"I Wouldn't Start From Here"

Testimony by Jared Bernstein to the House Budget Committee for the Hearing: "The Best Metric to Reverse the Curse: A 3% Deficit-to-GDP Path to Fiscal Sustainability"

Chairman, Ranking Member, and Members of the Committee, I thank you for the opportunity to testify today.

For as long as we've debated fiscal policy in this country, the opposing sides in that debate have been called fiscal doves and fiscal hawks. The former, wherein I used to reside, argued that so long as the economy's growth rate surpassed the interest rate of the government's debt and the primary deficit stayed roughly in check, deficit spending was not particularly worrisome. The hawks took the other side of that argument.

Of course, even we doves were concerned about the fiscal trajectory post the temporary 1998-2001budget surpluses. And we always emphasized that it mattered what purpose the debt accumulation was serving. Investment in people and projects with expected future returns, including anti-poverty programs, made more sense than unnecessary tax cuts or wasteful spending.

There are surely some fiscal doves left but many of us have flown the coop. The reasons are that the budget math has become more threatening, primary deficits have been growing quickly, and almost every tax and spending measure enacted by Congress in recent years has worsened the fiscal outlook.

Which is to say I welcome this hearing which I take to be in the interest of finding a bipartisan path toward a more sustainable budget outlook. That task has been made more urgent, and considerably more difficult, by the deficit financing of the recently enacted budget bill, which is actively worsening the very fiscal path we seek to improve in the context of this hearing today.

My one other overarching framing point is that while deficit reduction is necessary and desirable, it is easy to do so in a way that does far more harm than good. Examples include deficit reduction that increases post-transfer poverty, that is a function of failing to offset negative economic shocks, that cuts productivity-enhancing investment in public goods, and that imposes indiscriminate, automatic cuts.

I will briefly outline seven points that I urge the committee to consider as you work to construct a path back towards sustainability.

1: Fighting over whether the problem is too much spending or too little revenue is a dead end.

To understand this assertion, it is useful to start with the idea of "revealed preferences," an economic concept that tells us to watch what people do as opposed to what they say.

No matter how often policymakers say they are displeased with the fiscal outlook, their actions—their revealed preferences—show that our deficits are born of an unwillingness to raise the revenue we need to meet the spending policymakers believe is warranted.

Of course, there are members who would like to lower today's deficits and tomorrow's debt through spending cuts and tax increases. But I'm talking about the broad, majority-driven outcome, which is as I've described it.

The essence of our fiscal problem is thus neither obviously a revenue problem nor a spending problem. It is that Congress has long been unwilling to raise the resources necessary to pay for the institution's revealed spending preferences.

Given that framing of the problem, policymakers who truly want to reduce the debt must either reduce Americans' expectations about the role of government in our economy and their lives, raise the revenues necessary to meet those expectations, or some combination therein.

2: There is nothing wrong with aspiring to a deficit that's capped at 3% of GDP, but it matters how you get there. As Duke and Kogan put it, "Bringing the budget deficit down to 3 percent of GDP represents a laudable goal if done in a way that protects programs Americans rely on." In fact, supporters of last year's budget bill have already revealed a willingness to take away vital protections from economically vulnerable families, including nutritional and health coverage, to partially offset the cost of tax cuts. If that's how advocates of this approach intend to cap the deficit at 3%, it will do much more economic harm than good.

In no small part, such destructive cuts are a function of taking the vast majority of the budget off the table, including Social Security, Defense, Medicare, and so on. But I can assure this committee that they cannot and, in terms of causing deep and unnecessary human suffering, should not achieve their 3% cap by exclusively cutting programs for the poor and non-defense discretionary programs.

In considering this 3% pledge on the heels of last year's deficit-financed tax cut, which CBO tells us will add $3.4 trillion the debt over the next decade, one is reminded of the old Scottish joke wherein a traveler asks a farmer how to get to Aberdeen. The farmer replies, "Well, I wouldn't start from here."

An objective observer would be forgiven for finding it confusing that many of the same policymakers who just last year voted for a budget that made our fiscal path considerably less sustainable are now proposing a deficit cap. This effort would, in that regard, benefit from an explanation to people trying to understand these paradoxical actions how they make sense together.

3. ***If setting a deficit target helps focus Congress on our unsustainable fiscal path, then sure, go ahead.*** Just make sure it's flexible and can expand, if needed, in downturns.

Since Keynes, it has been widely understood that when the private sector is in a recession, the federal government can avoid much unnecessary suffering by temporarily at least partially replacing the lost demand.

4. The flipside of deficits expanding in downturns is that they should contract in strong economies.

We will be very unlikely to achieve a more sustainable fiscal path if we do not return cyclicality to the revenue flows into our government coffers. Bobby Kogan and I recently focused on this problem, linking it to a "…relentless one-way ratchet on tax policy this century" wherein tax cuts have resulted in a "weaker connection between economic growth and revenue flows to the U.S. Treasury." We show that "while economic downturns are still highly correlated with fewer jobs and therefore lower revenues, strong economies are less correlated with higher revenues than they were in the past" and that the "weakening of this linkage makes closing fiscal gaps a heavier lift, as the United States can no longer count on growth to have the same deficit-reduction impact as in prior years."

In 1969 (fiscal year), the unemployment rate was a very low 3.5% and revenues were 19% of GDP; in 2023, the unemployment rate was also a very low 3.6%, yet revenues were 16% of GDP. In fact, there have been three periods of full employment since 2000: the latter 1990s, the pre-pandemic period in the latter 2010s, and the post-pandemic bounce-back. The table below shows the average of the jobless rate in those periods along with revenues as a share of GDP.

	unemployment	rev/gdp
1998-2000	4.3	19.5
2017-2019	4.1	16.6
2023-25	3.9	16.8

Sources: BLS, CBO (the table references fiscal years)

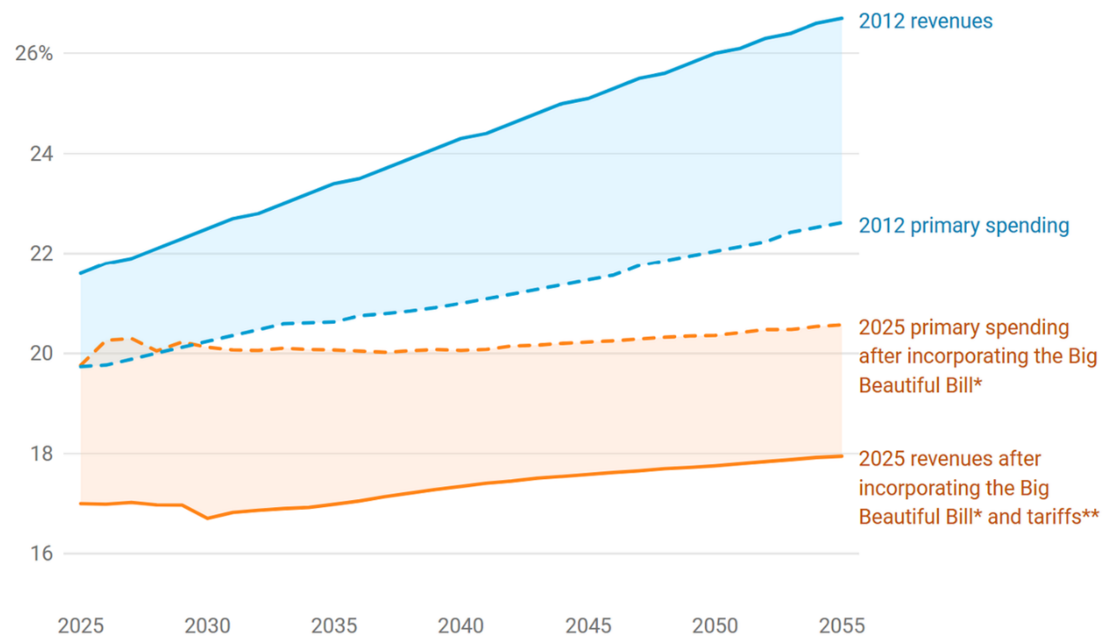
In the latter 1990s, low unemployment interacted with the Clinton tax increases (along with a spike in realized capital gains) to generate a revenue flow that was roughly three percentage points higher than the other two periods, wherein unemployment was even slightly lower.

5. **In considering how to get on a more sustainable path it is essential to recognize that spending is below where CBO thought it would be while revenues are much lower.**

As the figure below shows, compared to CBO forecasts from over a decade ago, spending outside of interest payments is actually on a *lower* trajectory (we leave out interest not because it isn't a significant and growing budget component, but because we're focused on the policy changes driving spending and revenues, the ones this Congress could address). The revenue line, however, is 5-8 percentage points of GDP lower now than it was then.

Both revenues and spending are lower than earlier projections, meaning low revenues are responsible for persistent primary deficits

2012 and 2025 adjusted Congressional Budget Office (CBO) projections of annual revenues and primary spending as a percentage of U.S. gross domestic product, 2025–2055



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** Assumes temporary provisions are extended.*
*** Assumes only one-third of tariffs remain after 2029.*

6. The tariffs reveal that we can raise new revenues. While many Republicans have long claimed to eschew any tax increases, and many Democrats have pledged not to raise taxes on households with incomes below $400,000, it is notable that President Trump introduced a significant tax increase last year: a sweeping import tax at levels we haven't seen for many decades.

Though the Supreme Court declared Trump's main tariff implementation to be illegal, my point here is that almost $290 billion was raised in tariffs in 2025 (compared to around $50 billion, pre-pandemic). The tariffs have not been costless, of course. They've put upward pressure on inflation, raising the inflation rate by just under 1 percentage point, and they were and are a source of stress for

American consumers and businesses, especially small businesses. They're also a regressive tax, hitting middle and low-income households more so than higher income households. In so doing, they've exacerbated existing affordability struggles.

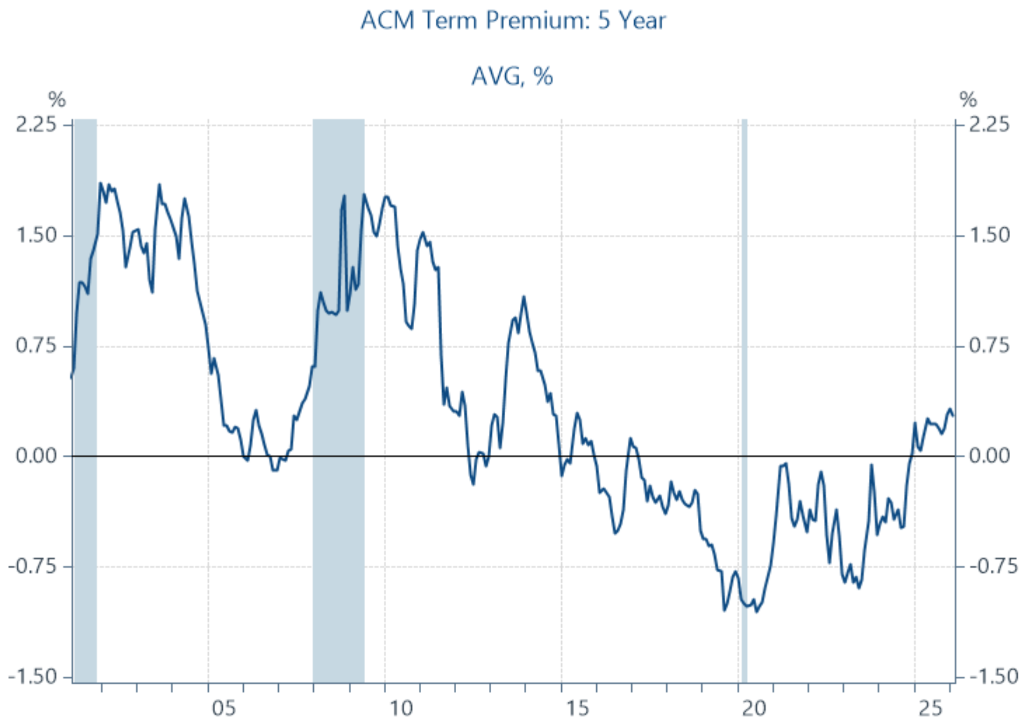
This argues for replacing the tariffs with other revenue raisers that are not targeted at families with the least ability to absorb them. But it is a contemporary example of a rare action—or at least a non-action (the Republican majority has generally not argued against the tariffs)—going in the other direction of the tax-cut ratchet.

7. The timing of a budget crunch is unknowable, but the shift in the budget math means it is closer than it used to be.

I began this testimony worrying about an unfavorable shift in the three key variables that determine budget sustainability: the growth rate, interest rate, and primary deficit. Such concerns raise the question: when do we think our fiscal path will clearly be hurting growth, investment, and living standards?

There is no way to reliably identify such a particular point-in-time. We can look abroad, but that exercise is not particularly informative. A reckless budget proposal in the UK led to a "sudden stop" in credit markets that formerly bought UK debt, but given the size and scope of the U.S. debt market and the dollar's role as the world's sovereign currency, such a moment is unlikely here. Then there's the case of Japan, a country that for years had a debt ratio that was double our own but did so while maintaining rock-bottom interest rates.

Still, I'm already seeing some signs that are at least slightly discomforting. Debt service to GDP is historically high at over 3% of GDP and is forecasted by CBO to climb to historically unprecedented levels in the mid-4s over the next decade, and this likely constrains our budget options. The interest rate term premium has also been a creeping up in recent months, though it remains at an historically low level. This both makes debt service more expensive and probably signals some discomfort among our creditors regarding the outlook.



Source: Federal Reserve Bank of New York/Haver Analytics

The bottom line, however, is that while we can't know when or even if a discrete economic moment-of-reckoning will occur—an American "Liz Truss" moment—we do know that the direction of travel is not sustainable. Thus, the sooner we take actions that are consistent with the spirit of this testimony ("do-no-harm" to vulnerable Americans), the better.

To conclude, I'm encouraged that this committee is looking for a bipartisan path to fiscal sustainability. The fact that the budget math looks considerably worse, i.e., less sustainable, than it used to is all the more reason to work together in this regard.

While I clearly emphasize a revenue shortfall relative to earlier projections, as well as the tax-cut-induced broken linkage between growth and revenue flows, I've suggested that fights over whether we spend too much or tax too little are not likely to move the ball downfield. The path to a better path surely requires both spending cuts and tax increases.

If a deficit target helps in this regard, and the target can be hit without doing more harm than good, then why not? But we cannot ignore that the history of such pledges has an even worse track record than New Year's Resolutions. As a long-term participant in this fiscal debate, I am convinced the way forward is to recognize that our best wishes are invariably overridden by our revealed preferences. If that's right, then the arithmetic couldn't be simpler. We must more closely match our revenues with the spending that our preferences reveal us to continuously endorse.