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The Strategic Implications of U.S. Debt

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Mr. Chairman:

I want to begin by thanking the Committee for this opportunity to testify. I should also make clear that I am speaking for myself and not for the Council on Foreign Relations, which takes no institutional position on this or any other matter of public policy. But before I turn to the subject matter of today's hearing, I also want to commend the Chairman and the members of the Committee for holding this hearing. People often talk about issues such as the debt and issues involving national security, but rarely do they bring the two together and talk about them at one and the same time in an integrated manner. What you are doing here today is just what is needed; as I am fond of pointing out, universities have departments but the world does not.

I would add that what makes this issue particularly difficult is that it is part of a class of what I would describe as slow motion crises. Slow motion crises are just that: phenomena or processes that are under way and that have potentially substantial or even devastating consequences that will kick in gradually, or, even if suddenly at some point, only after the passage of considerable time. They are thus fundamentally unlike an infectious disease outbreak or a financial collapse.

There is both good and bad news in this. The good news is that to a large degree we know where things are heading. We also have time to do something about it. We can see the iceberg in our path, and there is ample time to turn the ship around. The bad news is that slow motion crises generate little or no sense of priority but rather tend to promote complacency. The temptation is to put them aside, to focus on today's crisis, to allow the urgent to take precedence over the important. The problem with this is that we will forfeit the opportunity not just to prevent a crisis from materializing but we deny ourselves those remedies that are not severe. To switch analogies, the medical equivalent would be to ignore the symptoms in the patient when the sickness was relatively easy to treat and to wait to do something only when it became life threatening.

The problem being addressed here today is fairly straightforward. According to the Long-Term Budget Outlook released in June 2015 by the Congressional Budget Office and the CBO's more recent (January 2016) ten year Budget and Economic Outlook, the public debt of the United States is fast approaching $14 trillion. It now is equal roughly to 75% of GDP and in a decade will reach between 80 and 90% of GDP. Depending upon spending and revenue assumptions, it is a question of when and not if the amount of debt comes to exceed or far exceed GDP. This could well happen by 2030. What it will cost to service the debt will begin to rise rapidly, consuming an ever larger percentage of GDP and federal spending.

I should note that this prediction is not universal, and that there are those who think it too negative based on revenue and rate predictions and above all on larger than expected cost-savings in the medical domain. This is of course possible, but so too is a worse than expected future based on slower growth, higher rates, higher than expected medical costs owing to a larger aging population, and much higher than imagined costs associated with adapting to the many effects of climate change.

The causes of the debt problem are somewhat more controversial but still fairly straightforward. Although the federal deficit is considerably lower than it was just years ago, it is once again increasing, the result of greatly increased spending in select areas and low rates of economic growth. Some would say taxes or rather the lack of them are to blame as well, but US corporate rates are high by global standards and individual rates are not conspicuously low.

All things being equal, the problem will not only not fix itself but will grow worse. There are at least two reasons. First, the principal driver of spending increases, spending on entitlements such as Medicare, Medicaid, and Social Security, will likely become more not less of a factor as Americans retire in large numbers and live longer lives. Second, interest rates are near historic lows and are far more likely to rise than fall over future decades. Specific projections as to the size of the debt and what it will cost to finance necessarily vary depending on assumptions regarding economic growth, spending, taxation, inflation, and interest rates, but the trend is clear, and the trend is not our friend. Nor is time.

There are a good many foreseeable strategic consequences of growing indebtedness. Let me suggest several:

The most direct is that the need to finance the debt will absorb an ever-increasing amount of dollars and an ever-increasing share of the US budget. This will mean proportionately fewer resources will be available for national security, including defense, intelligence, homeland security, and foreign assistance. There will as well be fewer dollars available for discretionary domestic programs ranging from education and infrastructure modernization to scientific research and law enforcement. What this portends is an increasingly sharp and destructive debate over guns versus butter while the two fastest growing parts of the budget, debt-service and entitlements, remain largely off limits.

Mounting debt will raise questions around the world about the United States. Our inability to deal with our debt challenge will detract from the appeal of the American political and economic model. It will make others less likely to want to emulate us and more wary of depending on us as it will raise questions about this country's ability to come together and take difficult decisions. The result would be a world that is less democratic and increasingly less deferential to US concerns in matters of security. To some extent this is already happening; not dealing with our debt promises to make a worrisome evolution that much more so.

Mounting debt will leave the United States more vulnerable than it should be to the whims of markets and the machinations of governments. Already approximately half of US public debt is held by foreigners, with China one of the two largest lenders. There are those who say not to worry about this, that China will be constrained by its interest in not seeing its own huge pool of dollars lose its value and by its need for the United States to continue to buy its exports. The result, according to this line of thinking, is the financial equivalent of nuclear deterrence. This may be true, but I for one am not sanguine that China would not decide to slow or stop accumulating US debt as a signal of displeasure or even sell debt amidst say a crisis over Taiwan. In such circumstances, Chinese leaders might well judge it was worth paying a financial price to protect what they viewed as their vital national interests. Interestingly, it was American threats aimed at the pound sterling that more than anything else persuaded a British government that was fearful of the need to devalue its currency to back off its ill-fated venture to regain control of the Suez Canal in 1956.

Mounting debt could absorb funds that could otherwise be usefully invested at home or abroad. This will in turn depress already modest levels of economic growth. Making matters worse is that high levels of debt and debt financing will increase concerns about the government's willingness to maintain the dollar's value or worse yet meet its obligations. This will cause foreigners in particular to demand high returns on their loans, something that will increase the cost of debt financing and further crowd out other spending and further depress growth. This is a vicious, not a virtuous, cycle.

Mounting debt limits American flexibility and resilience. There is no way of stating in the abstract what constitutes the right level of debt for the United States or knowing with precision what level is sustainable. But the United states does not want to make high levels of debt the new normal as it removes flexibility if, for example, there were to be another financial crisis that required large-scale fiscal stimulus or an unexpected major national security challenge that demanded a costly response. Keeping debt levels low enough to allow for a surge in spending without triggering a debt crisis seems to be a prudent hedge and, as is the case with preventive medicine or insurance, worth paying a reasonable premium for.

Let me just add one more prediction. Mounting debt will hasten the demise of the dollar as the world's reserve currency. This will happen as a result of loss of confidence in US financial management and the related concern that what the United States will need to do to finance its debt will be at odds with what it should be doing to manage the US and indirectly world economy. It is possible such a move away from the dollar would have happened were it not for the EU's problems and China not being prepared to free up the yuan. But the United States cannot depend forever on the weaknesses and errors of others, and a post-dollar world will be both more costly (as it will require Americans to move in and out of other currencies) and one of less leverage when it comes to imposing dollar-related sanctions.

I understand it may be somewhat beyond the purview of today's hearing to offer up prescriptions about what needs to be done. That said, I find it impossible to resist laying down a few markers.

A big driver of the debt will be the cost of entitlements. We need to raise the current and projected retirement age so that Social Security better reflects economic and demographic realities. It would also make sense to subject Social Security to a means test and reduce payments to the relatively wealthy for whom by definition such payments are not essential, to moderate cost of living adjustments, and to reform the fast-growing Disability program.

Medicare and Medicaid are even more responsible for the entitlement burden. Some changes that could help here include accelerating the move away from a system based on fee for service and towards one that reflects quality of outcomes, finding a way to better deal with so-called "dual eligibles" who qualify for both Medicare and Medicaid, raising the age of Medicare eligibility, increasing co-payments, limiting malpractice torts, and introducing some means-testing of benefits.

Congress should avoid false "solutions." The sequester is one of them. It ignores entitlements and favors both spending over investment and the present over the future. It should be jettisoned once and for all. The same holds for threats not to raise the debt ceiling. As every senator knows, failure to raise the debt ceiling does nothing to limit debt already incurred but it does raise major doubts in markets and around the world as to whether the United States is reliable and serious. Ironically, failure to raise the debt ceiling would trigger reactions that would lead to an increase in rates, something that in turn would slow growth and exacerbate the debt burden.

Congress needs to be similarly careful about cutting defense. Current and projected defense spending is around 3% of GDP, far below historic averages. What is more, it is an increasingly dangerous and precarious world out there, and if the world becomes messier, there is no way the United States will be able to wall itself off from consequences partly brought about by our doing less. There is no other country willing and able to make a sizable contribution to order, and the world cannot order itself. Only the United States can play this role. The good news is that we can do so and tackle our debt challenge at one and the same time if we spend our resources wisely.

What would help as much as reducing entitlements would be taking steps to increase economic growth. My list includes better K-12 as well as life-long education, a robust public/private infrastructure modernization program, immigration reform that creates greater opportunities for those with advanced degrees and needed skills to come and stay here, reform of corporate taxes so more money comes back to this country and is put to use, a reduction in so-called tax-expenditures such as the mortgage interest deduction and a decision to tax employer contributions for health care premiums, and passing the Trans-Pacific Partnership and other trade pacts.

Mr. Chairman, let me conclude where I began, by commending you and your colleagues for putting a spotlight on this issue. You will have performed an important public service if this hearing leads to more people in this country viewing our current and future debt not simply as an economic or domestic concern but also as a significant threat to this country's national security.

Thank you. I look forward to any questions you may have.