe that is going to happen? Maybe that is the other, the flip side of this brinkmanship rhetoric.

I appreciate the points that this is—the debt ceiling is one of the few remaining opportunities for restraining expansion of the Federal Government. And Vice Chairman Klobuchar said the same in 2011. Now it is time to have the vote tied in with getting some progress on the long-term debt for the country.

And I think that is where Republicans and Democrats actually agree going forward.

So, very briefly, Mr. Malpass, you made the case that it is economically important to restrain the growth. So what are the one

or two most key elements Congress ought to be focusing on on that restraint in that area?

Mr. Malpass. I think it is useful to have both sides offering their vision of how to restrain spending. There are ample areas. Senator Enzi was in New York on Monday and said there were $900 billion of spending restraint that is available to Congress.

We have seen in the recent Ag bill a huge amount of extra spending. Each of these is going to be painful. My bottom line is that Congress should, and is almost required by its responsibility, to prioritize spending so that there is a concept that some of it is less vital than others.

Chairman Brady. And you are thinking both continuing within discretionary funding, because there is still spending that is less of a priority there, and as well as the steps we take to make Social Security and Medicare solvent for future generations?

Mr. Malpass. Yes. In yesterday's CBO numbers, they showed the rapid growth of entitlements in the outyears. So it would be very market positive if Congress began talking about ways to slow the growth in entitlement spending.

It would set the U.S. apart from other countries in its ability to adjust to the aging demographics.

Chairman Brady. So our government's financial outlook is getting worse, not better, as we sit here today?

Mr. Malpass. Yes. Because of the trend path in spending, the debt is going to mushroom. It is vital that steps be taken now to find ways to have an open discussion of ways to slow down that growth in spending.

Chairman Brady. Thank you.

Dr. Mitchell, you take the controversial position that a short-term default would not be nearly as damaging as the consequences of our long-term financial insolvency. I note that the House has already passed legislation that takes default off the table; that requires the Federal Government Treasury to pay the bonds as they come due in full interest. It looks like we are getting set to do that again on Friday.

You know, do you think that is one avenue that helps reassure markets in the short term so that we can actually focus on solving, together—Republicans and Democrats—the long-term problem we have?

Dr. Mitchell. Well I do not think that default is on the table at all for the reasons I mentioned earlier, with nearly $3 trillion of revenue being generated and only about $230 billion of annual interest payments.

So unless the Treasury Secretary wanted the U.S. to default, which I am sure he does not, it is just unrealistic. My argument is that short-term controversy and fiscal mess, as Donald mentioned because of the payments for other things besides interest payments on the debt would be a relatively small price to pay if at the end of the day, we avoid the kind of truly horrific, catastrophic fiscal problems that you see in European countries that never did have an action-forcing event like a debt limit that enabled them to get control of spending.

So are we willing to incur a little bit of headache and hassle and fighting now to avoid a much, much bigger fiscal crisis at some

point down the road? And if I knew when that was, I would be one of these rich Wall Street guys. But, you know, all I know is it is going to happen if we do nothing.

Chairman Brady. So you are saying the most dangerous and risky path is continuing the unrestrained spending and ignoring the problems with our entitlements?

Dr. Mitchell. Yes. If you look at that CBO Long-Run Fiscal Outlook, it is very, very clear that the growth of entitlement programs, left unreformed, will be an enormous burden on our economy. Even if a couple of trillion dollars of revenue just floated down from Heaven, that would not change in my mind that the argument that we need to make Medicaid and Medicare and Social Security more structurally sound with the kinds of reforms that people have been talking about.

Chairman Brady. As I yield back, I recall a hearing here two years ago when we asked experts—Republicans and Democrats—what is the true debt ceiling of America? What is the point where investors lose confidence?

And from all parties, the answers were relatively the same. Which is: We don't know. It's sooner than you think. Don't wait to find out. Act as soon as you can.

Vice Chairman.

Vice Chair Klobuchar. Thank you very much.

Representative Maloney.

Representative Maloney. Thank you very much. And I would like to welcome all the panelists, especially Mr. Malpass who is from the Great State of New York, and a former candidate for the United States Senate. We appreciate all your testimony.

This morning President Obama urged CEOs to call on Congress to avoid the debt ceiling showdown and the damage it would do to business and the economy. He described the financial brinkmanship that was taking place. He called it terrifying, and it should not be tied to ideological arguments, which is what is happening in Congress.

In a general sense, do you have any reports—or maybe you could get it to me in writing, if not right now—of the damage that it did to our economy in the 1970s, and the other times that we have just gone up to the brink? And how harmful is it? And this uncertainty certainly has a terrible impact on businesses.

Senator Klobuchar talked about the letters that came in from American business urging us to work together and avert it in the past, and we do not seem to have the same type of voices from American business now as we have had in the past. Why do you think that is? That American business is not weighing in with the letters and the phone calls that we have gotten in the past? Maybe they just believe it is not going to happen—your point, Mr. Zandi—but in a general sense, your response to this?

Mr. Malpass. Very nice to see you.

My sense is, the markets have examined carefully the actual dynamics of debt payments during the 2011 incident. What I am seeing and hearing right now is, no real market concern about either a default or a technical default.

My thought would be that there is going to be less of a market reaction throughout this period because we went through the experience in August of 2011.

Representative Maloney. Dr. Zandi.

Dr. Zandi. I think we have become desensitized. We have gone down this path a number of times—2011, and——

Representative Maloney. Same old same old.

Dr. Zandi. Yes. And each time we have the brinkmanship, there is vitriol, we hit each other over the head. But at the end of the day when it comes down to brass tacks, we come to an agreement. And there is a hundred percent certainty in the marketplace right now that that is the movie we are going to see.

If we don't—and in fact, I would argue, in a couple, three weeks—say we get into the early part of October and no one is fashioning a narrative, or a storyline with respect to how this is going to work out, then the markets will start to react. Because they will say, how is this all going to play out?

And then a couple, three days before D-day, whenever that is, October 18th, or October 21st, the markets are going to react very violently. So it is going to be: I am okay. And then it is going to be: I am not okay. And then you are not going to be able to get that back into the box.

Representative Maloney. And Chairman Brady——

Mr. Malpass. Madam, if I may, we should note that July and August of 2011, the bond market reacted favorably to the risk of default. Meaning, the yields fell sharply during that period of time.

From a bond market standpoint, investors tend to run into the Treasury market the bigger the risk of a stalemate in Washington.

Dr. Zandi. Just a point of clarification, a very important one. The Treasury yields fell. Every other yield rose. So borrowing cost to businesses, borrowing costs to consumers, to households because of higher mortgage rates because of the spreads widened because of the concern.

Representative Maloney. Well Chairman Brady also talked about tying deficit reduction to any of these negotiations, but tying it together creates another type of uncertainty for businesses and investors. And this uncertainty would jeopardize economic growth.

But we do need to reduce the deficit. And Senator Warner has been so effective in pointing that out in his studies, also. But have we swung the pendulum too far? We have achieved $2.4 trillion in deficit reduction. The CBO came up with a study last week saying that sequestration was costing 1.7 million jobs in one year; and that the severe cuts are hurting the economic growth that expands the economy.

And so the whole type of indiscriminate spending, I tell you I just got out of an election in New York City. I have never seen it so bad. Forty-five percent of the population is near poverty line, or poverty line. People are afraid of not being able to even stay in their apartments because of the recession, downturn in the economy.

The $40 billion, now we're going to have it on the Floor, cuts in the SNAP program, where people do not even have the food they need. So are the cuts getting too close? Some people think it should be a one-to-one, but it is now like a four-to-one spending cuts to

revenue increases. And is this—how much more deficit reduction is needed to put the Nation on a sustainable fiscal path? And how should we balance between spending cuts and revenue increases?

Have we reached a point where we are overall hurting the economy? And I would like to ask Dr. Zandi. You know, he is an economist who gets fired if he is wrong. So I always like to hear him. When you work for a think tank, you don't necessarily get fired; but if he's wrong for Moody's, they're going to fire him.

Dr. Zandi. Yes, they will. Yes, they will.

[Laughter.]

I only have to be right, though, like 53 percent of the time.

[Laughter.]

So they'll leave me alone. I think the fiscal austerity, the spending cuts and tax increases that you speak of, in the near term is overdone. If I were king for the day, I would smooth that in over a longer period of time to allow the private economy to digest that fiscal drag.

So we are navigating through it. It is painful. Our economy is very lackluster. Unemployment is still very high. It is not coming down quickly enough, in large part because of the austerity. But nonetheless, I think ideally it would be better to smooth that in over time.

Clearly we needed to bring down the deficits. We needed to get the deficits down at least to stabilize the debt-to-GDP ratio. But we are doing that awfully quickly and taking a big chance in the process.

Representative Maloney. Any other comments on it?

[No response.]

Vice Chair Klobuchar. All right, thank you very much, Representative. Representative Duffy.

Representative Duffy. Thank you, Madam Vice Chair.

Thank you, panel, for being here today. You know, I did not necessarily run for Congress in 2010 to come here and raise the debt ceiling. I came here to reform the way we spend, reform the way our government works.

But I've got to tell you, I am willing to raise the debt ceiling. I am willing to take that vote and get some trouble back at home as long as we engage in a reform of the way we spend.

I am willing to vote if we reform our entitlement program. But for the panel, or my friends across the aisle to say, listen, we just want a straight debt ceiling increase with no real reform? I think you are going to be hard-pressed to find colleagues on my side of the aisle to actually vote for that.

So when we talk about brinkmanship, we all have to come to the center. And my good friend, Senator Klobuchar, might say, well, listen, we're not going to give up on Obamacare, whether defunding it or delaying it, but we will come to the table and we will actually look at our entitlement system. We will look at the way we spend.

But we have to engage in some form of a dialogue where we can meet in the middle. And I think brinkmanship is one where one side—like the President says, hey, I will negotiate with Syria, or with the Russians, but I won't negotiate with Republicans on the debt limit.

That is brinkmanship. In 1990—you guys only went back to 1990, but in 1990, as you guys recall, Democrats held the Bush Administration hostage over the debt ceiling. Same goals. Different tools were used, but same goals.

Just to look back, you guys are well aware of a quote from March 16th, 2006, from a famous Senator. He gave a Floor speech where he said:

Increasing America's debt weakens us domestically and internationally. Leadership means that the buck stops here. Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. America deserves better. Therefore, I intend to oppose this effort to increase America's debt limit.

You guys all know who that—who gave that famous speech, right? President Barack Obama.

And so when we talk about brinkmanship, I am not in favor of that. But I am also in favor of a group of men and women from both parties and both Chambers coming together to find solutions to this problem.

And so I guess, Mr. Zandi, and Mr. Marron—I'm slaughtering your name and I apologize—do you think this is a one-size solution? Are you telling—are you here testifying today that we should just increase the debt limit without any negotiation on reforming how we're spending? That is not your position, is it?

Dr. Zandi. Well what I am here to say is: You need to raise the debt limit. I mean, there are no options. Otherwise, it is disastrous and it is counterproductive to your own goals because it is going to result in a recession, bigger deficits, and raise the debt.

You know, my sense is that both Democrats and Republicans have negotiated and debated the debt limit since the debt limit has been around, since 1962 or whenever it was put into place. So it has been used by both sides.

But that does not make it right. You know, you can only put the gun to your head so many times before someone is going to make a mistake and pull the trigger, and it is to everyone's detriment.

So, you know, maybe this is the best time to say: Look, this is not the way to run a railroad.

Representative Duffy. And maybe to this point, I mean the panelists have all agreed we have to reform the way we spend. There are long-term consequences for the fiscal course we're on. I don't think anyone has disagreed with that.

One of the problems is our entitlement system. And the long-term issues that that brings 10 and 15 years down the road. My question is: Where is the plan coming from the President that says: Listen, I may not like Paul Ryan. I don't like the House budget. But let me tell you my plan to reform entitlements that is going to bring us on this pathway to sustainability, or reform spending that brings America on this pathway to sustainability, where there we can come together and negotiate?

I have not seen that plan yet. I mean, the budgets that come out, they never balance. They never, ever, ever balance, the President's budget doesn't. I don't know if they're political documents, but at some point if we are going to negotiate outside of the debt limit, we need to be able to have an honest conversation.

And if you cannot get people to come to the table and honestly talk about these problems, I do not know how we come to a resolution unless you get a deadline that says we are all going to come to the table or there's going to be big problems.

Does anyone disagree with that?

Mr. Malpass.

Mr. Malpass. No. I agree. And I think there's not enough emphasis on the upside. There's been a lot of talk about brinkmanship or the idea of going up to the end, but in reality I think it is going to come up to voters. There ought to be a presentation by Members of ideas about how to restrain spending, creating a national debate that begins to make progress on this.

We have a gigantic spending problem in the Federal Government, and it is time today to start down this path. This has been going on year after year, where you say, well, next year we are going to deal with some way to restrain spending.

I think right now is as good a time. Markets are in a very healthy condition. And so it is a good time to have this debate.

Dr. Mitchell. Congressman, if I could add one thing. The President has never proposed a plan that balances, but one thing that concerns me is that he did say the value-added tax was, quote, "something that has worked for other countries." This does make me worry that he sees Europe as a role model to follow, when certainly the events that we are seeing with the welfare states collapsing in many European countries should be a warning sign to all of us that we cannot allow government spending to grow; it has already climbed since the end of the Clinton Adminstration from total government spending on the U.S. at about 32 percent of GDP to now 37, 38 percent of GDP. We cannot allow it to climb to European levels at 45 or 50 percent of GDP.

Representative Duffy. And before I get gaveled down—which I am right now—I would just note that I think you make a good point with regard to some countries that are going through fiscal problems today. Fifteen years ago I bet they do wish they'd had a debt limit and people held them accountable to get that reform done. That's a great analogy.

Vice Chair Klobuchar. And I want to take you up, Representative. We're turning to Senator Warner who has done so much work in this area, but we want to get our Senate budget and House budget to conference committee. So if you could join us, that is where we can have this discussion, and that is why Senator McCain and Senator Collins have joined us in saying let's get them to conference committee. That is the place to have this discussion, and not with a few weeks to go on the debt ceiling.

So with that, I turn it over to Senator Warner.

Senator Warner. Thank you, Vice Chairman.

You know, I have not been here that long but I have been in business a lot longer than I have been in politics, and it is stunning to me that anybody that would claim economic expertise would say that messing with the full faith and credit of the United States of America is a responsible action.

I mean, it is mind boggling. I am going to make a couple of comments here. There has been no major industrial nation that has ever gone through a significant default and recovered. I mean, Ar-

gentina did a decade ago, maybe not a major industrial nation but depending on the estimates 40 to 60 percent of net wealth in that country disappeared in a few days, a few weeks.

The analogies back to 2011 when our first absurd actions around here, when, yes, perhaps money moved to T-bills a bit because we looked only slightly less worse off than Europe, and we still had a few remaining bullets of extraordinary actions on monetary policy—that have all been spent now.

The Fed acted today to extend one more time actions that, you know, can only go so long because of our inability to do our basic job. We, candidly, ought to all get fired if we don't raise this debt limit.

Again, I respect my colleagues and people on the panel who say we need to control spending. We absolutely do. And I have laid out a series of plans with Republicans and Democrats that make major changes to entitlements.

But I find it stunning to me that there are people that think that this can be solved on simply one side of the balance sheet, without looking at any historic norms on the revenue side as well. With an aging population. And even with the entitlement changes that are needed, any notion that we are going to be able to drive spending down to 18, 19 percent GDP with an aging population and increasing medical technology is so divorced from reality that it is, you know, it is not a budget that has I think again much merit.

I desperately think the challenge here has been about how we find revenues. I think the New Year's Eve deal was a bad deal, and a huge missed opportunity to do the major economic entitlement transition and change that needed to be made. And the relatively marginal amount of additional revenue that is needed to be made, this is the thing that is so absurd.

We took $4.5 trillion out of the revenue stream on the so-called Bush-or-Obama, because both parties were part of this tax cut. Nobody is talking about putting $4.5 trillion back in the revenue stream.

Simpson-Bowles, roughly about 1.5. Gang of Six, about 1.2. We're talking about putting about a third of that back in the revenue stream, along with major entitlement changes. That is a negotiating point that would be valid.

I would argue—I mean, memo to Congress going forward, I would simply say when we set up the so-called Budget Control Act we set up, let's think of the stupidest thing we could do as a default mechanism to make sure that we would not allow that to happen. It is called "Sequestration."

I would ask any of my colleagues in either party to come with me to NIH, or come with me to Hampton Roads, where we have so many of our military installations, and see the cancer that is eating at the insides of both the people who are making long-term commitments to public service, our Nation's readiness; or from a business perspective. The House budget, which over about a 10- or 11-year plan, takes domestic discretionary spending from 16 percent of spend when you can't count tax expenditures down to about 4 percent.

I spent my career investing in businesses. I would never have invested in a business that spent less than 5 percent of its revenues

on training and equipping its workforce, investing in its plant and equipment, which is our Nation's infrastructure, and in a global economy staying ahead of the competition, which is R&D. And yet that is our business plan at this moment in time.

That is a business plan that I would have never accepted. It was a business plan that, candidly, Mitt Romney would have never been able to get through Bain Capital. So I urge, and I accept, candidly, the fact that a lot of folks on my side of the aisle have not been willing to go as far as we need to go on entitlements.

And let's have that discussion. But anybody that says on any historic basis, looking at the past 75 years of when those five or six years when we've had balanced budgets, when those revenues have ended up between 19.5 and 21 percent, that somehow we're going to get back to a historic 18 percent revenue line that is going to be sustainable with anything approaching what the American people have come to expect, is again divorced from reality.

So I appreciate the Chair and the Vice Chair holding this hearing, but I guess I would have to say—and both sides bear plenty of blame—but the notion that the greatest Nation in the world with the dislocation in Europe, with China slowing down, with India's economy almost grinding to about 4 percent growth, with countries like Turkey and Brazil that we saw as growing, with the uncertainty that we see—and I will acknowledge I have been a bit of a debt Cassandra, I know I've been called on my side—you know, we got through the debt limit that didn't crash. We got through the so-called Super Committee, we didn't crash. We got through the stupid fiscal cliff.

But I tell you, I think this time we are playing with fire exponentially greater without virtually any other tools to react.

So my apologies to the panel that I went past my time.

Vice Chair Klobuchar. Oh, it was more than worth it. Thank you, Senator Warner. It was very good. Thank you.

Senator Warner. Thank you.

Vice Chair Klobuchar. All right. Senator Coats.

Senator Coats. Well I appreciate the passion of my colleague, and I know that he spent an extraordinary amount of time and effort trying to pull together bipartisan support for putting together the larger plan which would incorporate a number of factors that could have put us on the path to fiscal health.

And I was not a central part of that, but I was a part of it, and I think the Chairman was also, and a number of efforts have been made, as you know, over the past three or four years to achieve the so-called "deal" that reassures investors around the world, reassures the financial markets, and sends the message that they have finally gotten their act together. And even though this will require a long-term effort to get to where we ultimately want to get, just coming together in support of something of that magnitude, which would include probably tax reform, a significant comprehensive tax reform, which would include entitlement, structural entitlement reform, puts them on the glidepath to continued sustainability, which it's not on now. Which would have incorporated both revenue and meaningful spending.

Replacing sequester with something far more efficient in terms of how we separate the essential functions of the Federal Govern-

ment—that we all want and know we need to Support—from "well, this would be nice to do, but we just don't have the money to do it, and once we get it, maybe we should take it up" from "why are we even doing that in the first place?"

But despite the efforts, whether it's the Gang of Six, the Committee of 12, Simpson-Bowles, Domenici/Rivlin, all the efforts, the Dinner Party Group that I've been a part of—they have all come up short. And they have not—and it has led us to a series of crises, whether it is debt limit crisis, whether it is a funding next year's government crisis which we are facing here in just a week and a half—it has not removed that cloud of uncertainty that exists.

You know, you talk to CEOs, business people, whether they are small, medium, or large, they are essentially kind of frozen in place in terms of hiring, in terms of expanding, in terms of research and development commitments, in terms of looking to the future.

Now the discouraging part of all this is that, despite all these efforts, it appears that there is no real early solution in place. The Congress is divided on how best to go forward regarding revenue versus spending.

The public is divided in terms of what we think they want us to do. I think it is fair to say that the current Administration is holding to a formula which cannot be accepted by the Congress.

And so, despite this, we have stumbled through. I think everyone acknowledges that we could have been doing much better.

My question is: Stepping away a bit from the debt limit, anticipating that probably we are going to keep doing these kind of things for the next three-and-a-half years, we are going to have a new President in 2017. Based on your knowledge of where we are, what we have done so far, some of it constructive and helpful, but likely what we won't do going forward for the next three-and-a-half years, what is that new President going to face when he sits down with his team, his economics team, and says okay, where are we? And what kind of situation are we in?

Are we going to continue to have to rely on some outside precipitating factor like what happened in Europe, a Greece, or a crisis, or a spike in interest rates that is going to drive us to some type of compromise solution?

I would just like to get your thoughts on that. Why don't we start with Dr. Zandi and go down the line, and that is my only question, and give the panel a chance to address that question.

Dr. Zandi. I think if you can, if Congress and the Administration can come reasonably together and pass a budget, fund the government, extend the debt ceiling, and do nothing else, nothing else, the economy will kick into gear and in 2017 the next President will be facing an economy that is pretty close to full employment.

I fully agree that we have long-term fiscal problems. Entitlement reform is necessary. Tax reform is necessary. But the key issue, the only missing ingredient to a much better economy over the next few years to really getting things rolling here and getting us back to full employment, is for you all to come to terms and just sign on the dotted line and we will be off and running.

Senator Coats. But part of my question was, not only was——

Vice Chair Klobuchar. Senator Coats, because you had already gone over your time, we are just going to give each witness 30 seconds, like Dr. Zandi, to answer it, if that is okay. Thank you.

Mr. Malpass. Thank you. Some quick points. It would be a missed opportunity right now to pass this opportunity by. I think critical is to take small steps. If there were simply one program that you knew of in the vast government that there could be bipartisan consensus that it could be downsized, that would go a long way. That would be a starting point. It is something we are not doing right now.

By the time you get to 2017, if you assume things stay as they are now, that means there will not have been a single program that you can identify that needs to be downsized. That means U.S. growth will have been slower. We will have millions of people unemployed, or who have not found a job because of that inaction going on right now.

Senator Coats. Dr. Marron.

Dr. Marron. So clearly we will miss many opportunities to do larger things. A couple things that will press. One emergency that is going to come in the 2016–2017 time period the disability portion of Social Security, whose Trust Fund will likely run out of resources. And so the new President in 2017 may face that as a pressing new immediate fiscal challenge.

And then one thing that will happen is, a lot of the uncertainty around the implementation of health reform will presumably be resolved by then—not all, by any stretch, but we will learn a lot in the next few years about how health reform operates or doesn't operate, which I think will be very important information for thinking about health care going forward.

Dr. Mitchell. I will say something optimistic. In the last two years, because we have actually reduced government spending a little bit two years in a row, the deficit has fallen by more than 50 percent, and the burden of government spending has dropped by a couple of percentage points of GDP.

If over the following three years before the next President takes office, we limit the growth of government so it grows by one percent a year, the new President will have a balanced budget and be in a much stronger position to start considering some of the entitlement reforms to deal with the long run.

So I think there is light at the end of the tunnel if we can just make sure the trend lines are correct in terms of the growth of government versus the growth of the productive sector of the economy.

Senator Coats. Madam Chairman, thank you.

Vice Chair Klobuchar. Very good, Senator Coats. I know we're almost done here, so if you want to stick around and ask Dr. Zandi your second question, we're not going to do a second round but you can do it on your own.

And next we have Senator Murphy.

Senator Murphy. Thank you very much, Madam Vice Chair. Thank you for having this hearing. Thank you to our witnesses.

Sorry I'm a little late in getting here, but am glad to be here in time for Senator Warner's very passionate case on behalf of a balanced approach. I think he makes as good an argument as anybody

in this place as to ultimately what our approach has to be to get beyond government and budget setting by manufactured crises.

But I guess I look at it at a little bit simpler level. And that is in terms of making a distinction between policy and process.

When I got to the gas station to fill up my car with a tank of gas, that is policy. I have made a decision that I need gas in the tank and I'm going to pay for that, and maybe as a consequence I am not going to, you know, go out and get an ice cream with my kids that night.

The process is when I stick the card in the machine to pay for it. That's not a decision that I make. That's just a consequence of the decision I made when I filled up the tank of gas.

And as I listen to people prognosticate as to how this whole thing may play out over the next several weeks, that there's some suggestion that maybe we will do a continuing resolution and then a couple of weeks later potentially abrogate American debt obligations, the hypocracy to me is just stunning; that within weeks we would make a policy decision to spend more than we are taking in, and then just a handful of days later essentially refuse to pay the bill, the equivalent I think of essentially filling up your tank and then driving off.

My question, though, is about what this all means for the flow into the United States of foreign investment. I was in Europe—I'm Chair of the European Subcommittee on the Foreign Relations Committee—I was there earlier in the year, and if you want to feel good about America, go to Europe.

They look at the American economy with some degree of envy because they see rates of growth that, although anemic are better than what many of those countries are experiencing. They look at demographic trends that are very positive in the United States compared to the aging populations of Europe. They look with some envy upon our energy sector as we are starting to achieve a greater degree of energy independence.

And they scratch their heads because the one thing they don't understand is how, based upon all that relatively good news, especially as compared to Europe, we haven't figured out that the one thing that stands in our way, as Mr. Zandi has said, and others have said over and over again, is our ability to get control of these long-term liabilities.

And so my question in that context—and I will frame it to whomever wants to take the question—Mr. Zandi, you have been taking most of these first, so I will give it to you first, is: If we continue in this sort of cycle of manufactured crisis after manufactured crisis, what does this mean for the flow of foreign investment into the United States? What has it meant already, and what can it mean in the future?

There is world capital that is looking to find a home and a place, and my question is: Have our actions over the past several years already had a chilling effect on the amount of foreign investment in the United States? And what is the future if we continue to be trapped in this cycle?

Dr. Zandi. Well I think the evidence is that it undermines confidence in the ability to pay our obligations. It raises the cost of funds, and investors are demanding higher interest rates as a re-

sult. That is the evidence that we have gotten from the 2011 event, that it has raised interest rates even a small amount, but that adds up to a lot of money because we are talking about trillions of dollars in debt.

So it is incredibly costly, and the only thing that has really saved us from an even greater cost is that the rest of the world is in worst shape. And their political and budget issues are much worse than our own.

Senator Murphy. Right. And I guess that's the context of my question, that given the potential return on investment in other first-world or G–20 countries, does that still create an incentive to put money into the American economy notwithstanding the crisis? Or do we still have a chilling effect above and beyond some relative competitive advantage we have against the rest of the world.

Dr. Zandi. Well we can't keep going down this path, because presumably the rest of the world is going to get their act together.

Senator Murphy. Right.

Dr. Zandi. And if we don't, we are going to have a problem.

Senator Murphy. Any other comments?

Mr. Marron.

Dr. Marron. I would just say that from where I sit, I mean I think the primary risk of these showdowns is mostly borne by Americans—particularly if you had a government shutdown, or if payments don't go out.

And then as Mark says, obviously if there is some aspect of this that really weakens confidence in our system and the odds that folks' capital will be treated well here, it is clearly a significant risk. But really I think most of it is about Americans.

Senator Murphy. But I think, just to wrap up, Senator Klobuchar, I think, Dr. Zandi, your comment is spot on. We have not maybe borne the full brunt of this because there has not been a lot of safe landings any other place. But to the extent that Europe does make a turn, or other places do, that hurts us even more.

Dr. Zandi. And actually evidence of that, there are a couple of economies that have gotten it together—Canada is a good case in point; Australia is another pretty good case in point—and they have benefitted enormously from the capital flows that have come to their country. That is because they are on sound fiscal ground and they are doing the right thing.

Senator Murphy. Thank you.

Vice Chair Klobuchar. Very good. Well I want to thank our witnesses today. We had a very good attendance, I hope you noticed, and a tribute to all of you as witnesses, as well as the importance of this issue.

As I was sitting here—not that I wasn't raptly listening to every word of my colleagues—but I did look at the iPad and I noticed a story just posted on the Star Tribune that the Twin Cities economy grew at its fastest pace in nearly a decade last year. The U.S. Commerce Department reported Tuesday that real GDP, the total value . . . grew by 3.9 percent, adding more than $7 billion in economic activity.

So that is the kind of good news that is out there, and I think it is what Dr. Zandi was talking about when he talked about how we are on this cusp of some real economic expansion.

I even think when, Dr. Mitchell, you talked about some of the work that has occurred on bringing down the debt that has helped to at least make people understand that the Congress is serious about doing something.

That being said, I would just end with this. We are on this cusp of opportunity, and I don't want us to go backward by sending the economy into a downward spiral. And I would much prefer to do the kind of work we could do in a conference committee, or the kind of negotiations that were going on at the end of last year with Speaker Boehner and the President and others and the work that's been going on with Senator Warner and a group of us on the debt reduction, than having something sort of political positioning going on on either side on this debt ceiling.

And that's my last words. I don't know if you want to say anything here, Mr. Chairman.

Chairman Brady. Well I appreciate you holding this hearing. It is timely. It is important. Our panelists really were very articulate, and it just seems to me with the Fed continuing to pump this monetary morphine into Wall Street, now is the time for us to get our fiscal act in order because the clock is really ticking. This is the perfect opportunity.

Vice Chair Klobuchar. Very good. Thank you, everyone, and the hearing is adjourned.

(Whereupon, at 3:53 p.m., Wednesday, September 18, 2013, the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIR, JOINT ECONOMIC COMMITTEE

Vice Chair Klobuchar, distinguished witnesses, and guests from the Republic of Ireland and Northern Ireland, welcome.

Vice Chair Klobuchar and I agree that political brinkmanship over raising the debt ceiling is costly to our economy. I wish President Obama felt as we do. His declaration this weekend—"What I haven't been willing to negotiate, and I will not negotiate, is on the debt ceiling."—represents the inflexible brinksmanship the American people deplore.

Despite the recent decline in the federal budget deficit, future projections are troubling. Add to that an ever-growing national debt; Medicare whose main trust fund runs empty within twelve years; and Social Security that had to borrow nearly $150 billion last year from foreign investors and the Fed simply to make payments to our seniors. As Dr. Zandi noted in his testimony, " . . . the long term fiscal outlook remains disconcerting."

This bleak outlook hurts middle-class families and the 20 million Americans who can't find a full-time job today in the weakest recovery since World War II. That's why House Republicans have reasonably and prudently passed a bill to take default off the table and invited the President to sit down together—today—to find a bi-partisan solution that puts Washington on a responsible fiscal path through pro-growth tax reform, ending wasteful spending and taking substantive steps to extend the lives of Medicare and Social Security.

Children born today owe nearly $50,000 as their share of the national debt. In other words, they owe a Lexus to Uncle Sam. If Washington doesn't change its spending ways by the time they reach 13 years old, they'll owe another Lexus. And when they graduate from college ready to begin their career, they'll owe yet a third.

Of course, young people don't buy luxury sedans for Uncle Sam. Instead, they will pay the price for this generation's spending addiction through a sluggish economy with higher taxes and higher interest rates. So if they are able to find a job, they'll have lower wages and keep less of their paycheck to pursue their American Dream.

For the first time in our history, we can't be confident that the next generation of Americans will be better off than the current one. That's unacceptable.

Admittedly, the debt ceiling is an imperfect vehicle to control the growth of federal spending. I would prefer that Congress and state legislatures amend the U.S. Constitution to limit the growth of federal spending and require a balanced budget except during war or emergencies. However, the debt ceiling remains an effective tool for Congress and the President to reach bi-partisan consensus on measures to limit the growth of federal spending and reform entitlements.

Both parties, Democrats and Republicans, have used the debt ceiling as a responsible means to shore-up America's financial house—the Omnibus Budget Reconciliation Act of 1990 came about through debt ceiling negotiations between congressional Democrats and President Bush, and the Budget Control Act of 2011 came about through debt ceiling negotiations between House Republicans and President Obama.

It is irresponsible to give the White House another blank check. Instead, it is responsible to limit the growth of federal spending and secure the future of entitlement programs in exchange for raising the debt ceiling.

If now isn't the time to tackle Washington's spending addiction, when is? Perhaps brinkmanship is just another word for a long overdue intervention.

One of today's witnesses, Dr. Mitchell, summarized good fiscal policy in a simple golden rule: private output should grow faster than government spending. In other words, Main Street should grow faster than Washington. I agree.

Some advocates of "big government" claim that modest savings from the recent sequester are decimating government services and threatening economic growth. The reality is that since the recession ended, real federal consumption and investment spending has grown faster than real GDP—6.4 percent compared with 4.6 percent. The sequester is merely asking the 500-pound federal government to lose about 10 pounds.

What ails our economy is not too little government, but too much. Therefore, I will soon reintroduce the Maximizing America's Prosperity or MAP Act to limit the growth of federal spending through a new, innovative spending cap—non-interest spending as a percentage of potential GDP.

Using non-interest outlays as the numerator in the spending cap forces Congress to limit what it can control—program spending—through appropriations bills and changes in entitlement legislation, not what it can't—interest outlays—that are determined by past spending decisions and the Fed's monetary policy.

Using potential GDP as the denominator in the spending cap eliminates the "boom-bust" cyclicality in spending caps tied to GDP. The growth of GDP fluctuates

with the business cycle, allowing spending blowouts in boom years, and then forcing deep cuts during recessions. Using potential GDP provides a more stable path for federal spending over time.

Vice Chair Klobuchar and I might not agree on what's the right level for a spending cap, but we should be able to agree on the right metric. And non-interest spending as a percent of potential GDP is the right metric.

I look forward to the testimony of today's witnesses.

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Joint Economic Committee

"The Economic Cost of Debt-Ceiling Brinkmanship"

September 18, 2013

The U.S. economy remains frustratingly far from full employment. While there are many reasons for this, brinkmanship around the federal budget and Treasury debt ceiling has been a significant contributing factor. Much progress has been made since the Great Recession, and the economy's prospects are improving, but this will continue only if policymakers can resolve their differences in a timely way.

While negotiations over these fiscal issues will be difficult, it is generally expected that lawmakers will come to terms in time to avoid a government shutdown or a breach of the debt ceiling. They have shown an ability to come together at the last minute in other recent fiscal battles, including the showdowns over the debt ceiling in summer 2011 and the fiscal cliff earlier this year.

As such, the current budget battle should have little adverse effect on investors, consumers or businesspeople, provided it is resolved in time. But policymakers should not take solace in this. If they botch it and the government shuts down or fails to meet all its obligations, investor and consumer psychology will be damaged, and the economy will suffer serious harm.

To resolve the current budget impasse, policymakers should not add to the significant fiscal austerity already in place and set to last through mid-decade. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. In 2013 the fiscal drag is as large as it has been since the defense drawdown after World War II.

Moreover, because of fiscal austerity and the economic recovery, the federal government's fiscal situation has improved markedly. The budget deficit this year will be less than half its size at the recession's deepest point in 2009. Under current law and using reasonable economic assumptions, the deficit will continue to narrow through mid-decade, causing the debt-to-GDP ratio to stabilize.

As part of any budget deal, lawmakers should reverse the sequester. The second year of budget sequestration will likely have greater consequences than the first, affecting many government programs in ways that nearly all agree are not desirable. A sizable share of the sequestration cuts to date has been one-off adjustments, but future cuts will have to come from lasting reductions in operational budgets.

It would, of course, also be desirable for lawmakers to address the nation's daunting long-term fiscal challenges. While the fiscal situation should be stable through the end of this decade, the long-term fiscal outlook remains disconcerting. If Congress does not make significant changes to the entitlement programs and tax code, rising healthcare costs and an aging population will swamp the budget in the 2020s and 2030s. Both cuts in government spending and increases in tax revenues will be necessary to reasonably solve these long-term fiscal problems.

A grand bargain with comprehensive entitlement and tax reform is likely too much to hope for, but lawmakers can do some things now to address our long-term fiscal issues and help resolve the current impasse. New budget rules that recognize the magnitude of our long-term problems and encourage solutions would be especially helpful. These could include incorporating fiscal-gap and generational accounting in the budget process and significantly extending the current 10-year budget horizon.

Adopting the chained consumer price index for adjusting Social Security benefits and the tax code would also be a small but positive step in the appropriate direction. The chained CPI is a more accurate measure of inflation, and adopting it would both cut entitlement spending and raise tax revenue. The budget savings would not come close to what is needed, but it would be consequential nonetheless.

Revenue-neutral corporate tax reform that scales back tax expenditures in exchange for a lower top marginal corporate tax rate would also be a significant policy achievement. This would significantly improve the competitiveness of U.S. businesses and the economy's long-term growth. Much of the hard intellectual work necessary to accomplish this has been done, and there is general agreement among economists that this would provide a meaningful boost. As part of corporate tax reform, multinationals could be encouraged to repatriate their overseas profits with a temporarily lower tax rate. The resulting onetime boost to tax revenues could be used to finance infrastructure development here at home, also improving U.S. competitiveness and long-term growth.

Congress should use this opportunity to eliminate the statutory debt ceiling. It is an idiosyncratic, anachronistic and, as has been demonstrated, potentially destructive rule that is detrimental to sound economic policy. Absent repeal, an alternative would be to require debt-ceiling increases when spending, taxation and appropriations bills are passed. Doing so would restore the fundamental economic relationship between budgeting and borrowing, and reduce the risk that political brinkmanship could damage the full faith and credit of the United States or the stability of world financial markets.

Recommendation #1: Do not shut down the federal government

Congress' first order of business is appropriating funds for the fast-approaching 2014 fiscal year. If lawmakers fail to act by October 1, the federal government will partially shut down. At a minimum, lawmakers must pass a continuing resolution to extend current spending authority, which expires at the end of this month.

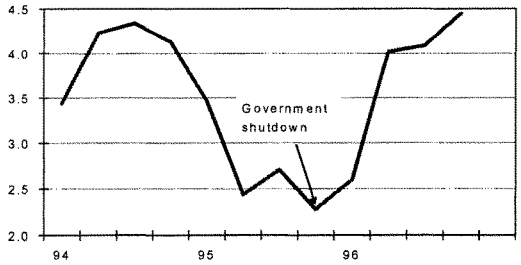
A shutdown that lasts only three or four days would have modest economic consequences, costing the economy approximately 0.2 percentage point of annualized real GDP growth in the fourth quarter. A brief shutdown would have limited economic impact because it would affect only discretionary spending, the one-third of the budget funded through congressional appropriations. Mandatory spending would not be affected. Some appropriated spending would also likely be considered essential and not cut, in such areas as national security, air traffic control, law enforcement, and the processing of benefit payments. Using the 1995 government shutdown as a guide, approximately half of all government employees would not be able to go to work. Moreover, most government spending would be delayed and not canceled in a brief shutdown. Federal employees would lose pay, but most other activity would be made up later.

However, shutting the government down for three or four weeks would do significant economic damage, reducing real GDP by 1.4 percentage points in the fourth quarter. And this likely understates the economic fallout, as it does not fully account for the impact of such a lengthy shutdown on consumer, business and investor psychology. Any interruption much longer than a month would cause GDP to fall over the quarter, and one longer than two months would likely precipitate another recession.

For context, the longest government shutdown on record, in late 1995 and early 1996, lasted about three weeks. The economy's growth slowed sharply as a result (see Chart 1).

Chart 1: '95-'96 Government Shutdown Hurt Growth

Real GDP growth, % change yr ago



Sources: BEA, Moody's Analytics

Recommendation #2: Raise the Treasury debt ceiling

Lawmakers must increase the $16.7 trillion Treasury debt ceiling before mid-October. According to Treasury Secretary Jack Lew, that is when the "extraordinary measures" the Treasury has been using since May to stay under the limit will no longer work (see http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf). At that point, the government would be able to pay bills with only the cash it has on hand, about $50 billion on any given day.

It is impossible to know precisely when the Treasury will run out of ways to avoid the ceiling. The key uncertainty is revenues: Quarterly corporate income taxes were due September 16, giving the Treasury some leeway, but the Treasury must issue a large amount of nonmarketable debt to the entitlement-related trust funds on October 1, reducing its flexibility. Timing will become clearer after that, but the Treasury will likely be out of options by the end of October, when a large interest payment on Treasury securities is due.

Operationally, the Treasury might be able to prioritize interest payments on U.S. government securities, as those payments are handled by a different computer system than other government obligations. But practically that would be difficult; it would entail paying bond investors before Social Security recipients, for example. Prioritizing other payments would likely not be possible, as the Treasury might not be able to sort through the blizzard of payments due each month to decide which to pay.

More likely, the Treasury would delay payments as officials suggested in a 2012 inspector general's report. The Treasury could also wait until it received enough cash to pay a specific day's bills. Initially, the resulting delays would be short, but they would increase over time. For example, if the Treasury hit its borrowing authority on October 18, payments to Medicare and Medicaid providers due that day would be delayed one business day, to October 21. But checks to be issued on November 1 for Social Security, veterans benefits and active-duty military pay would not go out until November 13.

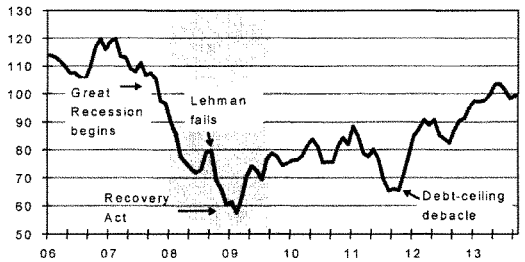
It has become typical for Congress to run down the clock, but in the end it has never failed to come through. The motivation is clear: Any delay in raising the debt ceiling would have dire economic consequences. Consumer, business and investor confidence would be hit hard, putting stock, bond and other financial markets into turmoil.

This was clearly evident in the near-debacle that occurred in summer 2011, when lawmakers raised the debt ceiling at the very last minute. Brinkmanship nevertheless undermined consumer confidence, sent stock prices reeling, and caused credit default swap spreads on U.S. Treasury debt to widen sharply (see Chart 2). The bitter showdown

led Standard & Poor's to cut its rating on Treasury debt from AAA to AA+. Although policymakers acted before the debt ceiling was reached, the fallout nearly caused the fragile economic recovery to stall.

Chart 2: Debt-Ceiling Debate Undermined Confidence

Consumer confidence index, Oct 2001=100



Sources: Rasmussen Public Opinion Research, Moody's Analytics

Another such confrontation would also effectively shut the government, which would have authority to spend but would not have the cash to pay for it. The Treasury would have no choice but to eliminate its cash deficit, which will run as high as $130 billion in November. This is about 9% of GDP (annualized). The economy would quickly fall into another severe recession.

Given the serious consequences of not raising the debt ceiling in a timely way, it is widely expected that Congress will do so. After several rounds of fiscal brinkmanship over the last few years, financial markets have become increasingly desensitized to the headlines coming out of Washington. However, lawmakers should not become complacent, thinking that breaching the debt limit is somehow all right. It is not. There will be a violent reaction in financial markets if policymakers fail to act in time.

Recommendation #3: Do not add to near-term fiscal austerity

In any agreement to increase the debt ceiling or extend funding for the federal government, lawmakers should avoid adding to the fiscal austerity in place through mid-decade. Congress has been appropriately focused on reducing the government's large budget deficits, but recent tax increases and government spending cuts have put a significant constraint on growth. Under current law, fiscal headwinds will continue to blow hard in 2014 and 2015. It would be wise not to add to those headwinds, and allow the private economy to gather momentum.

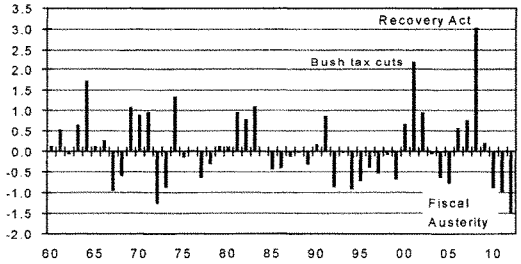
While the U.S. economy has begun its fifth year of recovery from the debilitating Great Recession, it remains fragile. Growth has been modest, with real GDP expanding close to 2% per year since the recovery began, and payrolls are still nearly 2 million jobs shy of their prerecession peak. The nation's 7.3% unemployment rate remains well above most estimates of full employment, which is closer to 5.5%. And this understates the stress in the job market given the large number of potential workers who have left the labor force because of a lack of perceived job opportunities.

The private economy has made significant strides since the recession. American companies have strong balance sheets with low debt and lots of cash, and they have done an excellent job reducing their costs. By most measures, they are highly competitive. The financial system is much better capitalized and liquid, and increasingly willing and able to extend credit. Households have also significantly reduced their debt loads, which are now about as low as they have ever been. Higher house prices and stock values are also supporting households' better financial condition.

But the strengthening private economy is not evident in the nation's overall performance because of fiscal austerity. In calendar year 2013, the drag on the economy from federal tax increases and spending cuts will amount to 1.5 percentage points of real GDP growth. That is, if fiscal policy were simply neutral with respect to the economy, real GDP growth this year would be closer to a strong 3.5% (2 percentage points in actual real GDP growth plus 1.5 percentage points from the elimination of the fiscal drag). The fiscal drag will reach its apex in the current quarter, and over the year is greater than in any other year since the defense drawdown that followed World War II (see Chart 3).

Chart 3: Fiscal Headwinds Are Blowing Hard

Real GDP growth impact of federal fiscal policy, fiscal yr, ppt



Source: Moody's Analytics

The federal government's improved fiscal situation also provides lawmakers with some leeway. Tax revenues are growing at a double-digit pace and government spending is falling. The budget deficit for fiscal 2013 is set to come in well below $700 billion.

This is still large, but it is half of what it was at its peak in fiscal 2009. Under current law and assuming the economic recovery stays intact, the deficit will continue to narrow through mid-decade. The nation's debt-to-GDP ratio, while uncomfortably high at more than 70%, will stabilize.

Given the still-fragile economic recovery, the austerity already in place, and a better near-term federal budget situation, policymakers should not add to the fiscal burden on the economy through mid-decade. This will help the private economy kick into higher gear, hasten a self-sustaining economic expansion, and promote a quicker return to full employment.

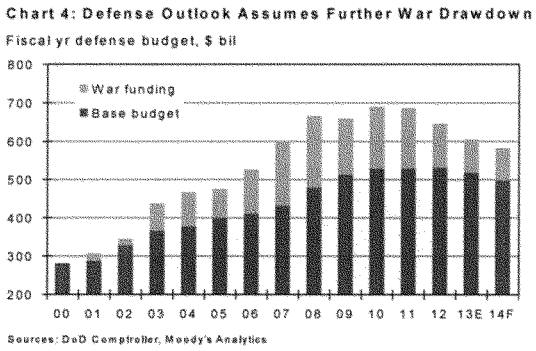
Recommendation #4: Replace the sequester

Policymakers should replace the cuts scheduled for the coming year as part of the sequester with other budget savings.

The impact of the current year's sequester, which began in March, is becoming more visible in the economic data. Hiring freezes announced early this year appear to have accelerated the decline in federal government employment. There has been an even larger impact on hours worked and personal income. Federal furloughs caused government wages and salaries to decline by half a percent in August alone. Cuts in procurement spending are also reducing support for private sector jobs, particularly among defense contractors, although the impact of the sequester on private employment is occurring gradually, with a significant lag.

A second year of sequestration will have greater consequences for the economy. The cuts will be larger and will start immediately, rather than beginning six months into the fiscal year as occurred this year. Because of lags between budgeting and actual spending, and between federal spending and its impact on the job market, the fallout from this year's cuts will carry over into 2014. A sizable share of the fiscal 2013 sequestration cuts was also made through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continuing the sequester would have particular implications for the Pentagon. While in fiscal 2013 sequestration cuts were divided evenly between security spending—on defense, homeland security and international affairs—and nonsecurity spending, in 2014 and beyond the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations. The potential for an escalation in military operations in Syria could increase the overseas contingency operations budget, which is not exempt (see Chart 4).



Recommendation #5: Enact budget reforms

The statutory debt ceiling is an anachronistic law that if not repealed should be reformed so that it can no longer lead to a voluntary default on U.S. government obligations. Fiscal-gap and intergenerational accounting should also be adopted in the budget process.

Using the threat of a default on U.S. government obligations as a tool in fiscal policy negotiations has meaningful economic costs. Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing, tax and spending policy, by requiring "ability to pay" language in any legislation that adds to future deficits. Ability to pay is defined as sufficient projected tax revenue and borrowing authority to cover the current Congressional Budget Office deficit forecast. This requirement would be applied to all direct spending, taxation and annual appropriations bills. Any discrepancies that result from changes in the CBO forecast could be reconciled in the annual budget process.

The debt ceiling would still force lawmakers to think about the long-term fiscal impact of any legislation, but it would do so in the context of the spending and taxation bills that create the need for that debt. This proposal makes use of current CBO budget projections and scoring practices, and thus should cause no new compliance costs.

Policymakers should also adopt the INFORM Act, which would require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting. (http://www.theinformact.org/content/text-bill) This provides a more accurate calculation of the nation's long-term fiscal obligations and thus would create the basis for sounder budgeting and fiscal decision-making.

The fiscal gap describes the difference between the present value of projected government expenditures, including interest and principal payments on outstanding federal debt, and taxes and other receipts, including income accruing from the government's ownership of financial assets. Generational accounting measures the burden of closing the fiscal gap on today's and tomorrow's children, assuming they must do so on their own and that the burden on each generation is proportional to its labor earnings.

Fiscal-gap and generational accounting are comprehensive and forward-looking, and determine the sustainability of fiscal policy and the burden of that policy on future generations. Fiscal-gap accounting has already been adopted by the Social Security Trustees and Medicare Trustees and is becoming more widely used in other countries.

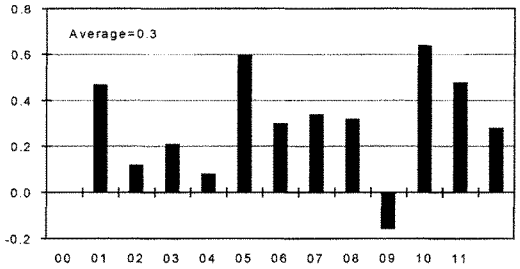
Recommendation #6: Adopt chained CPI and corporate tax reform

To break the budget impasse, policymakers should consider adopting the chained consumer price index in calculating Social Security benefits and tax liabilities. Revenue-neutral corporate tax reform resulting in a lower marginal corporate tax rate would also help the competitiveness of U.S. companies and thus support stronger long-term economic growth.

The chained CPI index is a more accurate measure of inflation than the current CPI index used in budgeting. Since chained CPI accounts for changes in consumers' spending behavior due to changes in the relative prices of goods and services (e.g. if the price of apples increases more quickly than that of bananas, consumers will buy fewer apples and more bananas) it grows more slowly than the CPI (see Chart 5). If the chained CPI were adopted in the budget, future Social Security benefits would increase more slowly and tax revenues would increase more quickly.

Chart 5: Chained CPI Grows More Slowly Than CPI

Difference in growth between CPI and chained CPI, ppts



Sources: BLS, Moody's Analytics

Overall, the change would save the federal government about $130 billion over the next decade, and much more in subsequent decades. This does not go nearly far enough to address our long-term fiscal problems, but it is a step in the right direction, as it includes both entitlement and tax reform. More of both will be necessary to put the nation on a sounder long-term fiscal footing.

Corporate tax reform, which involves reducing or eliminating tax expenditures in the corporate tax code and using the resulting additional revenues to reduce marginal rates for businesses, would also be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that result in lower effective tax rates. All the loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus long-term economic growth.

As part of corporate tax reform, multinational corporations would be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. This would give a onetime boost to tax revenues that could be used to finance needed infrastructure development in the U.S. This too would help the competitiveness of U.S. companies and thus long-term economic growth.

Conclusions

Washington's recent budget battles have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and anxiety among consumers, businesses and investors, weighing on their willingness to spend, hire and invest.

Despite this, the economic recovery is four years old and counting, and the private economy has made enormous strides in righting the wrongs that triggered the Great Recession. Business balance sheets are about as strong as they have ever been, the banking system is well-capitalized, and households have significantly reduced their debt loads. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is Congress' willingness to fund the government after the end of this fiscal year and to raise the Treasury debt ceiling. If policymakers can find a way to do these things in a timely way, almost regardless of how ungainly the process is, then the still-fragile recovery will quickly evolve into a sturdy self-sustaining economic expansion.

We are close to finally breaking free from the black hole of the Great Recession. All it will take is for Washington to come together over the next few weeks.

PREPARED STATEMENT OF DAVID MALPASS

Vice-Chairman Klobuchar, Chairman Brady, members of the Committee, thank you for the invitation to testify on the debt limit. It's a vital economic and legislative issue.

The national debt already exceeds the nation's annual output, and the Administration is now requesting that Congress increase the debt limit above $17 trillion. As part of providing this increase, I think there should be an honest national debate on federal spending priorities and an agreement with the President on constructive spending restraint. There's huge economic upside for jobs, investment, the stock market and the dollar if you could lower the federal spending path or rewrite the debt limit to make it more effective.

The federal government is spending nearly $3.6 trillion per year and is planning to increase spending rapidly in coming years even with the sequester and the underfunding of national defense. Some of the spending is successful and adds to the nation's well-being, but another portion of the spending, several hundred billion dollars, is not successful enough to justify the taxes and debt used to pay for it.

This has created a spending and debt crisis that harms the economy and undermines investment and jobs. The crisis is particularly acute because several categories of federal spending will need to increase over the next two decades as the baby boom ages and requires more government services. Government health-care spending will more than double over the next decade to $1.8 trillion annually in 2023, while annual debt-service costs are expected to quadruple as interest rates normalize.

Given this demographic and interest rate cycle, spending and debt should be at lower-than-normal levels now in order to prepare for the coming increases. In addition, the maturity of the national debt held by the private sector should be longer than normal. Instead, the Fed's bond purchases have materially shortened the effective maturity of the national debt, and both spending and debt are at record levels even though the demographic bulge is just beginning to hit the federal budget. This leaves fiscal policies completely out-of-synch with long-term growth.

The debt limit provides a good opportunity to address this crisis. In negotiating the next increase, Congress and the Administration should take steps to downsize current spending and slow future spending growth. It's also vital to improve the allocation of spending—less successful government programs should be reduced in order to make room for new programs and for more spending on successful programs. In my August 30 Wall Street Journal column, I advocated a menu approach in which the various parties suggest numerous methods to reduce spending and then negotiate a compromise.

Looking longer term, Congress should work to repeal and replace the current debt limit with a more effective limit. The current debt limit law is fatally flawed because Congress and the President are able to make unlimited spending commitments without first choosing how to pay for them. The debt limit law was initially created in 1917 to facilitate debt rather than limit it. The goal was to relieve Congressmen from having to vote for individual bond issues to fund their spending plans. This has left members unaccountable to voters—they get to create new spending programs and then let the Treasury Department and President demand more debt in order to pay for spending that has already occurred. The debt limit needs to be rewritten so that debt is approved prior to spending commitments rather than after-the-fact.

In my Forbes and Wall Street Journal columns, I've advocated replacing the debt limit with legislation to establish continuous spending restraint that strengthens when the debt-to-GDP ratio rises above a ceiling. I was privileged to work for Senator Bill Roth on this Committee in 1990 when he wanted to create a 50% debt-to-GDP limit. Unfortunately, the debt ratio is now more than double that, and it will take many years of continuous spending restraint to restore a more pro-growth debt level. In the ideal, there should be a downward glidepath for the debt ratio. It would set gradually lower debt-to-GDP limits which, if exceeded, would require Congress and the Administration to reduce their spending commitments or face escalating procedural restraints on spending.

I emphasize the huge economic and market upside from lowering the spending path and rewriting the debt limit to make it effective. Around the world and in the competition among U.S. states, investors reward spending limitations—private sector investment and employment increase and median income rises. The second term of the Clinton Administration provides an example.

Movement toward spending restraint would also cause U.S. assets to appreciate materially. This lowers the cost of capital and creates more jobs. We've already seen a demonstration of that with the big market gains when the sequester was imple-

mented. The sequester was a blunt instrument—well-thought-out spending restraint would be even better received by financial markets.

There's been a great deal of discussion about whether an extended negotiation over the debt limit might unsettle financial markets or slow the economy. I think the benefits of a negotiation far outweigh the costs. Bond markets have examined the U.S. debt limit process and are very comfortable holding U.S. Treasury debt during debt limit negotiations—in fact, bond yields fell sharply during the 2011 negotiations, with the 10-year Treasury yield falling from 3.2% to 2% in July and August 2011.

In contrast with August 2011, it's unlikely that a major credit rating agency would downgrade the U.S. credit rating. I think financial markets would greet a partial shutdown of government spending during the debt limit negotiations with a yawn or quiet applause. The Administration would like to use financial markets to scare Congress into a clean debt limit, but I think the reality is that voter reaction will be the stronger referee on the debt limit negotiation. If voters think the negotiations are reasonable and constructive, they'll tolerate a partial shutdown, as will financial markets. There's no indication that financial markets are worried about a default or technical default on U.S. debt.

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. Austerity or "fiscal consolidation" encompasses two separate economic policies: government downsizing on the one hand, which causes more growth; and private sector downsizing on the other hand, which causes recessions. Many of the reform programs undertaken in Europe were harmful because they were built on private sector austerity, not government downsizing. The austerity often took the form of higher value-added taxes, wealth taxes and increases in government fees.

As the U.S. examines options, it should aim to reduce ineffective government spending. It drains the private sector because it requires new taxes or debt. An open Washington discussion of spending restraint, even a contentious one using a menu of options—would receive a very positive market reaction.

In addition to spending restraint, I think the debt limit increase should include three steps to make the debt limit more honest. In recent years, the Federal Reserve has incurred extra debt by buying higher coupon Treasury bonds at a premium. The cumulative premiums that the Fed has paid and includes in its liabilities is already $200 billion and climbing fast. It is true national debt and should be included in the statutory debt limit.

Second, the Treasury is planning to issue a new class of debt, floating-rate notes. This would understate the nation's fiscal burden because interest payments on this type of debt will go up faster than on fixed-rate debt when interest rates rise.

Third, the debt limit should also consider the burden the Fed is creating for future taxpayers by buying longer-term Treasurys with trillions of dollars in short-term Federal Reserve debt. This will escalate the deficit and the national debt when interest rates rise.

One of the reasons for a debt limit is to protect future generations. This is being undermined by the government borrowing short-term. One concept would be to require Treasury to maintain a five-year minimum on the effective duration of the national debt held by the private sector. The Fed's bond purchases and any floating-rate notes issued by Treasury would reduce the effective duration, causing Treasury to lengthen the maturities of its fixed-rate debt issuance.

In conclusion, the U.S. is stuck in a "new normal" of very slow economic growth, high unemployment and falling median incomes. Federal spending and debt trends are weighing on growth and investment. The debt limit provides an opportunity to break out. The Administration and Congress should create a menu of constructive restraints and agree on a package. Movement in this direction would create a very positive economic and market reaction. Changes made now, even if they take effect in several years, would bring immediate benefits by improving the debt outlook.

The Costs of Debt Limit Brinksmanship*

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Testimony before the Joint Economic Committee
September 18, 2013

Vice-Chair Klobuchar, Chairman Brady, and Members of the Committee, thank you for inviting me to discuss the debt limit. It's a particular honor and pleasure to appear before this Committee, which gave me my start in public service more than a decade ago.

As you know, the federal government reached the debt limit in May. Since then, Treasury has used a variety of extraordinary measures, such as suspending investments in the Thrift Savings Plan's G-Fund, to stay within the limit. Those measures will be exhausted in mid-October, according to Treasury Secretary Jack Lew, leaving the government with just $50 billion of cash on hand.[1] The debt limit will become truly binding sometime soon thereafter. For example, the Bipartisan Policy Center projects that the "X Date" will fall between October 18 and November 5.[2] After that, Treasury won't be able to pay all of America's bills.

Congress should keep four things in mind as it works to raise the debt limit before that deadline.

1. Congress must increase the debt limit. Failure to do so will result in severe economic harm.

2. Debt limit brinksmanship is costly, even if Congress avoids breaching the limit at the last minute. The 2011 showdown scared investors and consumers, weakened the economy, and drove up Treasury borrowing costs.

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* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its trustees, or its funders. Erin Behrman, Len Burman, William Gale, Benjamin Harris, Erika Poethig, Roberton Williams, and Eric Toder provided helpful comments, but all errors are my own.

[1] Lew (2013)
[2] Bell et al. (2013)

3. Our economy remains fragile. Unemployment has declined since the worst days of the Great Recession but remains far too high. Full employment appears to be years in the future. Now is not the time to hit the economy with unnecessary shocks.

4. The long-run budget outlook remains challenging. Deficits have fallen sharply in the past few years, due to the economic recovery, fading stimulus, deficit reduction efforts, and slower growth of health care costs. But current budget policies would still create an unsustainable trajectory of debt in coming decades. Congress should address that problem. But the near-term fiscal priorities are funding the government and increasing the debt limit.

Given the focus of today's hearing, I focus on the first and second points in the remainder of my testimony.

Failing to raise the debt limit would hurt our economy, perhaps catastrophically

If Congress fails to increase the debt limit, Treasury won't be able to pay all of America's bills. Someone—perhaps millions of someones—won't be paid on time. The resulting economic damage would grow with each passing day.

Delaying and prioritizing non-debt payments

After the "X date," Treasury would have to delay or stop transfer payments, employee salaries, and other non-debt payments. A key question is how it would do so.

One approach would be to delay payments day-by-day until sufficient resources are available. For example, if Treasury owed $15 billion on a particular day but had only $5 billion of free cash, it could wait—a day or a week or a month—until it had the full $15 billion in hand and then make all of those payments together. It could then repeat the process for the next day's set of payments. With each passing day, unpaid bills would pile up further, and payments would become more and more delayed. According to Treasury's Inspector General, officials concluded that this approach was "the least harmful option available to the country" during the 2011 debt limit impasse.[3]

Another approach would be for Treasury to pay some bills as they come due, while delaying others indefinitely. For example, Treasury might (hypothetically) prioritize

[3] Thorson (2012).

unemployment insurance and veterans' benefits, while delaying tax refunds and payments to contractors. In theory, such prioritization might allow Treasury to avoid some of the worst damage from a sudden stop in federal payments. In reality, however, it poses a host of logistical, legal, and political challenges. For example, Treasury's systems are not designed to allow picking and choosing among the more than 80 million payments it makes each month; payments are automatically made as they come due.[4]

Either approach would damage the economy. Federal employees, contractors, program beneficiaries, businesses, and state and local governments would find themselves suddenly short of expected cash, creating a ripple effect through the economy. Delays would be short at first, but would grow rapidly given current borrowing needs. The Bipartisan Policy Center estimates, for example, that if we hit the "X date" on October 18, Treasury will be more than $100 billion short in paying all its bills over the following month.[5]

Such delays could pose a significant challenge for any families or businesses that operate with tight budgets. Through no fault of their own, they could find themselves unable to pay their own bills.

The personal costs of delayed payments would grow, of course, as delays mounted. So would the macroeconomic damage. A short delay in non-debt payments might do relatively little harm to the overall economy, but a prolonged delay would be a powerful "anti-stimulus." In essence, the federal government would have to balance its budget immediately by cutting spending. That shock would grow with each passing month (except those occasional ones in which the government runs a surplus). It would also undermine confidence and increase economic uncertainty, further discouraging economic activity. During January's debt limit debate, Macroeconomic Advisers (2013) estimated that such spending cuts could drive the economy into a deep recession. Deficits have since come down, so the effect would be smaller today, but the basic result still applies. If the government has to suddenly move to a balanced budget for an extended period, the U.S. economy would likely plunge into recession.

Debt default

An even more severe possibility is that Treasury might default on the federal debt. To prevent that from happening, I expect that Treasury will attempt to prioritize interest and principal payments, but there is a risk that it won't succeed.[6]

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[4] Thorson (2012).
[5] Bell et al. (2013).
[6] The Bipartisan Policy Center (Bell et al. 2013) and Macroeconomic Advisers LLC (2013) also anticipate this approach. As far as I know, no administration representative has publicly endorsed

Prioritizing debt payments over other obligations is technically feasible because they go through Fedwire, a computer system separate from the one that handles other payments. It is also appropriate because it would maintain the full faith and credit of the United States in financial markets. Less clear is whether prioritizing debt payments would be financially feasible. Interest payments average only 8 percent of federal revenues at the moment,[7] but cash management isn't about averages. Interest payments are lumpy, and tax receipts are lumpy and uncertain, so Treasury would have to take care in matching them. In addition, there's a risk that a debt limit crisis may cause problems rolling over maturing debt issues. For both reasons, debt prioritization is harder than sometimes claimed, and Treasury might unintentionally find itself short of cash when an interest payment comes due or maturing debt needs to be rolled over.

In considering this risk, Congress should keep in mind that accidents can happen. In 1979, for example, Treasury accidentally defaulted on a portion of the debt in the wake of a debt limit showdown:

> Investors in T-bills maturing April 26, 1979 were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills which became due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules. (Zivney and Marcus 1989)

That default was narrow, applying only to T-bills owned by individual investors, and was rectified in a few weeks. Nonetheless, financial markets reacted badly. Zivney and Marcus (1989) estimate that T-bill interest rates increased by about 60 basis points after the first default and remained elevated several months thereafter. The default thus significantly boosted the government's borrowing costs.

If a debt limit impasse forced Treasury to default on the debt today, the results would be at least as severe. Faced with new risks, investors would demand a premium to invest in U.S. Treasuries. Debt service costs would rise, crowding out funding for government programs, forcing higher taxes, or boosting deficits.

But higher interest rates are only the beginning of the costs. Default would also threaten our financial system and, thereby, the real economy. Treasury securities play a unique and

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debt prioritization, but in the final days of the 2011 impasse, one anonymous official reportedly said that Treasury would do it if necessary (Cook and Hopkins 2011).

[7] Congressional Budget Office (2013).

vital role in financial markets. Large swaths of America's financial infrastructure have been built on the assumption that U.S. Treasuries pay on time. Treasury securities serve as collateral in the short-term lending markets that provide trillions of dollars of liquidity to the financial system. In addition, money market funds hold Treasury securities to make sure they can repay savers' investments.

Those financing arrangements all presume that Treasuries are money-good. If the federal government defaulted, those markets would begin to unravel. Credit would tighten, financial institutions would scramble for cash, and savers might desert money market funds. The magnitude of the resulting economic harm is difficult to judge and would depend on the scope and duration of the default. But anyone who remembers the financial crisis of five years ago should shudder at the thought of disrupting these markets again.[8]

"Super-extraordinary" measures won't save us

Given the severe economic harm of delaying payments or defaulting on the debt, many observers have wondered whether Treasury might find another way out—a "super-extraordinary" measure—that would allow it to keep paying America's bills even if the debt limit isn't raised. Ideas include ignoring the debt limit on the grounds that it violates the 14th Amendment to the Constitution,[9] using a loophole in coinage laws to mint platinum coins of extremely large denominations,[10] or selling gold or other assets owned by the government.

These ideas differ in their particulars, but share one common feature: administration officials have rejected all of them as impractical or illegal. The president's lawyers reportedly do not believe that the 14th Amendment gives him the authority to ignore the debt limit.[11] Treasury and the Federal Reserve announced that platinum coins won't work.[12] And Treasury officials have concluded that selling gold would be "destabilizing to the world financial system" and that selling student loans (the government's largest financial asset) would not be feasible.[13]

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[8] Matthew Zanes (2012) describes the financial market risks at greater length; at the time, he chaired the Treasury Borrowing Advisory Committee.
[9] Section 4 of the amendment reads: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."
[10] Marron (2013).
[11] See, e.g., Calmes and Hulse (2011): "'I have talked to my lawyers,' Mr. Obama said, and 'they are not persuaded that this is a winning argument.'"
[12] Klein (2013) quotes Treasury spokesman Anthony Coley: "Neither the Treasury Department nor the Federal Reserve believes that the law can or should be used to facilitate the production of platinum coins for the purpose of avoiding an increase in the debt limit."
[13] Thorson (2012).

Treasury thus has no good options when the debt limit clock runs out. Billions, then tens of billions, then hundreds of billions in federal obligations would go unpaid, and millions of Americans would suffer the consequences.

Brinksmanship also imposes large economic and fiscal costs

Going past the "X date" would harm our economy and our people. That's why it's vital for Congress to increase the debt limit.

But that isn't enough. To completely avoid harm, Congress must do more: it must raise the debt limit without the extreme brinksmanship we saw in 2011. Such brinksmanship does not come free; instead, it imposes costs in its own right.

First, and most important, is the risk of making a mistake. Cash flows are uncertain, and parties to heated negotiations sometimes misread their opponents' position and capabilities. As a result, there is always the risk that brinksmanship would result in the United States going over the brink by accident, delaying payments and raising the risk of debt default.

Second, interest rates would rise. Investors are forward-looking. If they believe there is a real risk that Treasury might default in the future, they will demand a premium for holding Treasury securities today. That's exactly what happened during the 2011 crisis. As documented by the Government Accountability Office (2012), the funding advantage that the United States enjoys over private businesses narrowed during that debate, suggesting that investors saw greater risk in holding Treasuries. GAO estimates that the federal government paid out an extra $1.3 billion in interest during fiscal 2011 as a direct result. Over the full maturity of the debt, that figure balloons to $18.9 billion according to the Bipartisan Policy Center. Brinksmanship can be expensive.[14]

Third, debt limit showdowns increase uncertainty and reduce confidence. As a result, families and businesses may cut back on their spending and investment while they wait to see what will happen. During the 2011 debt limit crisis, consumer confidence and the stock market both plummeted and concern about financial market risks skyrocketed.

[14] The GAO (2011) notes that debt limit impasses disrupt the regular schedule of Treasury bill and bond auctions and thus weaken Treasury's ability to get the lowest interest rates. The GAO estimates that the debt limit debates in 2002, 2003, and 2010 "modestly" increased borrowing costs as a result.

Finally, brinksmanship weakens America's global image. The United States is the only major nation whose leaders talk openly about the possibility of self-inflicted default. At the risk of sounding like Vladimir Putin, such exceptionalism is not healthy. As every other nation understands, if you need to borrow, you can only hurt yourself by scaring your creditors. But the problem is deeper than that. Debating intentional default contributes to the perception that the United States does not know how to govern itself.

The debt limit is one failure of a broken budget process; we need a new one

The debt limit is a peculiar and flawed feature of America's fiscal policy. Borrowing decisions cannot be made in a vacuum, separate from other fiscal choices. America borrows today because this and previous Congresses chose to spend more than we collect in revenue, sometimes with good reason, sometimes not. If Congress is concerned about debt, it needs to act when it makes those spending and revenue decisions, not months or years later when financial commitments are already in place.

When the dust settles on our immediate fiscal challenges, Congress should re-examine the entire budget process, seeking ways to make it more effective and less susceptible to dangerous, after-the-fact brinksmanship.

Thank you again for inviting me to appear today. I look forward to your questions.

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PREPARED STATEMENT OF DAN MITCHELL

Vice Chair Klobuchar, members of the Committee, thank you for this opportunity to testify about the debt limit. My name is Dan Mitchell. I'm a Senior Fellow at the Cato Institute. The views I express here today are my own.

I want to make five points.

First, it's important to understand that America's chief fiscal problem is an excessive burden of government spending. That's true today, and, as yesterday's long-run CBO fiscal outlook demonstrated, too much spending is our problem in the future.

Deficits and debt are undesirable, of course, but so are high taxes and printing money, which are the other two ways of financing government spending.

Simply stated, the true fiscal tax on our economy is how much government is spending. That's the problem. Deficits and debt, by contrast, are symptoms of that problem. Overall government spending is the measure of how much money is being diverted from the economy's productive sector. That's the primary problem. The various ways of financing that spending are secondary problems.

Second, the best way to gauge the success of fiscal policy is to see whether the burden of government spending is growing faster or slower than private economic output. If the private sector is growing faster than the government—which I consider to be the Golden Rule of Fiscal Policy—then lawmakers are doing a good job.

But if the converse is true and the burden of spending is rising faster than the private sector, then policy is heading in the wrong direction.

The data for any one year is important, but the real test is what happens over time. In other words, fiscal trendlines are critical.

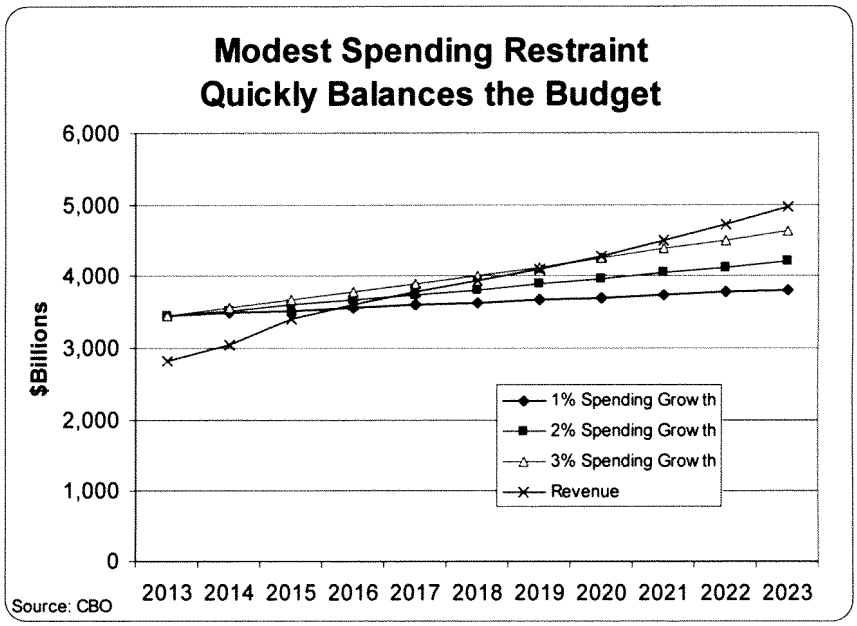
If government spending grows slower than the productive sector of the economy for an extended period of time, this almost certainly means better economic performance because the relative burden of government is declining. And because the problem of spending is being properly addressed, this also means that the symptom of red ink almost certainly is falling as well.

But if the opposite occurs, and government grows faster than the private sector for an extended period, then it's just a matter of time before serious fiscal and economic problems occur. Nations such as Greece, for instance, got in trouble because the politicians did the opposite of the Golden Rule of Fiscal Policy.

Third, it's possible to make rapid progress with even a modest amount of spending restraint. Consider what's happened the past two years. For the first time in more than 50 years, we've enjoyed two consecutive years when overall government spending was lower than the previous year.

This has led to a big improvement in the key fiscal indicator, with the burden of federal government spending falling from 24.1 percent of GDP to 21.5 percent of economic output. And because there was progress on the real problem, the symptom of red ink got much better as well, with the deficit falling by more than 50 percent, from $1.3 trillion to $642 billion.

We don't even need that degree of fiscal discipline going forward. As illustrated by this chart, we can balance the budget in just 3 years if spending grows by an average of 1 percent annually. Red ink disappears in 4 years if spending grows by an average of 2 percent per year. And the deficit goes away in 7 years if spending grows by an average of 3 percent each year.



Indeed, it's worth noting what Canada achieved in the 1990s. The burden of government spending had reached crisis levels by 1992, with government consuming more than 50 percent of economic output. But Canadian lawmakers—primarily during a time when the Liberal Party was in charge—put the brakes on spending.

For a period of five years, government outlays grew by an average of just 1 percent per year. That dramatically reduced the burden of government relative to the private sector. And by dealing with the underlying problem, Canada also went from having a large deficit of about 9 percent of GDP to a budget surplus.

Let's now deal directly with the debt ceiling. My fourth point is that an increase in the debt ceiling is not needed to avert a default. Simply stated, the federal government is collecting far more in revenue than what's needed to pay interest on that debt.

To put some numbers on the table, interest payments are about $230 billion per year while federal tax revenues are approaching $3 trillion per year. There's no need to fret about a default.

But don't believe me. Let's look at the views of some folks that disagree with me on many fiscal issues, but nonetheless are not prone to false demagoguery.

Donald Marron, head of the Urban-Brookings Tax Policy Center and former Director of the Congressional Budget Office, explained what actually would happen in an article for CNN Money.

> If we hit the debt limit ... that does not mean that we will default on the public debt. ... [The Treasury Secretary] would undoubtedly keep making payments on the public debt, rolling over the outstanding principal and paying interest. Interest payments are relatively small, averaging about $20 billion per month.

And here is the analysis of Stan Collender, one of Washington's best-known commentators on budget issues.

> There is so much misinformation and grossly misleading talk about what will happen if the federal debt ceiling isn't increased ... it's worth taking a few steps back from the edge. ... if a standoff on raising the debt ceiling lasts for a significant amount of time ... a default wouldn't be automatic because payments to existing bondholders could be made the priority while payments to others could be delayed for months.

Or what about the Economist magazine, which made this sage observation.

> Even with no increase in the ceiling, the Treasury can easily service its existing debt; it is free to roll over maturing issues, and tax revenue covers monthly interest payments by a large multiple.

Let me add one caveat to all this analysis. I suppose it's possible that a default might occur, but only if the Secretary of the Treasury deliberately chose not to pay interest in the debt. But that won't happen. Not only because the Obama Administration wouldn't want to needlessly roil financial markets, but also since research by Administration lawyers in the 1960s concluded that the Secretary of the Treasury might be personally liable in the event of a default. Mr. Lew has more than one reason to make sure the government pays interest on the debt.

My final point is that a fight on the debt limit might be worthwhile, even if it does cause considerable short-run angst and uncertainty. It all depends on whether it leads to desirable reforms.

Let's look at the example of Greece. There's nothing akin to a debt limit in that country, but imagine there was. Let's further imagine that a group of lawmakers 15 years ago dug in their heels and refused to allow more red ink.

That probably would have caused a lot of turmoil at the time. But if the net result was to force Greek politicians to restrain spending for a multi-year period, then it's quite likely that the people of Greece would have been spared the economic and fiscal misery that they've been suffering over the past few years.

Let's close with an analogy. Yesterday's long-run fiscal outlook from CBO shows that a do-nothing or status-quo approach guarantees fiscal chaos. We don't know if a crisis will occur in fifteen years or twenty-five years. Or maybe we even have more than 25 years since the U.S. will benefit from capital flows when nations such as Japan and France implode.

But at some point the United States will suffer the same type of crisis that we've witnessed in other nations. We're in a car and we're heading toward a cliff, even though it's hard to estimate how much father we can drive before we careen over the edge.

Wouldn't it be a good idea to take steps today—when it's relatively easy—to avoid that potential future crisis? To at least begin to steer away from the cliff? Perhaps by adopting something akin to Switzerland's "debt brake," which basically imposes an annual spending cap?

In other words, I'm not at all worried about short-run brinksmanship. Particularly since there's no realistic possibility of default. But I am worried about the long-run trendline of government spending. And if some brinksmanship today means spending in the future won't grow as fast, then the nation will be in a much stronger fiscal position.

JOINT ECONOMIC COMMITTEE
VICE CHAIR AMY KLOBUCHAR
UNITED STATES CONGRESS
SEPTEMBER 2013

THE ECONOMIC COSTS OF DEBT-CEILING BRINKSMANSHIP

Executive Summary

The federal government effectively reached its borrowing limit on May 19, 2013. "Extraordinary measures" undertaken by the Treasury Department since then will allow the federal government to postpone default until mid-October. Even if an actual default is averted, a delay in lifting the debt ceiling could increase uncertainty, erode consumer confidence and result in higher borrowing costs for businesses and individuals.

Because a default would cause significant harm to the economy, even the mere prospect of a default can affect the decision-making of households and businesses. A default would disrupt financial markets, limit access to credit and raise financing costs. It could also trigger a run on money market funds and cause significant harm to the U.S. economy by forcing the country to renege on commitments to individuals, businesses and governments.

With so much at stake, debt-ceiling brinksmanship poses serious and unnecessary risks to the U.S. economy, a fact that became clear during the protracted debt-ceiling showdown of 2011. The Dow Jones Industrial Average dropped over 2,000 points in late July and early August of that year as Congress struggled to raise the debt ceiling, and Standard and Poor's downgraded the U.S. credit rating. Consumer confidence also fell sharply in that period.

A delay in lifting the debt ceiling, and the resulting uncertainty, also increases borrowing costs for the government. The impasse on lifting the debt ceiling in 2011, for example, meant that the Treasury had to pay higher yields than otherwise would have been necessary, costing taxpayers $1.3 billion.

This report examines the effects of debt-ceiling brinksmanship and outlines its impact on the U.S. economic recovery.

JOINT ECONOMIC COMMITTEE
VICE CHAIR AMY KLOBUCHAR
UNITED STATES CONGRESS
SEPTEMBER 2013

THE ECONOMIC COSTS OF DEBT-CEILING BRINKSMANSHIP

The federal government effectively reached its borrowing limit on May 19, 2013.[1] Since then, the Treasury Department has undertaken so-called "extraordinary measures" that increase the federal government's borrowing capacity, allowing the government to postpone default until mid-October.[2]

With that deadline approaching, there is broad agreement among the nation's economic leaders that action must be taken to raise the debt ceiling and avoid default. Failure to do so would have serious economic consequences – potentially disrupting financial markets, limiting access to credit and raising financing costs for consumers and businesses. Foreign investors, who hold nearly half of U.S. debt, could reduce their purchases of U.S. Treasuries for an extended period of time, or sell some of their holdings of U.S. debt. A default could also trigger a run on money market funds, sparking a severe and disruptive crisis.[3]

Because the economic stakes of a potential government default are so high, debt-ceiling brinksmanship increases economic uncertainty, which has economic costs. The prolonged uncertainty during the debt-ceiling debate in 2011 resulted in a downgrade of the U.S. credit rating by Standard and Poor's. Delays in lifting the debt ceiling have been shown to increase costs for the federal government and impair the operation of the market for Treasury debt, affecting those who benefit from the liquidity provided by that debt market.

Background

The debt ceiling, or debt limit, is the maximum amount of outstanding federal debt the government can incur under statute. Raising the debt ceiling allows the United States to pay for mandatory and discretionary spending Congress has already obligated, honoring commitments made to households, businesses and governments, both here and abroad. Normally, the U.S. government sells Treasury securities to finance budget deficits. Once the debt limit has been reached, Congress must approve an increase to the debt ceiling before the Treasury can issue new bonds. Increasing the debt limit authorizes the Treasury to sell bonds to finance spending.

Because the debt limit is defined in terms of a particular dollar amount, normal growth in the U.S. economy means that the debt limit will be reached inevitably after some time. Congress has raised the debt ceiling more than 70 times since 1962 and has voted on the debt limit 12 times since 2002.[4] The last Congressional vote to increase the debt limit was part of the Budget Control Act of 2011, signed into law by President Obama in August 2011, which increased the Treasury's borrowing capacity by between $2.1 and $2.4 trillion in three increments.[5] More recently, Congress voted to suspend the debt limit through May 18, 2013.[6] Once the debt-limit suspension lapsed, the Treasury reset the debt limit at $16.699 trillion ($305 billion above the previous statutory limit) to go into effect on the next business day, May 20.[7] The Treasury Department also began

extraordinary measures to allow the government to continue to operate.

How a Default Might Affect Markets, Consumers and Businesses

If Congress does not increase the debt ceiling to pay for spending already committed by Congress and, as a result, the Treasury fails to make the debt-related payments for which it is responsible, default would occur, resulting in significant harm to the economy.

In 2011 testimony before the Senate Banking Committee, Chairman of the Federal Reserve Ben Bernanke said that a default would be a "calamitous outcome" and "create a very severe financial shock."[8] The global financial system relies on Treasuries, which have long been considered one of the safest investments. Bernanke explained that a "default on those securities would throw the financial system into chaos."[9] He likewise observed that not raising the debt ceiling is "like a family saying, 'Well, we're spending too much – let's stop paying our credit card bill.'"[10]

It is difficult to provide a precise estimate of the economic costs resulting from an actual default, but it is not hard to illustrate the significance of those potential costs to consumers and businesses.[11]

Chaos in the financial system, such as Chairman Bernanke described, would undermine credit and equity markets and impair the economy's capacity to grow. Limitations on access to credit, for example, would raise investment costs. For consumers, the increased cost of credit could translate into less borrowing for purchases of homes, autos or other durable goods and education. Businesses could encounter difficulties in acquiring the short-term debt they need to finance their payrolls or accumulate inventories, and higher financing costs would lead them to invest less in equipment and construction. In addition to the costs to consumers and businesses, cash-strapped municipalities would also face higher financing costs and could be forced to make cuts to essential services such as education and public health.

Apart from the costs that stem directly from the financial market impacts, a default would require the federal government to limit, delay or even suspend payments to creditors, program beneficiaries and others. The federal government makes about 80 million payments each month.[12]

Delays in Social Security, Medicare, Medicaid, veterans' benefits, unemployment insurance and other essential government programs would have a direct impact on millions of Americans and, in turn, would negatively affect the economy by pushing down consumer spending. For example:

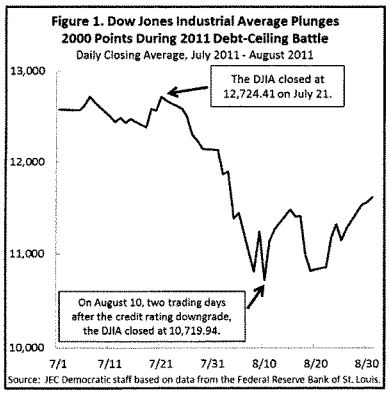
- If Social Security benefits were delayed or disrupted, 57.5 million Americans would not receive their monthly Social Security payments in a timely manner.[13] About 70 percent of Social Security beneficiaries are retirees and 30 percent of beneficiaries receive survivors insurance or disability insurance payments. The average monthly Social Security benefit is $1,159.[14] Without these payments, retirees, widow(er)s and disabled workers would struggle to make ends meet. In addition, more than $66.6 billion in monthly benefits would not enter the economy when expected – damaging the economic recovery.

- If veterans' benefits were delayed, 3.4 million veterans would not receive service-connected disability benefits on time. While those payments vary greatly based on the degree of the veteran's disability and the number of dependents, the average annual payment is $11,500. In FY 2011, those annual payments totaled nearly $39.4 billion.[15]

Uncertainty and the Costs of Delaying an Increase in the Debt Ceiling

Even if a default is ultimately avoided, the increased uncertainty in the days leading up to a debt-ceiling deadline would also have negative effects on the economy. That is because the costs of default are so significant that even a small chance of such an outcome must be factored into the decisions made by consumers, businesses and investors. In the face of the uncertainty, a consumer or business may choose to delay purchases or decrease investment. The way in which the debt-ceiling impasse is resolved can also affect uncertainty and economic behavior.

There is precedent for this uncertainty to harm the economy: In 2011, the Dow Jones Industrial Average dropped more than 2,000 points in late July and early August as Congress struggled to reach an agreement on lifting the debt ceiling, and Standard and Poor's downgraded its quality rating of U.S. sovereign debt (**Figure 1**).[16] Although the stock market eventually recovered, the lower Standard and Poor's rating remains. The volatility affected the portfolios of consumers and businesses and may have led many to change their consumption and investment plans, even if only for a short period.



Standard and Poor's downgraded the U.S. government's credit rating from AAA based on the protracted delay in increasing the debt limit and on its assessment of how the impasse was resolved. In announcing the first-ever downgrade of U.S. sovereign debt, Standard and Poor's noted:

> *"We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process."*[17]

Some fear that a repeat of 2011 could lead other ratings agencies to also downgrade the U.S. credit rating. Fitch Ratings warned on January 15th of this year that "failure to raise the debt ceiling in a timely manner will prompt a formal review of the U.S. sovereign ratings."[18]

Standard and Poor's, which on June 10, 2013 changed its long-term rating on U.S. sovereign debt from "negative" to "stable" due to the improved U.S. fiscal outlook, noted that:

> *"Although we expect some political posturing to coincide with raising the government's debt ceiling, which now appears likely to occur near the Sept. 30 fiscal year-end, we assume with our outlook revision that the debate will not result in a sudden unplanned contraction in current spending – which could be disruptive – let alone debt service."*[19]

Thus, another bout of debt-ceiling brinksmanship, or forcing indiscriminate spending cuts as a condition for raising the debt ceiling, would be a step in the wrong direction. It could endanger U.S.

creditworthiness and reduce market confidence in the U.S. economy.

Consumer surveys in 2011 also illustrated the potential for a debt-ceiling impasse to increase uncertainty. Consumer confidence, as measured by the Thomson Reuters/University of Michigan Index of Consumer Sentiment, fell sharply in July and August of 2011, dropping from 71.5 in June to 63.7 in July and 55.8 in August (**Figure 2**). In releasing the August data, Thomson Reuters/University of Michigan noted:

> "*Never before in the history of the surveys have so many consumers spontaneously mentioned negative aspects of the government's role, and never before have consumers rated economic policies so unfavorably.*"[20]

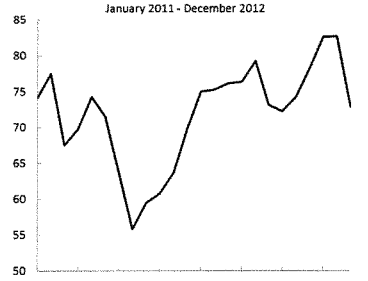
It took until January 2012 for confidence to return to the June 2011 level (**Figure 2**). This decline may have signaled a drop in consumers' willingness to make purchases, relative to what they would have done had the debt ceiling been resolved in a timely manner.

Delays in lifting the debt ceiling also complicate the already complex task of managing the federal debt. By forcing the Treasury to take "extraordinary measures" to temporarily increase the government's borrowing capacity, brinksmanship forces the Treasury into decisions it would not have otherwise deemed consistent with prudent debt management. Such measures could affect market outcomes. For example, in the past the Treasury has been forced to cancel auctions for short-term debt as a debt-ceiling deadline approached without a resolution in sight. These cancellations can be extremely disruptive to the operation of global money markets especially as the global financial system continues to recover from the crisis of recent years.[21]

Impasses over raising the debt ceiling, and the extraordinary measures the Treasury must take in the interim, can erode confidence in the relative risks that markets associate with holding Treasury securities. That decline in confidence has translated

Figure 2. Consumer Confidence Drops Sharply in 2011 Debt-Ceiling Showdown

Thomson Reuters/University of Michigan Consumer Sentiment Index, January 2011 - December 2012



Source: JEC Democratic staff based on data from Thomson Reuters/University of Michigan Surveys of Consumers.

into higher borrowing costs for the federal government. The United States has long benefited from the widespread belief that U.S. debt is among the safest forms of debt in the world; indeed, Treasury rates are widely used as benchmarks for "risk-free" rates that determine other market rates. If investors believe that U.S. debt has become riskier, they will demand a higher yield when purchasing it, which would increase the costs of borrowing for the U.S. government.

Studies have concluded that in recent decades some debt-ceiling events have raised short-term Treasury yields relative to comparable private market debt.[22] During such periods, the Treasury has to pay higher yields than would otherwise be necessary, as happened in 2011. A recent study of daily market data collected during the debt-ceiling impasse of 2011 found higher borrowing costs to the Treasury, and American taxpayers, which amounted to $1.3 billion in fiscal year 2011 alone.[23]

Debate over raising the debt ceiling should not be tied to negotiations on further reducing the deficit. While more must be done to move the nation toward fiscal responsibility, Congress has already taken steps to reduce deficits by at least $2.4 trillion. However, the vast majority of the savings to

date come from spending cuts and, if sequestration continues, the ratio of spending cuts to revenue increases will be four-to-one.[24] Both the National Commission on Fiscal Responsibility and Reform and the Senate-passed budget call for a roughly even split between spending cuts and revenue increases. Future deficit reduction needs to be more evenly balanced between revenue and spending cuts, and the debate on the budget should not be tied to raising the debt ceiling.

Conclusion

A delay in lifting the debt ceiling – even if default is ultimately avoided – increases uncertainty and has real economic costs. Delays in raising the debt ceiling increase costs for the federal government and affect the market for U.S. debt. Individuals and businesses may also face higher borrowing costs. As was seen in 2011, consumer confidence and the financial markets may be negatively affected. There is broad agreement that another bout of debt-ceiling brinksmanship would increase uncertainty, creating a new headwind for the ongoing economic recovery.

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[12] Letter from Secretary of the Treasury Geithner to Speaker of the House of Representatives Boehner, January 14, 2013. http://www.treasury.gov/connect/blog/Pages/Secretary-Geithner-Sends-Debt-Limit-Letter-to-Congress-1-14-13.aspx.

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