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EXAMINATION OF PROPOSALS FOR ECONOMIC GROWTH AND JOB CREATION

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

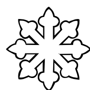
ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

INCENTIVES FOR CONSUMPTION AND INVESTMENT

FEBRUARY 11 AND 12, 2003



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EXAMINATION OF PROPOSALS FOR ECONOMIC GROWTH AND JOB CREATION: INCENTIVES FOR CONSUMPTION

TUESDAY, FEBRUARY 11, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Snowe, Kyl, Smith, Baucus, Breaux, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I want to welcome everybody to our committee, and to another hearing. This is the second in a series of hearings on economic growth and job creation.

Last week, we had the new Secretary of Treasury, John Snow, and he was presenting the revenue proposals that are in the administration's budget. The budget proposals included the President's plan for economic growth and job creation.

So today, for the second of this series, we are going to focus on the President's package once again, but we are going to limit our discussion focus to incentives for consumption. We will expand our focus to cover not only the President's plan, but others put forward by members of the House and the Senate.

It is clear that we have experienced a very serious decline in investment. I have told many stories even about my State of Iowa. We have some very heavy lifting to do on the investment side. I do not think we should make any mistake about that.

Over a long period of time, with recent improvement but still probably going back to the middle of the year 2000, we have had manufacturing in a decline or flat. Everyone knows about the recent history of the stock market.

In the meantime, as investment has sagged, American consumers have done their best to keep the economy afloat. With the lowest interest rates and the largest tax relief package in a generation, the consumer, fortunately, has had the resources to counter the slow-down in investment.

So in this hearing we will focus on the status of the consumption side of the economy. We will examine proposals for maintaining the level of consumption. The witnesses will testify, I believe, to the ef-

ficiency of various proposals, their short-term benefits, and hopefully, as we have a responsibility to look long term, what some of those implications are.

I think I should reiterate a couple of points from last week's hearing. One—and I speak just for myself—I believe all proposals are on the table as we seek what is absolutely necessary in the institution of the Senate with bipartisanship, and in this case a bipartisan growth package.

Number two, although we have split the topics into incentives for consumption and for investment, I believe the two are necessarily linked. We should not arbitrarily divide from business, particularly small business owners, and investment. Capital is the life blood of businesses, whether they are large or whether they are small.

It is just as true that businesses need consumers. Secretary Snow put it this way: the two concepts form a circle that make up the economy. Federal fiscal policy does not exist in a vacuum. There are consequences for our actions in Washington. Those consequences are going to ripple through the capitals of our 50 States.

On the one hand, our system of federalism does not make the Federal Government the insurer of all fiscal decisions made at the Federal level. State and local officials make their own fiscal policy. It is their right and their responsibility.

But, on the other hand, we in Washington need to be cognizant of those areas of fiscal policy where we are partners with State and local governments.*

Today, we are pleased to welcome four distinguished witnesses. Addressing the issue of consumption incentives generally are two veteran participants in economic policy, Steven J. Entin and Peter Orszag. Addressing the issues of State and local role are Oklahoma State Senator Angela Monson, and Chris Edwards, another veteran of economic policy debates.

Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I appreciate that statement. I also appreciate these new microphones we have here. They are pretty cool.

The CHAIRMAN. We can see our colleagues without looking through a forest of steel.

Senator BAUCUS. I might say, though, Mr. Chairman, you might get a brighter button here. These are awfully difficult to see when they are turned on. They are very faint.

Mr. Chairman, the President and Treasury Secretary Snow have said they want to see more employers put out "Help Wanted" signs, and I have got to tell you, I very much agree with that. But, all across the Nation, I think if you look closely, there are a different kind of "Help Wanted" signs.

That is, our Nation's businesses continue to operate at about three-fourths of capacity, which means they are not producing all the goods and services that they can.

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* For additional information on this subject, *see also*, "Economic Growth and Job Creation: Background and Proposals Relating to Incentives for Consumption and Investment," staff report of the Joint Committee on Taxation, February 10, 2003 (JCX–9–03).

Last week, the private out-placement firm of Challenger, Gray & Christmas reported that layoff announcements at U.S. firms surged to 42 percent in January over December's levels.

We simply will not see the "Help Wanted" signs that we all want until we do something about the "Help Wanted" signs that are already out. So what do we do?

The Federal Reserve has done its best to revive a sluggish economy. Last year, the Federal Reserve lowered the short-term interest rate 11 times. It is down to 1.25 percent. There is not much more rate to cut. In fact, Chairman Greenspan, at this moment, is speaking, and I doubt he is going to signal any further rate cut.

So we turn to fiscal policy, that is, taxes and spending. Today we are focusing on ways to strengthen the economy by increasing consumption. Tomorrow, we will look at the long-term economic growth by examining incentives to increase investment.

It is important to recognize that there are no one-size-fits-all solutions for the economy. The economy is weak, as is the case right now. Stimulus is needed. Stimulus can only come about if consumers and businesses spend more money now, that is, consumption.

To encourage spending may sound wrong. We have been taught the virtues of saving by our parents and by others. But when the economy is not operating at full capacity, only increases in spending will increase demand so that businesses will hire more workers and produce more goods and services.

Now, when the economy does get back into full employment and peak capacity, the situation will be different. Most everyone will have a job, and businesses will be producing much more.

To avoid inflation and encourage economic growth, we need higher productivity and new capacity. That is when we need to provide savings which businesses can use to invest in new facilities and equipment, and the new plant and equipment can produce more goods and services. That is, savings at that point, less the consumption.

Last year, there was a bipartisan agreement, as you will recall, for both the House and Senate budget committees on a set of principles for short-term stimulus. The House Budget Committee and Senate Budget Committee bipartisanly agreed on these points last year.

What are they? They agreed that any economic stimulus proposal must be, first, timely, take effect quickly, be sizeable, be targeted at consumers and businesses who will spend it, that is, get the most bang for the buck, and in a year, that is, not a long period of time, and not increase long-term budget deficits. These are good, I believe, common-sense principles and we should use them to guide our choices for economic stimulus right now.

So what are the best ways to stimulate consumption? As I see it, three stand out. First, aid to the States. When there is a recession or a weak economy, States face large deficits.

Starting in 2002, States are facing deficits of at least $171 billion, and for the current fiscal year, projected deficits for States are in the neighborhood of 70 to 85 billion. There may be more updated figures than that, but at least they are in that area.

Almost all States have balanced budget requirements. So what does that mean? That means, when faced with deficits, States must lay off workers, cut spending on programs, or raise taxes. These actions only make the economy weaker.

States are being forced to take such actions. Sixteen Governors, Republicans and Democrats, have already proposed tax increases to keep their upcoming budgets in balance.

States are cutting Medicaid. Massachusetts will cut about 50,000 people from Medicaid coverage. California is considering eliminating Medicaid health care coverage for 500,000; of these, 200,000 have income levels below 60 percent of the poverty line.

Oregon has not only cut education funding and Medicaid funding, but they will let prisoners go free in order to balance the budget.

We need to get aid to the States. We can pass all of the Federal tax cuts we want, but what good do they do for the American taxpayer if we are forcing States to raise taxes or cut education funding?

Second, we need to extend unemployment benefits to the people who were left out in January. We know the labor market is tough. There simply is not enough jobs. More than 2 million jobs have been lost since March of 2001.

One sign of the sluggish economy is, according to the Conference Board, that a number of "Help Wanted" ads in newspapers is at the lowest level since the Kennedy administration. Let me repeat: the fewest "Help Wanted" ads in newspapers since the Kennedy administration. That is 40 years.

When the economy is bad, we extend unemployment benefits. America has a tradition of helping those in need. We extend unemployment benefits to help these people pay their rent and put food on the table. It is the right thing to do, and it is also good for the economy.

We are talking about families on the edge, just barely getting by. When we give them aid, they spend it quickly. In fact, a Department of Labor study found that every dollar in Unemployment Insurance benefits results in a $2.15 increase in GDP. For every dollar spent on unemployment benefits, we more than double the impact on the economy.

In January, we extended unemployment benefits through the end of May. Unfortunately, we left out about one million Americans. These are displaced workers who have already received an initial round of extended benefits and still cannot find work. They have exhausted their eligibility. We should extend their benefits.

Third, we should give a tax cut to those who will spend it. I want to get one to the school teacher in Shelby, Montana and the police officer in Billings. Taxes are taxes, whether they are payroll taxes or income taxes. We must get money into the hands of consumers. We should eliminate taxes on the first $3,000 of wage income. One hundred and ten million working taxpayers would see their paychecks increase and $41 billion would be put into the economy.

I know there would be a lot of talk about accelerating many of the tax cuts that were enacted in 2001. Let me be clear: I am not opposed to accelerating some of the tax cuts.

But any plan to accelerate tax cuts must include acceleration of marriage penalty relief for Earned Income Tax Credit recipients

and the refundable portion of the child tax credit so we could expand the group of consumers who will pump money into the economy.

So there are ways we can stimulate the economy: aid to the States, extend unemployment benefits to those we left out in January, and give a tax cut that will stimulate consumer spending.

With these proposals in mind, Mr. Chairman, it is my hope that our committee can work together to forge a broad bipartisan plan to strengthen our economy, and I look forward to working with you.

The CHAIRMAN. Thank you, Senator Baucus, for your statement.

We will go, now, to our witnesses. Any members that have statements that they want to put in the record, those will be accepted for the record.

We would encourage each of you that have longer statements, that they would be included in the record, so you will not have to ask for permission to do that. We would ask for a summary.

We will start with Ms. Monson, then we will go across the table until we get done with Mr. Orszag. Then at that point, we will ask questions in the order of the members, first-come, first-served.

I want to tell you how we kind of keep everything in order here. We have the blue light, the yellow light, the red light. You have, I think, one minute after the yellow light comes on. When the red light comes on, I am not going to bang the gavel and shut you up, but would you very quickly finish sentences or ideas at that point, since your entire statement is in the record?

Ms. Monson.

STATEMENT OF HON. ANGELA MONSON, OKLAHOMA STATE SENATE, OKLAHOMA CITY, OK

Ms. MONSON. Thank you, Mr. Chairman. In my home State, in the Oklahoma Senate, when your time runs out they simply turn the microphone off. [Laughter.]

Senator BAUCUS. I am sorry you mentioned that. [Laughter.]

Ms. MONSON. Just an idea. Just an idea.

Chairman Grassley, Ranking Member Baucus, and distinguished members of the committee, good morning. My name is Angela Monson, and I am the president of the National Conference of State Legislatures. I am also the Assistant Majority Leader of the Oklahoma State Senate, where I previously served as Chair of the Senate Finance Committee.

I thank you so much for the invitation to appear before you today and testify on the fiscal condition of the States and how we can develop a partnership with the Federal Government to spur economic development, economic growth, and job creation.

I will summarize my prepared statement which has been submitted for the record, Mr. Chairman.

Last week, NCL released its latest update on State fiscal conditions. The news keeps getting worse and worse. State budgets are under siege. Legislatures and Governors are trying to close a $26 billion gap in the current fiscal year, an increase of 50 percent in the last 2 months.

The 39 States responding to our survey anticipate a $68 billion shortfall in their fiscal year 2004 budgets. These are staggering

numbers for the legislators and Governors who must develop strategies for bringing their budgets into balance.

They are sobering numbers for national leaders who are developing strategies for economic recovery. Because States must balance their budgets each year, the actions that they take, cutting spending or raising taxes, slow national economic recovery.

They have the opposite effect of the economic stimulus that the Federal Government is trying to promote. The National Conference of State Legislatures, therefore, believes that Federal and State officials must work in partnership to spur economic recovery.

Federal economic recovery efforts should adhere to five basic guidelines. One, they should recognize the critical link between States and the national economy. Two, they should include tax strategies to encourage, not constrain, State investment.

Three, they should invest in capital projects that leverage State and private investment. Four, they must avoid unfunded mandates and under-funded national expectations. Five, they must provide immediate fiscal relief for States.

I will elaborate briefly on each guideline. The first guideline is the point I have already made. Federal efforts at economic recovery must recognize the substantial contributions that State governments make to the national economy through purchasing, employment, the services that they provide, and their tax policies.

We commend many of the members of the Senate Finance Committee for their proposals that view State fiscal relief as an integral part of economic recovery.

Changes in tax policies are major features of many of the stimulus proposals. In contemplating these plans, we ask that you keep in mind their effect on State revenues and tax policies.

In my written testimony, I describe in detail the effects of last year's Federal change in the depreciation schedule on State revenues. That example, as telling as it is, is not isolated.

Several members of this Finance Committee once served in their State legislature. They, in particular, know how intertwined are the State and Federal Tax Codes. That is why NCSL generally favors tax relief and growth incentives through tax credits rather than changes in definitions of adjusted gross or taxable income.

Our guidelines also call for investment in capital projects. We are grateful to Senator Baucus for his proposal to increase highway spending through issuance of new highway bonds in the early 1990's.

Many of the members of this committee worked with State legislators, Governors, and local officials to curtail the use of unfunded Federal mandates. We rejoiced in the passage of the Unfunded Mandate Reform Act, and we were pleased that it truly had stifled unfunded mandates. I regret to tell you, though, that they are back, and with a vengeance.

NCSL estimates that four programs alone have burdened State budgets with a minimum of $25 billion in unfunded mandates. Fully funding these mandates would help States close their budget gaps and remove some of the drag that State budget actions are placing on the economy.

Finally, we are grateful to members of this committee for advancing various plans for immediate State fiscal relief, to Senator Bau-

cus for counter-cyclical revenue sharing, to Senator Snowe for one-time revenue grants, to Senator Rockefeller and several others for proposing the return of unspent Children's Health funds to the States, and to Senator Smith for proposing an advanced refunding for tax-exempt bonds.

We support each of these proposals and look forward to working with this committee to incorporate them into an economic growth and recovery package.

We also look forward to working with Senator Nickles and the Budget Committee to ensure that these funds are included in the Federal budget resolution.

Again, I am pleased for this opportunity to testify today and look forward to working in partnership with Senator Grassley, Senator Baucus, and the other members of the Finance Committee on economic recovery and State fiscal relief.

Thank you again, Mr. Chairman and members, for listening. We will be happy to, at the appropriate time, respond to questions.

The CHAIRMAN. The State Senators in Oklahoma are very disciplined. [Laughter.]

Ms. MONSON. We have been taught well.

[The prepared statement of Ms. Monson appears in the appendix.]

The CHAIRMAN. Mr. Edwards.

STATEMENT OF CHRIS R. EDWARDS, DIRECTOR OF FISCAL POLICY STUDIES, THE CATO INSTITUTE, WASHINGTON, DC

Mr. EDWARDS. Thank you very much, Mr. Chairman and members of the committee. Thank you for inviting me to testify on economic growth proposals. In particular, I would like to talk about proposals for a Federal bail-out of the States.

Across the Nation, budget gaps are forcing State governments to make tough fiscal policy choices. There are some proposals on the Hill here to provide a Federal bail-out of $31 billion, and Democratic Governors in the States want $50 billion to close State budget gaps.

Yet, the Federal Government already has its own $300 billion deficit problem and certainly cannot afford further spending increases. All Federal spending ultimately falls on taxpayers who, of course, pay the bills at both the Federal and State level. Increased Federal aid to the States simply moves money from one pocket to the other without any net economic effect.

State budget problems are not the result of revenue shortfalls, in my view, but of spending excesses during the late 1990's, fueled by rapid growth in income and capital gains taxes, as I document in the report included in my written testimony.

A Federal bail-out would simply delay the top spending adjustments that are needed in the States. Like all subsidy programs, a Federal bail-out would probably lead to another bail-out down the road.

It would create a bad precedent and allow States to avoid needed budget restructuring. Temporary State aid would probably be renewed, turning into a permanent drain on Federal coffers.

Despite the word "crisis" being thrown around a lot by State officials and newspaper headlines, aggregate data for the 50 States

does not reveal a crisis, although it is true that some States are in more trouble than others.

There has simply been a sharp spending slow-down from prior rapid growth rates, sort of like a motorist getting off a freeway and having to slow down as he exits the freeway.

Budget gaps appeared after State spending growth of 7 percent in 1999 and 2000, and 8 percent in 2001. Even as budget gaps appeared, State spending still increased, although slightly, in 2002 and 2003, in aggregate.

Looking at the tax side, total State tax collections grew 7 percent in 1998, 5 percent in 1999, 8 percent in 2000, and just looking at the first three quarters of 2002, total State and local receipts rose 3.4 percent. So, revenues in the States are recovering.

Some pundits are blaming prior State tax cuts for current State budget troubles, but net State tax cuts that occurred in the late 1990's were not enough to return to taxpayers the $36 billion in net State tax increases that occurred in the early 1990's during the last recession.

Note also that Federal grants and aid to States have soared. Federal grants increased just in the last four years from $285 billion in fiscal year 2000 to a proposed $399 billion under the Bush budget for fiscal year 2004. Medicaid, which has been mentioned, in just 4 years jumped from $125 billion in Federal grants and aid to $194 billion by 2004.

So I would ask the committee to take a skeptical view of the so-called State budget revenue shortfalls. Frankly, these could alternatively be called spending excesses. Budget gaps are partly based on faulty budget forecasts at the State level that were far too optimistic.

Supposing a Governor had planned for a 6 percent budget increase, but now has to pare that back to 3 percent. That is often said to be a 3 percent shortfall. But, in fact, revenue and spending would still be rising by 3 percent, or an increase.

California is an interesting case study of how a remarkable run-up in spending led to a large budget gap. California's State spending jumped a remarkable 15 percent in fiscal year 2000, and 17 percent in fiscal year 2001. The increase in 2001 amounted to $12 billion.

It is true that California has had to cut back. In 2002, they cut spending by $1 billion, but that is just one-twelfth of the prior year's large increase.

As in other States, news headlines in California are making modest cuts, in my view, sound draconian. The boom/bust cycle in California and other States can be tamed if they move away from volatile income and capital gains tax bases toward consumption bases. Sales tax revenue has been a source of real stability for State budgets.

For example, in California, capital gains tax revenue plummeted from $17 billion in 2000 to $5 billion this year. So, such taxes, capital gains and income taxes, leaves State governments a lot more vulnerable in slow-downs.

Ultimately, States will have to live within their means, and a Federal bail-out would simply postpone needed adjustments, I be-

lieve. A Federal bail-out will simply trade a larger Federal deficit for a smaller State deficit problem.

Ultimately, again, taxpayers have to pay for any bail-out package. It strikes me that it makes no sense to fool State taxpayers about the high cost of State programs by hiding it in larger Federal taxes.

One unfair aspect of a Federal bail-out would be to reward fiscally irresponsible States with tax money from citizens in fiscally responsible States who have no need for a bail-out.

Taxpayers in States that have balanced budgets would effectively be handing their hard-earned dollars over to the fiscally irresponsible Governor of California and other States.

In my written testimony, I proposed some approaches that States should be taking instead of lobbying for a Federal bail-out.

To conclude, State budget troubles, I do not believe, are as serious as many newspaper headlines are suggesting. Overall State spending has not been cut and revenues are already recovering as the economy has resumed strong growth.

The supposed economic stimulus effect of further Federal or State spending, I believe, is a mirage. Added government spending simply shifts money from some citizens' pockets to others without adding anything to the productive or supply side of the economy.

Thanks a lot for holding these hearings. I look forward to working with the committee on these important issues.

The CHAIRMAN. Thank you, Mr. Edwards.

[The prepared statement of Mr. Edwards appears in the appendix.]

The CHAIRMAN. Now, Mr. Entin.

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. ENTIN. Mr. Chairman and members of the committee, thank you for the opportunity to testify before you this morning. My views are my own and do not necessarily reflect the opinions of everyone at the Institute.

Let me note, first, that I think the focus on consumption is misplaced. Consumption has been strong throughout the business cycle. The 2001 recession was due to a slump in investment spending, and that spending has been slower than normal to recover.

That is the source of the current unsatisfactory rate of economic growth. But, more fundamentally, we need to focus on production, not on spending, to create growth in jobs.

As for policy changes that would improve the economy, let us get the analytical framework right. Let me assert up front that there is no meaningful distinction between tax changes that are good for the economy in the short run and the long run. Only policies that are good for long-run growth and economic efficiency have any favorable short-run effects.

In particular, there are no tax changes that would succeed in "pumping up consumption" in the short run by "giving people money to spend" because the Treasury would have to immediately borrow back the tax cut to cover its outlays.

Furthermore, tax changes that promote work, saving, investment, and long-run growth actually start to work immediately, although they build over time. Fine tuning is impossible.

Temporary tax cuts are not generally effective at much of anything. Permanent tax cuts can promote growth in the near term and the long term, but only if they are of the right sort.

Finally, the deficits associated with the various saving, investment and work incentive tax changes proposed by the administration are manageable and would not raise interest rates by enough to dampen investment.

Over time, economists have had a changing view of economic and tax policy. There was a time in economics from the mid-1930's to the mid-1960's when economists believed in the pump-priming efficacy of rebates, credits, rate cuts, or any old tax reduction. But that time is long past, or it should be.

The old view is that a tax cut worked by giving people money to spend. This would then reverberate through the economy, leading people to assume that giving out $1 in unemployment benefits might trigger more than $2 in additional GDP.

But Milton Friedman and the monitarists, and the neo-classicists such as IRET's founder, Norman Ture, were never comfortable with these notions. By the mid-1960's, the Keynesian prescriptions were called into question.

Friedman made two key contributions. In his permanent income theory, he demonstrated that people do not rush out and spend as soon as their disposable income increases. It takes them time to recognize that this is a permanent increase in their income, and it is permanent income that governs spending. Therefore, temporary tax cuts would not be effective in boosting spending.

Later, Friedman went further to observe that a tax cut or a government spending hike that increased the deficit would not stimulate spending or demand unless the Federal Reserve monetized the added debt.

In one of his famous Newsweek columns he asked, "If the government cuts taxes from $500 billion to $450 billion without cutting spending, where does the $50 billion come from, the Tooth Fairy?"

His point was that, if the Federal Reserve did not pony up the money to buy the extra Treasury debt, the government was simply borrowing the tax cut back from the public, sort of a revolving door. He reiterated this recently in the Wall Street Journal.

If tax cuts do not work by giving people money to spend, how do they work? In neo-classical thinking, tax cuts improve economic performance and raise individual and national incomes if, and only if, they reduce tax barriers to producing more income by working, saving, and investing more than before.

This is the insight behind the neo-classical focus on marginal tax rate reduction and accelerated depreciation, and other things which make it more rewarding and less costly to increase the supply of inputs into the economy, to hire them, and to put them to work.

Events in the 1960's and 1970's bore out this neo-classical view. Look at the success of the Kennedy marginal tax rate cuts in promoting growth, and the success of the Johnson marginal surtax in causing the 1969 and 1970 recession.

Then look at the ineffectiveness of the many non-marginal increases in personal exemptions and standard deductions in the early 1970's. Also look at the damaging effect of the marginal increase in tax rates due to inflation-induced bracket creep.

These lessons helped inform the Economic Recovery Tax Act of 1981, which focused on the marginal tax rates, and the associated fight against inflation.

Rebates have a long tradition of failure. I have given you some information on the failure of the Ford rebate. When President Carter proposed an even larger rebate in 1976, Senator Russell Long laughed the idea out of the Finance Committee and replaced it with a better tax plan.

The 2001 rebates of $300 per adult taxpayer were about 80 percent saved. They created very little visible jump in the GDP and a big jump in the personal saving rate.

Permanent tax rate cuts work at the margin to raise rewards to additional work, saving, and investment, expanded capacity, output, employment, and income. They begin to work at once. Their effect builds over time as additional capital is put in place, and the primary beneficiaries are the workers who get to work with the additional capital.

The President has proposed a number of things such as dividend relief, accelerated reductions in marginal tax rates, and enhanced and simplified saving incentives that encourage investment, work, and saving. These things would promote growth.

The social parts of the program, the marriage penalty relief, the widening of the 10 percent bracket, and the increase in the child credit, would give quite a bit of money to low-income taxpayers, but the government would have to borrow that back. These should be viewed as social policy, not as things that promote growth.

In fact, I think selling the program with the notion that it would spur consumption in the short run was a mistake. It blurs the distinction between tax changes that work and those that do not.

Most of the rebate proposals that have been offered are not at the margin. Some even fall on last year's income instead of this year's income. They would have no effect on consumption and they would have no effect on economic growth, and should be set aside.

I will talk about deficits and interest rates, if you would like, during the questioning, but right now I will conclude. Thank you.

[The prepared statement of Mr. Entin appears in the appendix.]

The CHAIRMAN. Mr. Orszag.

STATEMENT OF PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. ORSZAG. Thank you, Mr. Chairman, Senator Baucus, and members of the committee.

I think you face a particularly challenging problem right now because the best things for the short run are dramatically different from the best things for the long run.

As Senator Baucus and others have emphasized, the best thing for spurring the economy in the short run is to get more demand for the goods and services that firms could produce with current capacity.

For example, according to Federal Reserve data, the capacity utilization rate for December of 2002 was 75 percent. That is relative to a three-decade average of about 82 percent. There is unused capacity that firms could use if there were more demand for their goods and services.

To get that demand, you need increased spending. It could be government spending, it could be consumer spending, it could be business spending, but you need more spending.

The long run is much different. In the long run, you need more saving. In the long run, the key question for spurring economic growth is expanding the capacity of the economy to produce goods and services, not fully using the capacity that we have.

So, they are much different challenges. The question of whether you want to spur consumption or saving is substantially different in the short run and the long run.

My written testimony argues that the administration's plan does not do particularly well in either the short run or the long run. In the short run, it does not do particularly well because it does not spur that much additional demand.

In the long run, it does not do that well because it expands the budget deficit and that reduces national saving. The reason that is important, is national saving is what finances expansions in capacity. It increases the capital stock owned by Americans.

The more that we save, the higher the capital stock owned by Americans in the future, and therefore the higher our future national income. I will return to that point in a moment.

I would note that I am joined in this judgment about the lack of effectiveness of the administration's plan by 10 Nobel prize winners and more than 400 other economists who released a letter yesterday to that effect. I would just note, in case you are getting the impression that economists are agreed that there could be no effective stimulus plan in the short run, 10 Nobel prize winners wrote.

"To be effective, a stimulus plan should rely on immediate, but temporary, spending and tax measures to expand demand, and it should also rely on immediate, but temporary, incentives for investment. Such a stimulus plan would spur growth and jobs in the short term without exacerbating the long-term budget outlook."

One of the reasons that, in the long term, there are concerns about the administration's proposals, is the size of the revenue losses that they would involve in the out years. If you look at fiscal year 2013, for example, the administration's tax proposals would amount to 1.7 percent of GDP.

That is, if anything, an understatement of the permanent loss involved because of unrealistic assumptions about the Alternative Minimum Tax, and because it does not take into account the full effects of the new savings accounts that the administration is proposing and that would have large revenue losses after 2013.

But let us just take the 1.7 percent of GDP. That is a significant number. Just for comparison purposes, the 75-year deficit in Social Security is 0.7 percent of GDP.

That means that in present valve, the permanent tax cuts being proposed by the administration are more than twice the size of the Social Security deficit over the next 75 years. We can talk about

other points of comparison, but by any measure these are significant revenue losses.

Now, in evaluating tax cuts, permanent tax cuts that expand the budget deficit, is important to take into account two effects. The Council of Economic Advisers, in its most recent Economic Report of the President, also recognizes these two effects.

On the one hand, you have positive incentive effects, like Mr. Entin and others have emphasized. But, on the other hand, you have expanded budget deficits which reduce national saving, and those have adverse effects. What you need to do, is weigh the two against each other.

Of the four studies of which I am aware of the 2001 tax cut that do try to weigh both of these effects, all of them come up with very modest effects on economic output, and if anything, a negative effect, because the adverse consequences from reduced national saving outweigh any positive effects from improved incentives.

But the point is, it is extremely unlikely that you are going to get a massive increase in economic growth from tax cuts that are financed by the deficit. Therefore, the argument that we can grow our way out of the long-term deficits is just not correct.

Finally, let me just turn, briefly, to a more auspicious set of policies. Given current conditions, I think the most effective set of policies would combine a short-term stimulus package of perhaps 1 percent of GDP or so, limited to 2003, with long-term fiscal discipline.

The short-term package could include measures like State fiscal relief—I will return to that very briefly in a second—increased government purchases, including for homeland security, temporary incentives for business investment, and a set of temporary, progressive tax rebates.

That could be combined with long-term fiscal discipline, which would address both of the problems facing the Nation, the need for more demand in the short run and the need for more savings in the long run.

Just very briefly, on the State fiscal crisis. Let me just note that, according to the National Association of State Budget Officers, there has been a real decline in aggregate State spending for fiscal year 2001 to 2002, and another one from 2002 to 2003, and I bet there will be another one from 2003 to 2004.

If you doubt that there is a problem at the State level, just look at what the States are doing on taxes. Out of the 34 States that have submitted their budgets for the next fiscal year, 24 have proposed a tax increase or delayed tax cuts. Governors would not be doing that if they did not face a pretty severe crisis.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Orszag appears in the appendix.]

The CHAIRMAN. We have had a very comprehensive panel and we will have a series of questions. We will take 5 minutes each, including the Chairman. We will go in this order, according to arrival, or seniority for people that were here before we started. So that would be: Grassley, Baucus, Kyl, Breaux, Snowe, and Smith.

I am going to start with Mr. Entin. We have heard much debate about a portion of the President's package that accelerates the marginal tax rate reduction to 35 percent. As you know, much is made

of the effect of the phase-out rates of the Earned Income Tax Credit and its effect on beneficiaries.

Though the critics on the left never acknowledge it, many provisions in the bipartisan tax relief package address those effects. Do you find it odd that some can point to the marginal rate effects on the phase-out of the EIC, but ignore those same effects with respect to rates that apply to upper-income or higher-income taxpayers?

Mr. ENTIN. Yes. I prefer a more consistent approach. Certainly, if you are worried about marginal tax rate and the disincentives they have, you have to look at the effects of the EITC and, as I go into in detail in my testimony, the child credit, which also boosts marginal tax rates, but does so near the top.

One must also acknowledge that lower marginal tax rates, through the form of rate reductions, have positive effects. You cannot say that one is negative and the other one does not exist.

I would look at the President's proposal to accelerate the rate reductions as helping to increase work effort, saving, and investment, particularly by small business people, beginning right away and having positive effects on the economy, not because they have given these people money to spend, but because they have enhanced the incentives to do more. I would also caution against the high marginal rate effect of the phase-out of the EITC. It is good to address that.

I would caution you that extending the child credit has the effect of increasing the marginal tax rate by about 5 percentage points near the top over a wider range of income. In fact, there is a chart in the economic report of the President, page 193, that would illustrate that.

You must focus on these marginal rate effects. It is not by giving money or taking money away that you are influencing the behavior, it is by penalizing or rewarding additional effort. That is how all of these tax plans should be viewed, and they should be uniformly regarded in that light.

The CHAIRMAN. I think you have addressed another two points that I was going to bring up. So just let me simply say, maybe by nod of your head, you would say that the 11 percent difference between the high marginal tax rate, 38.6, versus 35 percent for corporate, is biased in favor of corporations and against small business, and detrimental to the creation of jobs from that standpoint.

I think you were speaking about the legitimacy of not having a higher marginal tax rate for one class of business versus the other.

Mr. ENTIN. Yes. I would like to see them more even. But, bear in mind, even if they are even, that corporate rate constitutes a second layer of tax on the earnings of corporate capital, which is what the President's plan to relieve the double taxation of dividends and improve treatment of capital gains is all about.

The CHAIRMAN. Let me give Mr. Orszag an opportunity, then, to comment on any of your answers or my questions. It is my understanding that you would oppose the bipartisan tax relief packages of marginal rate reductions.

From that standpoint, maybe you might address my posture of the unfairness of the high marginal tax rates on individuals, which

affects small businesses that file with individual tax returns versus a Fortune 500 high marginal tax rate of 35 percent.

Mr. ORSZAG. Sure. First, on the small business point. I think it is important to realize that the vast majority of small businesses—and by small businesses here we mean individuals who are showing some income on Schedules C, E, or F, which often is not actually really a small business, but let us take that as our definition—are not filing at the top marginal tax rate. Well over 95 percent of small businesses are not earning that much money, and therefore are not paying that top rate.

In fact, if you look at the distribution of tax returns with business income, more than half would get less than $500 under the President's new growth package, which just reflects the fact that there are a lot of small businesses down at lower income rates.

Now, on the broader question of marginal tax rates and their effects, again, you need to weigh the positive effects from reducing marginal tax rates. There are some positive effects on work effort and on other aspects of economic activity from reducing marginal tax rates. But you have to weigh that against the cost of the expanded budget deficits over the long term.

Again, the available studies that I have seen suggest that the negative effect outweighs the positive. So if someone came up to me and said, we have got a policy that will not spur economic growth, will expand the budget deficit, and will exacerbate after-tax income inequity, that would not be something that would strike me as immediately being a good idea.

The CHAIRMAN. Mr. Orszag, there has been some talk about having a payroll holiday or reimbursing payroll tax through various income credits. Supporters failed, I think, to mention that we already have a program, the Earned Income Tax Credit, that in many ways fully reimburses payroll taxes. In addition, the child credit is partially refundable against the payroll tax.

So, as we now have many low-income families that pay no income tax and are fully reimbursed for the payroll tax, should persons who are exempt from both the income tax and the payroll tax qualify for an additional payroll tax holiday or refundable income credit based upon the same payroll wages?

Mr. ORSZAG. Again, I think the question is what your objective is. If your objective is to maximize the short-term effect on spending, then those are basically the people you want to be targeting.

Mr. Entin mentioned that a lot of families do base their spending decisions on permanent income, and that is true. But the evidence suggests that between 15 and 50 percent—with the range just indicating disagreements among economists—of spending is done by households that live paycheck to paycheck.

If you give them a dollar today, even if it is temporary, they are going to spend it. Those households are the ones who are disproportionately the ones that you are talking about.

So, it really depends. If your objective is to get the economy moving in the short term, concentrating tax relief on those families, temporary tax relief, would be the most effective tax relief that could be given.

The CHAIRMAN. All right. I will call on Senator Baucus, but just let me react with one or two sentences. That is, if we have an envi-

ronment where people are not paying income tax, they are getting the EIC against all of their payroll taxes, and you are transferring money through the tax system, it is quite obvious.

Where do you stop? If you are giving tax refunds to people that do not pay taxes, when do you stop sending the checks? It seems like there has got to be some end to it if the relationship is to have an Earned Income Credit against people that pay taxes.

Senator Baucus.

Senator BAUCUS. Thank you very much, Mr. Chairman.

Ms. Monson, could you please address some of the points that Mr. Edwards made? Basically, he said do not give aid to the States. He said, they caused the problems. They are spending money. It is kind of like a moral hazard. You give them a little bit of money and it just warrants inefficiency and warrants all the excesses that they have been engaged in, et cetera.

What are your thoughts about that?

Ms. MONSON. Of course, I respectfully disagree with that point of view. We think that States have acted responsibly. We know that there was an opportunity in the 1990's for States to do any number of things that we think were the fiscally responsible thing to do. Over a period of five or 6 years, States actually did cut taxes, to the tune of about $35 billion.

States also met those unfunded mandate needs and those other spending needs that had been, in essence, delayed or disregarded in the very early 1990's. In the mid-1990's, we were able to close the gap to some extent in education funding to meet the needs in health care expenditures.

So, we did act responsibly. At the same time, when States were cutting taxes and increasing some expenditures, we also saved in excess of $46 billion. Ten percent of State budgets, were noted in savings accounts.

Senator BAUCUS. He says, anyway, that if you help States now, that they will not get their act together the following year.

Ms. MONSON. No. Again, we respectfully disagree with that position. We thank many of you for your proposals that were tied to triggers such as unemployment, but certainly do not reflect rewarding States that have poorly managed their budgets. We believe States have been responsible.

We think that is important now for the Federal Government to share with us, particularly in the unfunded Federal mandates, which have actually caused some of the fiscal problems in our States.

When States continue to have this expectation of meeting needs, particularly in the areas of education and health care, then we meet those needs, although sometimes those requirements were imposed upon us by the Federal Government.

We will continue to act responsibly. We have balanced budget requirements in a majority of our States, so we do not have an opportunity to deficit spend. We think that it is important for us to realize, when States cut budgets, when States furlough or lay off employees, when States continue to remove dollars from the economy, then it does place an additional drag on the economy and it is important for us to spread out.

Senator BAUCUS. May I ask all of you, do you all agree that we need economic stimulus? Well, I guess one of you—I have forgotten who it was—said the economy does not need a stimulus now. Can I go down the row very quickly, and answer, please, in a sentence.

Ms. Monson, do you think the economy needs a stimulus now?

Ms. MONSON. Yes. I think the economy definitely needs a stimulus now.

Senator BAUCUS. All right.

Mr. Edwards.

Mr. EDWARDS. The economy definitely could be growing faster. I think we should——

Senator BAUCUS. Is there anything Congress can do to help the economy?

Mr. EDWARDS. I think we know for sure what creates long-term economic growth.

Senator BAUCUS. I am talking about, in 2003 and 2004.

Mr. EDWARDS. Right. I am saying, Congress should act to put in tax reforms that will benefit in the long term, and they may well help in the short term.

Senator BAUCUS. I am sorry. I am sorry. What I am really getting at, is does the economy need a stimulus now, irrespective of how it is done? She has one way of doing it, you have another way of doing it. Do we need a stimulus now?

Mr. EDWARDS. Yes.

Senator BAUCUS. All right.

Mr. Entin.

Mr. ENTIN. If you can find one that will work. The ones that work do good things in the short run and the long run.

Senator BAUCUS. If we can find one that works.

Mr. ENTIN. If we find ones just for the short run, they tend not to work at all and you might as well forget them.

Senator BAUCUS. All right.

Mr. ENTIN. But do the right ones, not the wrong ones.

Senator BAUCUS. All right. That is another issue, what works. But do you think we should do anything that has a positive effect in the short term?

Mr. ENTIN. We should always improve the Tax Code and other policies to make the economy stronger whenever we get a chance to do it.

Senator BAUCUS. Including the short term.

Mr. ENTIN. Including short term.

Senator BAUCUS. Mr. Orszag.

Mr. ORSZAG. Yes. But I would note that it is a close call. A growing number of economists have basically argued that there has been a lot of fiscal and monetary stimulus that has already been delivered.

I come down thinking that it is still persuasive that we should have a stimulus, but I think the fact that there is a debate about it suggests that the threshold should be high for making sure that it is well-designed and targeted.

Senator BAUCUS. How much are any of you concerned about the deficits and the long-term debt? Ms. Monson? Federal deficits and debt, with AMT, we are going to have to enact. You know the list.

Ms. MONSON. We are concerned about the deficits and the long-term debt that the Nation is acquiring. Of course, as States, we cannot deficit spend, so it is a different arena for us.

I think the more prudent question, and the more important question, now, is what do we do right now? There may be—and I cannot believe I am saying this—an opportunity for us to do some deficit spending now because the short-term benefit certainly is greater than the long-term negative impact.

Senator BAUCUS. Mr. Edwards.

Mr. EDWARDS. Deficits, of course, are caused by both the tax and spending sides. Federal spending, in really rough terms, has been rising about $100 billion a year every single year, $2.1, $2.2 trillion, and on and on.

The President's current tax proposal, I think, would result in a static revenue loss of just about $50 billion in the out year, 2008. So I think there is really much more of a problem creating deficits on the spending side of the Federal Government.

Senator BAUCUS. Mr. Entin.

Mr. ENTIN. Deficits allow the government to spend more than taxpayers are willing to support in the long run. That is their bad point. The effect on national saving and credit markets is grossly overstated, and I have explained some of that in the testimony.

Senator BAUCUS. In one sentence, why is it grossly overstated?

Mr. ENTIN. Most of the tax cut is saved and finances itself, and finances the added Federal borrowing. The only thing a tax cut does to promote anything—consumption, production, growth—is if it, in fact, causes people to want to do more—that is, if on that additional production, the tax rate has been reduced.

On the existing output, the tax cut and the deficit are a revolving door for the money and do not have a major effect on interest rates. We are in a global economy. We can borrow abroad. Domestic saving goes up to cover the deficit.

This is not the reason deficits are bad. The reason deficits are bad is that they promote over-spending and too much resource use by the Federal and State governments.

Senator BAUCUS. Mr. Orszag.

Mr. ORSZAG. I think there is broad bipartisan support for the notion that tax cuts reduce national saving. The argument to the contrary is held by just a fringe group of academics.

Mr. ENTIN. I am not an academic! [Laughter.]

Mr. ORSZAG. I would note that, by the administration's own estimates, the long-term budget outlook is not pretty. This is the administration's budget, the analytical perspectives, Chart 3–4.

What it shows, is large and growing budget deficits over time, even if these two lines show faster or slower productivity growth.

So even if you think productivity growth will be faster than is currently projected because of some magic potion from tax cuts, you still are facing very large out-year deficits. Again, in that context, I just doubt the wisdom of digging the hole deeper.

Senator BAUCUS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

Senator Kyl.

Senator KYL. Thank you. I would note that the magic potion of tax cuts worked for Calvin Coolidge, John F. Kennedy, and Ronald Reagan, and I suspect they can work for George W. Bush, too.

I would like to ask you, Mr. Orszag, since you just showed me a chart, I am going to show you a chart. It is maybe hard to see, but the line here is the line of personal consumption expenditures. It shows it steadily going up from 1999 into a projected time here.

You have on the lower end the fixed, private, non-residential investment, which is seen as rising dramatically up through the 2001 period, and then falling dramatically in the late 2001, 2002.

So consumer spending has remained positive over the past 2 years, while business investment has declined for eight consecutive quarters. The question I have is whether or not, therefore, you agree with Mr. Entin that it is not a matter of personal consumption here, but investment, that we ought to be focused on.

Mr. ORSZAG. I actually think it is a matter of both, Senator. In order to spur more investment, firms will need to see increased demand for their goods and services.

I do not know about you, but these businesses tell me that they are not thrilled to go out and build new plants or invest in new equipment unless they know that there is some demand for the things that they will produce with that plant and equipment. So, it is sort of both built on each other.

I do think there are things that we could do that would potentially spur investment in the short run, but we should be operating on both margins, basically.

Senator KYL. Well, let me ask all three of the economists here, which puts capital to work faster, savings or spending? Now, let me just put it in context.

It seems to me that savings is always immediately invested. I mean, we do not put money in shoe boxes. When you put it in the bank, the bank immediately buys something with it, some kind of security, some kind of debt instrument which is immediately put to use by whoever the money is lent to.

Spending also adds to business income. I should say, it adds to business income and, therefore, it can also provide working capital for growth of the business.

But it seems to me, it is difficult to argue as a general proposition that one is any faster than the other in providing capital for business growth.

What is your view on that, starting with Mr. Edwards and working on down?

Mr. EDWARDS. I think consumers, of course, can only do two things with their money, they can spend or save. Economists are always giving these contradictory messages. They always say, consumers, people, Americans ought to save more because that is good for the economy.

Now we are hearing, no, they ought to spend more. It strikes me, you can go around and around in circles when you think about what consumers ought to be doing. I think you have to think about businesses, big and small, and entrepreneurs.

For entrepreneurs, we can do a capital gains tax cut, get the venture capital market going again, we can spur entrepreneurs to start new businesses.

On the big business side, we can look at increasing the bonus depreciation stimulus to perhaps 50 percent and making it permanent. I think you have to think about business decision making when you think about stimulus, not consumers.

Senator KYL. Thank you.

Mr. ENTIN. Tax cuts tend to be saved. The saving goes to finance the Federal deficit. To get growth, the tax changes need to promote hiring and plant and equipment spending. They tend to do that.

Labor and capital are employed to produce a product and people are paid for their time, and they turn around and buy their product. Supply creates its own demand. It is production incentives that work faster than the other things, because the other things do not work at all.

Senator KYL. Thank you.

Mr. Orszag.

Mr. ORSZAG. Senator, I think in the current context there is an important difference. I would just refer to the Joint Committee on Taxation document that was prepared for this hearing.

I will just quote a sentence from it, which I completely agree with. "If the recent recession is seen as the major problem rather than sluggish long-run growth of the economy, then policies targeted to increasing aggregate demand"—and I will insert a parenthetical, that means spending—may be appropriate.

The key question is what you are trying to attack. Again, there is a difference, as Mr. Edwards noted, between what is appropriate for the long run, and that is increased saving, and what is appropriate for the short run, given excess capacity.

Senator KYL. Well, it seems to me—and I will let him describe it for himself—that he is talking about demand created by increased productivity, not spending. But maybe I misunderstood. Mr. Entin.

Mr. ENTIN. There are these two views in economics. One is that somehow you can prime the pump. Friedman and the monitarists asked, "Where does the money come from?" Unless the Federal Reserve is printing it, you have to borrow it back. There is no pump priming. That does not work.

We have had this debate since the 1960's, and even earlier. It is discouraging to see that it is continuing, because we think we have enough evidence to prove that pump priming does not work.

When you have a situation of unsatisfactory growth, people tend to think that we have higher capacity but we are not using it.

What is really happening is that taxes and regulations have created an obstacle to the use of that capacity, and it is not really there. Unless you get the tax barriers to new hiring and new investment down so that people want to produce more growth, you are not going to get the growth.

The capacity limit that people are trying to get up to is, in a sense, a mirage because the labor cannot come forward, it cannot be usefully employed. The capital cannot be replaced, modernized, expanded because of these barriers.

Unless you address the barriers, you are not going to get any improvement. There is no good saying that there is a difference between the short run and the long run, and we are operating under capacity, and then when we get there we can expand.

The changes that we are recommending have the effect of expanding capacity and utilization of capacity right from the start, although they do grow bigger over time.

Senator KYL. When that increased productivity occurs, it creates the demand, and that is what you are saying.

Mr. ENTIN. Yes.

Senator KYL. That is how you get the demand, which enables the economy to grow in a healthy way.

Mr. ENTIN. Yes.

Senator KYL. Thank you very much.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. I think I get more confused by the day, the hour, and the minute. I am looking at the CBO chart on the budget, the economy, and taxes.

It points out that, over the next 10 years, the deficit would go from $228 billion up to $252 billion in 2004, and then progressively get a little better, and ends up over the 10-year period of a $124 billion deficit.

The assumptions that CBO factors in to that deficit, because of whatever rules they follow, are really very unrealistic. The CBO assumptions assume no new laws affecting revenues, such as Medicare and Social Security, or additional tax cuts will be enacted over the next 10 years, and that discretionary spending will grow at the rate of inflation, and that there will be no significant repercussions for the United States' economy from any war with Iraq, and no shocks to the economy from major acts of terrorism.

They assume a growth rate of 2.5 percent in 2003, 3.6 percent in 2004, 3.2 percent in 2005 through 2008, and then 2.7 percent from 2009 to 2013.

Now, I guess my question is, let us try and be realistic and factor in assumptions that are out there. I mean, we are talking about going to war with Iraq in a couple of weeks, at a cost of who knows what, anywhere from $60 to $200 billion. We know that Medicare is, at minimum, a $500 billion problem, and Social Security, the transition costs alone, are about $1 trillion.

Can any of you take a stab at what kind of economic growth rates would we have to have if those things that we think are going to happen happen to end up with the same deficit that they are projecting after 10 years?

Mr. EDWARDS. I would touch on, I think you are right that the CBO baseline projections are very optimistic on the discretionary side, given the recent history since 1998. I think President Bush has got a 2.3 percent growth in discretionary annually through 2008.

I think, if we ever really wanted to meet such a low spending annual increase, Congress has really seriously got to look at many areas of Federal activity and either moving them back to the States, or terminating or privatizing. We are not going to get 2.3 percent growth unless we have a serious restructuring.

With the huge 7 percent of GDP increase in Medicare, Medicaid, and Social Security in the next 30 years, we are going to have an utterly different Federal Government a few decades from now than we have now.

I think, if we do not want a European-sized government, the Federal Government is really going to have to start hiving off some of its activities and either moving them back to the States or putting them into the private sector.

Senator BREAUX. Mr. Orszag.

Mr. ORSZAG. Senator, two points, quickly. One, is I would be happy to submit for the record a paper I have written with Bill Gale of Brookings that goes through some of the calculations you were just walking through.

What it shows, is even on a unified budget, even without a Medicare prescription drug benefitand the war, once you take into account the expiring tax provisions and real discretionary spending growing with the population, you are at a $1.1 trillion deficit over the next 10 years, and that includes Social Security and Medicare surpluses.

If you exclude the retirement trust funds, you are at a $4.5 trillion deficit, and that is before any of the new proposals. So, you are looking at very large out-year deficits.

I do want to also emphasize, according to the administration's own budget, there is a deficit in 2008 on a structurally adjusted basis—that means taking into account the business cycle—that is more than 1 percent of GDP. It is something like 1.2 or 1.3 percent of GDP, by their own figures.

If you wanted to grow your way out of that deficit—and that is under a series of unrealistic assumptions, but let us just take the number—and assuming the normal rule of thumb that one dollar of GDP raises about 20 cents of revenue, you would need GDP in 2008 to be about 5 or 6 percentage points higher than currently projected.

Now, again, the net effect of tax cuts—again, you have the positive incentive effects, but the reduced national saving effects. There is no credible estimate that gets you anywhere near that number. For example, the upper bound on the 2001 tax cuts is between 0.5 and 1 percent.

You would need 5, 6, 7 percent for this thing to pay for itself. It is not going to happen. So you are facing very large out-year deficits that will not be fixed just by higher growth, unfortunately. That is before we get to the retirement of the baby boomers, of course.

Mr. ENTIN. Many of the tax cuts enacted in 2001 were not at the margin, they were social policies, not pro-growth. So I would not condemn that bill for not generating a lot of growth. It apparently was not all intended to.

The deficits that you are seeing reflect the level of government outlays. You made a very good point about the war in Iraq, but let me rephrase it a bit.

If you call up, let us say, 200,000 reservists and send them to the Middle East, they will not be here producing goods and services. Even if you give consumers money to spend, these reservists will not be here producing goods and services for the consumers to purchase.

Longer term, if we need more doctors and nurses, people who go into those medical professions—assuming we find the money to pay for it, and I think we will—are not going to be producing other

things. They are not going to be teachers, they are not going to be steelworkers.

You are going to be reallocating resources. The government is going to crowd out production of normal goods and services in the private sector in favor of whatever it is the government is subsidizing or encouraging.

The government is going to have to cut some of its resource use in some area so that it can increase its resource use in other areas without squeezing the private sector consumption and investment.

That is why it is not so much the deficit and the borrowing and the national saving, it is the use of resources by the government in its government spending that is ultimately going to be the problem.

Senator BREAUX. Well, I was confused. Now I am even more confused. Thank you.

The CHAIRMAN. Senator Smith.

Senator SMITH. Thank you, Mr. Chairman.

I am reminded, with Senator Breaux's comments, that it is easy to DO what is right around here. It is difficult to KNOW what is right around here.

Do I understand, Mr. Orszag, that your comment is that, given no additional tax cuts, stimulus, or spending, to deal with the current obligations of the Federal Government and to get back to balance, we have to have growth of between 5 and 7 percent?

Mr. ORSZAG. Under the Administration's budget proposals, you would need the level of GDP in 2008 to be about 5 or 6 percentage points higher than projected in oder to eliminate the deficit in that year.

Senator SMITH. And that is holding current spending as it is, and that is holding current tax policy as it is.

Mr. ORSZAG. That is with the revenue and spending proposals that are in the administration's budget.

Senator SMITH. All right. So it assumes going forward with the tax cuts.

Mr. ORSZAG. Yes.

Senator SMITH. I am trying to get a handle on what the right thing is to do by the States, Ms. Monson. I was in a State Senate as well, the State of Oregon. Our State faces a big deficit. The taxpayers have said, on a landslide measure, no new taxes.

I am trying to calculate, what is the best way to help the States with the burden that they assume because of the Federal Government? Homeland security comes to mind; a lot of mandates are imposed without reimbursement.

Particularly, Medicaid is something that is spiralling out of control. My understanding is, and I think you said, 46 of the 50 States have deficits. Is that correct?

Ms. MONSON. That is about right.

Senator SMITH. And how many of those 46 are actually raising taxes right now, or withholding tax cuts?

Ms. MONSON. We know that in excess of 30 States have either proposed or implemented tax cuts. But we also know a substantial number of States, almost 20, have reduced spending in the areas of education. When you start reducing elementary and secondary education expenditures, you know it is a bad situation.

But you asked a very important question: what can we do? What do we think, as States, would be good to do?

Senator SMITH. What I am really trying to get at, I think the States have been as profligate as the Federal Government has in spending during the go-go years.

I think we have tried to assume that the balloon would always be there and would never pop, and it did. But I am not insensitive to the needs of the States. In fact, Senators Rockefeller, Collins, Nelson and I have proposed, increases FMAP for the past few Congresses.

I wonder if you feel that that is an appropriate way to help the States with increasing the Federal percentage of Medicaid. I would love all of your comments on that.

Ms. MONSON. Well, we certainly would not decline it. But let me speak to one additional way that we think the Federal Government could help initially, and that is in the area of unfunded mandates. The dollar amount ranges from probably a low of $26 billion to a high of $100 billion.

But particularly in the areas of education, and there are expectations in the area of homeland security that States would be responsible for. They may not be technically unfunded mandates like they are in, for instance, election reform, but these are all areas that we are required to respond to. States must do something, and there is a dollar amount that that will cost us.

The FMAP rate, the Medicaid expenditures, are growing in the States and are increasing. Every time people are laid off from their jobs, they are eligible. It is a federal/State shared program, so we think it is quite appropriate for the Federal Government to at least look at delaying some of the reductions in the FMAP rate, if not increasing the FMAP rate.

There are other ideas in terms of maintenance of effort requirements that come along with that that were open for discussion, but know that the demand is huge. The health care costs increases are something that have been totally out of our control. States do not have the control that we would like to have in that area.

Senator SMITH. I wonder if the others on the panel can give me one idea, or one way in which we could legitimately help the States. Is there anything we can do? Not to shore up their baseline budgets, which I think were irresponsibly inflated during the 1990's, but, in fact, to help with legitimate costs imposed by the Federal Government. Can each of you identify one or two, or whatever ones you think are appropriate?

Mr. ENTIN. I think the Medicaid area—and the administration has some block grant proposals in this regard—is a legitimate area. Unfunded mandates are irresponsible and harmful, and the States should have flexibility in dealing with these programs and should be compensated if the Federal Government is imposing something on them that they do not necessarily want to do.

Senator SMITH. And if we do not give them cash, give them flexibility.

Mr. ENTIN. Flexibility. But we should not be aiding the States simply to boost national consumption, because the federal government would have to borrow the money that we are giving to the States. That is not the reason for helping the States.

One reason to help is to straighten out these programs that are out of control and that are imposed on them where they have no flexibility. The other is, perhaps, if you must, to give them some assistance to prevent them from raising State income and local property taxes, which would be disincentives to produce.

Senator SMITH. Because that would offset whatever we do here.

Mr. ENTIN. Yes. But do not think you are going to boost national consumption and aggregate demand by giving them money to spend that you have, in turn, borrowed yourself.

Senator SMITH. All right.

Mr. ORSZAG. Senator, Just very briefly, I think the FMAP, which you have identified, is a particularly good way of getting money to the States quickly because it is an already established mechanism.

One thing just to note quickly about the spending experience during the 1990's. I do not have the percentage with me, but a significant share of the spending increase was associated with Medicaid and with prisons, with law enforcement. That gives a somewhat different feel to—it is partially related to the mandates—some of the spending expansions that did occur.

Senator SMITH. That is correct.

Mr. EDWARDS. I mean, certainly programs that are shared between the Federal Government and States, it does, in my view, breed irresponsibility. States have an incentive to put add-ons to Medicaid because they only pay about half.

So I think ultimately the States have to sit down with the Federal Government and change the focus of these programs, either send highway spending back to the States, make Medicaid just a Federal program or vice versa. I think there is a real problem when there is shared responsibility because there is a lot of finger pointing.

Senator SMITH. So you would argue more in giving more flexibility, not more cash.

Mr. EDWARDS. Oh, absolutely.

Senator SMITH. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. We will go around again on the same basis as we did the first round for a second round of questioning.

I am going to start with Mr. Orszag. Is it fair to say that accelerating the phase-in of the child tax credit and elimination of the marriage penalty would serve the same purpose as set forth by many of the rebate proposals from an administrative perspective?

Would those accelerations not be an easier way to accomplish the goals of getting money into lower income families' hands to encourage spending? That would be our objective, to enhance consumer spending.

Mr. ORSZAG. Marginally it probably is somewhat administratively easier, although I do not think that many of the rebate proposals that have been put out, which have paid some attention to how they would be administered, would be particularly difficult to administer. So, there might be some small difference, but I do not think that is huge.

I think the big difference is what is happening in the out years. When you accelerate the increases in the child credit, the child

credit alone would cost something like $100 billion over 10 years to accelerate.

When you accelerate them, you have costs not just in 2003 when we think it may be beneficial to boost aggregate demand, but also revenue losses thereafter. That is really the more important trade-off, in my opinion. I think the administrative issue, while it might be present, is of secondary importance.

The CHAIRMAN. Mr. Edwards, we have heard much about the multi-year revenue losses of permanent tax policy changes such as the tax-free dividend proposal. Yet, temporary spending changes are only scored for the current fiscal year. CBO adds these changes to the baseline and grows it for inflation for that period.

If we are concerned about fiscal discipline, do you think that we ought to consider a dollar of spending that is likely to become a permanent part of the baseline in the same manner as a dollar of foregone revenue?

Mr. EDWARDS. That is right. If you look 10 years from now, the Federal spending will be about a trillion dollars more than it is now. But we do not usually think of spending in those terms. We usually think just a single year ahead. Whereas, for some reason, we think of tax changes always on a 5- or 10-year basis.

I think tax cuts, of course, always have the advantage that, on a static basis, they generally do not lose, if they are pro-growth tax cuts, as much money as in the static score. Whereas, spending, on the other hand, often ends up costing a lot more than what was initially budgeted because there are always add-ons and increases later on.

The CHAIRMAN. So, obviously, a double standard between the two different types of proposals when they are discussed in terms of fiscal discipline.

Mr. EDWARDS. Absolutely.

The CHAIRMAN. Throughout our fiscal history, is there much of a basis for taking a contrary view, that is, that temporary spending increases will, in fact, turn out to be temporary?

Mr. EDWARDS. No, I do not think so. We are still left with many programs, such as the Rural Utilities Service, that were put in place decades and decades ago that have long outlived their usefulness, and they are still with us decades later.

When you increase spending, you have a new program, you expand beneficiaries of a program, you have created a constituency or special interest group that will come back year after year to argue for continuing the spending program.

The CHAIRMAN. Senator Monson, in your testimony you request that any additional assistance provided to the States not have associated with it additional unfunded mandates. I think that is a fair thing, having voted for the bill that you referred to that has not worked out the way intended.

You have also outlined some very expensive mandates that States currently face as a result of recent legislation in that testimony. To the extent that Congress provides money to the States, do you think that it would be appropriate to eliminate some of the existing mandates and/or to earmark Federal assistance for use of those current requirements?

Ms. MONSON. Well, let me simply say that some of the mandates are good programmatic mandates. They are things that States would like to accomplish as well; the No Child Left Behind provisions, some of the election reform provisions, are good provisions. The problem is, of course, the revenue is not there.

Our first choice would be, of course, if these things have been done, that the Federal Government would fully fund the mandates. It is, I know, very difficult. But that certainly would take the burden off the rest of the States' budgets so that we could continue to meet the other needs and other expectations of our constituents.

It is also important, as we talk about removing unfunded mandates or providing flexibility, as was mentioned earlier, that by the time we get to those kinds of changes, then the States have already fallen into a very, very deep hole.

The expectations that these programs would go forward are there. It makes it a very difficult situation for us. So, although flexibility is good, it does not meet the immediate need that States are facing. A way to address the immediate need would be to fully fund the Federal mandates that have been imposed upon States.

The CHAIRMAN. Mr. Entin, in the debate surrounding the consumption-based tax incentives, it is commonly suggested that lower income taxpayers have a higher propensity to spend or consume than those with higher income.

I know that many economists believe that this is true, and articulate that view. Are you aware of any factual evidence that would support that proposition?

Mr. ENTIN. If you pick up any of the old textbooks, they go into great detail on marginal propensities to consume. But realize that people tend to govern their consumption by what they expect their lifetime incomes to be. We over-consume when we are young because we do not have any income, and we are borrowing. Then we pay it off when we are middle-aged. Then we save for retirement, and then we consume more than we earn in retirement.

The marginal propensities to consume seem to even out across income levels looked at over a person's lifetime. There are many things that the textbooks mentioned to try to explain away some of that rather superficial appearance of differences as a point in time.

The real problem with the use of marginal propensities to consume to make tax policy, is that even if I give someone with a high propensity to consume a dollar, I have had to get it from somewhere, which means I have had to take it away from someone else who, if they did not spend it, would have lent it to someone who would have spent it, and you still have the revolving door problem.

Looked at economy-wide, this playing games among people who have different marginal propensities to consume gets you nowhere.

That is, indeed, supported by a number of Nobel prize winners on the other side, so I suspect you are not going to get a good policy by simply trying to find out who spends the most, and somehow steering money to them.

The CHAIRMAN. I should have suggested a study done for NBER by two University of Michigan economists, Slimrod and Shapiro, suggesting that only 20 percent of the 2001 tax rebate was actually spent rather than saved and used to pay debt, and that lower in-

come people were no more likely to save than their higher income counterparts. So if you know about that, would it call into question the notion of targeting temporary tax rebates at lower income?

Mr. ENTIN. Yes. That is what I was alluding to in my earlier statement. Let me point out that Franco Mendigliani, a Nobel prize winner, and Charles Stendel, did a paper out of Brookings in 1977 that studied the Ford rebate.

They found that something less than 25 percent of that was spent. They said, "We conclude that there is strong evidence that a rebate is not a particularly effective way of producing a prompt stimulus to consumption."

Alan Blinder indicated very little effect from temporary tax cuts, and particularly very little effect from the 1975 rebate. There are a number of studies which suggest that that is not the way to analyze tax changes.

Senator BAUCUS. Mr. Orszag, can you respond to that, please?

Mr. ORSZAG. Sure, Senator. First, on the Shapiro/Slemrod study, the finding which was based on a survey was that about 20 percent of households said that they primarily saved rather than primarily spent the rebate.

I would note that there were 51 million taxpayers, or workers, who were either entirely or partially left out of that rebate. Those are the ones who are disproportionately living paycheck to paycheck and would be more likely to spend any funds that were given to them.

It is also worth noting, Footnote 23 of my written testimony does provide, I think, three or four recent papers that study exactly the question you had asked about, the marginal propensity to consume, finding, as expected, that marginal propensities to consume are higher for lower income households than for higher income households.

All of this is to say it is certainly possible to design a temporary rebate that would have very little effect on current spending—that would be the result if the rebate were targeted at higher income households that base their spending decisions on permanent income.

It is also possible to design a rebate that is more effective by targeting households that are living paycheck to paycheck and are basing their spending decisions on current income, not lifetime income.

Senator BAUCUS. Mr. Entin, just intuitively, when you just talk to people living paycheck to paycheck, you give them more money, they are going to spend it. They have to.

Mr. ENTIN. I am sure they will. But where did you get the money to give them, and what happened to the people you took it from?

Senator BAUCUS. We are not addressing that point yet. I am just saying, are they not going to spend it? If you give it to people living paycheck to paycheck, are they not going to spend it?

Mr. ENTIN. If people are living paycheck to paycheck, they will spend it.

Senator BAUCUS. And how many Americans do you think are living pretty much paycheck to paycheck, just a percent, just a rough guess?

Mr. ENTIN. I do not want to guess. I am not an expert in income distribution. I do note that the rebate we gave in 2001 caused an enormous spike in the personal saving rate and accounted for most of the money.

Senator BAUCUS. Mr. Orszag.

Mr. ORSZAG. Senator, I would just say, again, my written testimony provides references to the literature. This is not the percent of households, it is the percent of spending.

But somewhere between 15 and 50 percent of spending is done by households that are basing their spending decisions on current income, effectively living paycheck to paycheck, instead of their longer run permanent income.

That does say there is a chunk of households or consumption where Mr. Entin's point is correct, that households are basing their spending decisions on longer run averages. But there is also a substantial share of households where that is not true.

Senator BAUCUS. There is probably both, is my guess. Yes?

Ms. MONSON. Senator, speaking not as an economist, but as an individual who talks with those kinds of families on a day-to-day basis, I would presume that upwards of 80 percent of my constituents, given a rebate, would spend those dollars. They would spend those dollars to provide the needs for their families.

Of course, spending those dollars has a positive effect on local and State budgets in terms of sales tax revenue generated. It has a positive effect on businesses because that is new capital in those businesses.

So I think it is clear. I am not an economist. I can only just deal with these kinds of questions from my conversations with consumers.

Senator BAUCUS. Well, using an economist's term, all things being equal, is it not true that giving people money that live paycheck to paycheck, they are probably going to spend it?

Now, you are getting to the point, all things are not equal. Your basic point is that, well, gee, if you give people money who live paycheck to paycheck, it has got to come from somewhere. Your point is, Mr. Entin, it is going to come from additional debt or borrowing, or so forth.

But what if it does not come from additional debt or borrowing, it is just less spending someplace else by the Federal Government? Let us say we do not spend so many dollars on Star Wars, or whatnot.

Mr. ENTIN. If you cut a dollar of Federal spending and enable a household to do a dollar of additional spending, then, indeed, the households will be better off. However, total spending in the economy will not have increased.

Senator BAUCUS. But those who are living paycheck to paycheck, of which there are many, would be spending it.

Mr. ENTIN. Or not borrowing so much to spend.

Senator BAUCUS. I am saying, assuming all things being equal again—we have to assume that if we are going to start——

Mr. ENTIN. That is called a partial equilibrium analysis and it does not quite cover——

Senator BAUCUS. I do not know what it is called.

Mr. ENTIN. It does not take all the effects into account.

Senator BAUCUS. I am just using common sense here. I do not care about partial or impartial analysis.

Mr. ENTIN. Equilibrium or disequilibrium. General equilibrium.

Senator BAUCUS. I just use my gut here. I have got to use common sense here.

Let me tell you something else, just for your information. I talk to a lot of people. That is my job. I talk to a lot of people in business about the President's tax cut. That is my job, too, to talk to them.

And most CEOs of major companies that I have talked to, and this is 80 percent of the people I have talked to, and that is a good number, say we just want people to buy our products. We need to stimulate consumption now. They do not care about dividends. They do not care about it.

They say, get people to buy our products now. That way, we will probably invest more. We are not investing now because people are not buying our products. I tell you, that is basically what CEOs are saying. And you have got to listen to people, use a little common sense, look at the adverse affects on the budget of some of these proposals. You have got to take a lot of things into consideration here.

But I am just telling you that my common sense—maybe it is not common—tells me that we should probably stimulate the economy now and worry also about the budget effects by not putting into place measures now which do significantly increase the debt.

I say that, in part, because I can see so many other demands on Federal spending coming down the pike. They are just incredible. We are going to have to deal with AMT. How much does that cost, do you think? Do you know?

Mr. ENTIN. Tens of billions.

Senator BAUCUS. Oh, hundreds of billions.

Mr. ENTIN. Per year. Hundreds over the decade.

Senator BAUCUS. We are talking about 10-year periods here. That is going to cost $500, $600 billion in addition.

Mr. ENTIN. That is not spending. That is a tax change.

Senator BAUCUS. That is a tax expenditure. That is a tax expenditure.

Mr. ENTIN. Correcting an abnormal tax item which is not part of a normal tax system is not considered, in technical terms, a tax expenditure. It means you are going to be losing some revenue.

Senator BAUCUS. We are going to be losing some revenue. I do not care what you call it.

Mr. ENTIN. I suggest that spending restraint to cover that would be an excellent policy combination.

Senator BAUCUS. Well, again, we are talking about all things being equal. I am just saying, we know we are going to have to spend that money. We know that, over the next 10 years. We are going to have to cover AMT, and that is not in the President's budget.

It is not in the President's budget, but he kind of later on talked about it, these retirement savings provisions. Ten years out, those are going to cost much more than AMT. We have got to be somewhat responsible, somewhat reasonable here in trying to put all these things into consideration here.

I am just saying to you, I am kind of astounded if you do not think that some short-term stimulus is not important, basically saying that they have this huge tax reform and people will automatically spend because they will see tax cuts in the future.

Maybe they will, maybe they will not. But I do know, if you put money in people's pockets now, particularly people living paycheck to paycheck, they are going to spend it.

The CHAIRMAN. Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman. I apologize for running late today, but I did want to come. I had a few questions for the panel.

First of all, anyone can answer these, but I think probably it might be better directed towards Mr. Edwards. Well, anyway, it does not matter. Anybody.

Does the budget that the President has proposed make it more or less likely that future generations will receive their full Social Security and Medicare entitlement?

Mr. EDWARDS. Well, I think citizens have a real problem here because they look to the future of Social Security and they see that payroll taxes will only cover perhaps three-quarters of future benefits. So, I think anything that we can do now to get Americans saving more so they do not have to rely on future political promises is a good thing.

I think the more private assets people have, with guaranteed legal benefits that they can rely on in the future, is a good thing. So, I think that the President's tax package, which will help boost household savings, is a good thing in the long run for retirement security.

Senator LINCOLN. But more or less likely, whether these generations are going to actually realize the benefits of the entitlements that they are putting into today.

Mr. EDWARDS. Well, I am saying, right now we have got a crisis because Congress has not planned ahead, in my view, adequately for future retirees. So I think anything we can do to help young people save more for the future is a net plus for future retirees.

Senator LINCOLN. Did you have a comment?

Mr. ORSZAG. Senator, one of the striking things about this budget is that it identifies Social Security and Medicare as a real fiscal danger, but then really does not do anything to fix the problem, and, as I mentioned before, shows very, very large long-term deficits out when the baby boomers are retired.

Furthermore, again, the tax cuts that are being proposed in the out years—we are not even talking about today when, arguably, the economy could use some stimulus—when presumably the economy will have fully recovered, will amount to more than twice the size of the Social Security deficit.

To me, that just reflects a different set of priorities than where I would be putting my money, but obviously that is up to you all.

Senator LINCOLN. Right.

Mr. ENTIN. Growth is important to increase the tax base to help people pay their Social Security taxes and still have enough after-tax income to live on. Saving incentives are important to give people an alternative to Social Security, and it might be wise to com-

bine additional saving incentives for individuals with some reform of Social Security to bring that program into balance in the future.

I think you have to look at people's incomes and private saving as well as Social Security to come to a solution here. If you want to increase output and production while maintaining high tax rates, you are going to have to do something about bringing more people into the country, because the current people will tend to work less and save less if the tax rates go up to cover these programs. In that sense, it makes it harder to cover the promises. You must have the real growth going if you want to cover the promises.

Senator LINCOLN. If you are advocating growth, do you not think it needs to be more immediate than long term? Look at the other situations we are looking at.

Mr. ENTIN. It needs to be permanently higher growth. The policies that promote long-term growth start at the beginning and give you positive effects in the short run, but they build and give you even more growth in the long run.

Senator LINCOLN. Considering the economy we are dealing with right now, does the growth or the stimulus not need to occur more immediately than long term if we are going to ever get this ball rolling?

Mr. ENTIN. There is a debate in the economics profession, but I believe that all of the things that are proposed for short-run stimulus have to be funded immediately. The Treasury simply borrows the money back, and they do not work.

The long-term changes that expand capacity and labor force participation work short run and long term. They do build more into the long term, but they do start immediately. That type of program does work.

Senator LINCOLN. Well, in some of the instances where we have heard much discussion about double taxation, last week Secretary Snow was here and indicated on the record that, left to the administration, Social Security would eventually be funded by IRAs, in other words, with the private savings that Mr. Edwards, I believe, has talked some about.

If people paying FICA taxes now, today, to support the system do not receive the benefits that they have been promised and they have to fund their Social Security with private savings, is that not double taxation? You are asking them to pay off the same debt.

Mr. ENTIN. The transition generation definitely has a problem.

Senator LINCOLN. Hello. You are looking at her.

Mr. ENTIN. Well, me, too, although I guess I am a little bit into the baby boom.

Senator BAUCUS. Right there.

Mr. ENTIN. But to help them out, we need to somehow reduce their tax burden so that they can put some money into savings, so that when they continue to pay their payroll tax they have something else on the side that is gaining for them.

To do that, we do have to be careful with Federal outlays over time so that these savings incentives can be funded with reductions in Federal outlays that do not simply borrow back the same money.

Senator LINCOLN. Well, just to touch on that, because you have talked about cutting back on spending. We have taken into consideration here the issue of Social Security and Medicare. Is it not

true, though, that under the President's budget in 2003 and 2004, we could eliminate the entire non-defense Federal Government spending and still be in the red?

I mean, how can you blame it on spending if that is the case? If we eliminate the entire non-defense Federal spending, we are still in the red.

Mr. ENTIN. Hopefully, we will eventually be able to do something about defense spending, just not in the middle of a war. I hope that is only temporary. But, ultimately, it is the growth of spending over time that needs to be trimmed.

We do not have to get back into the black tomorrow, but we do have to get there eventually. We will do that much more easily with some restraint in Federal spending and some real growth in the economy.

To get the real growth in the economy, some things have to be done that are not politically popular. But let us make sure the things we do actually work, and work short run and long term, because we need that growth long term as well, not just short term.

Senator LINCOLN. You wanted to comment, probably about the Social Security and maybe the double taxation there.

Mr. ORSZAG. Sure. Two things, just briefly. One, is on long-term growth, frankly, I think the best thing that you as Federal policymakers could do is to address the long-term fiscal gap and boost national saving, bottom line. That is for economic growth.

That is not just for the Federal budget. It happens to bring the benefit of also addressing the imbalance in the Federal budget, but it would be, in my opinion, the best thing that we could do.

Senator BAUCUS. I agree with that.

Mr. ORSZAG. As you mentioned, let us just look at domestic spending. Domestic discretionary outlays are now about 3.5 percent of GDP. That is down from numbers that are closer to 5 percent in the late 1970's, early 1980's. Project that out. Again, the tax cut in 2013 is 1.7 percent of GDP.

Do you want to pay for that in domestic spending? You have to eliminate half of the domestic discretionary spending. That, by the way, includes homeland security. So half of the FBI, half of the Department of Homeland Security, half of all these things. I think it is completely implausible to think that we are going to pay for tax cuts of this magnitude by spending restraint.

Senator LINCOLN. Thanks, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I am going to have just one more set of questions. If I do not get them all asked, I will submit some for answer in writing.

Just for the record and the issue of what the President does to encourage savings, he does make permanent a $52 billion part of the 2001 tax bill. All of those incentives for savings that we put in there, the President does make permanent. That is to encourage savings so people have the assurance that those laws are going to be on the books as permanent legislation and not sunset.

And, just for the record, as far as the AMT is concerned, Congress did, in 1999, repeal the AMT. It was vetoed along with other parts of a tax bill that President Clinton vetoed.

I am going to go back to Mr. Orszag. I want to deal with capacity utilization. You referred to it as being 75 percent for an average.

I do not argue with that. You suggest that this means that we do not need any new investment right now, so I am going to ask you to look at——

Mr. ORSZAG. Senator, I am sorry. I do not believe that I said that.

The CHAIRMAN. Correct me.

Mr. ORSZAG. What I think that capacity utilization rate suggests, is that there is a lot of capacity that could be used if there were more demand for the products that firms could make.

Now, more investment is part of that demand. When firms buy computers or build new buildings, there are computer firms and manufacturing firms that then have more demand for their products. So, business investment is one aspect of demand that could be spurred.

The CHAIRMAN. I agree with you. If I had read my notes correctly, I would have known you said that.

Now, what I want to do is kind of segment it. Seventy-five percent being an average figure, we have ranges of 90 percent in petroleum and coal, to 50 percent in communications.

In addition, consumer spending is near record highs, personal savings near record lows, and consumer debt is at the highest level in history. That leads me to say, not much shortage of demand. Excess capacity in the face of sustained demand suggests that we have too much investment, but in the wrong place, maybe at the wrong time. The solution to this problem, in my judgment, is not more demand, but rather more investment.

Do you believe the government should try to encourage people to buy old things they no longer want, or do you believe that the government should try to encourage people to invest in new things that they do want?

Mr. ORSZAG. Well, I think in the short run, Senator, again, putting dollars in people's pockets does not determine what they are going to go out and buy. They will use those funds in ways that they find most beneficial to them.

So, in the short run, certainly I would not advocate holding a gun to someone's head and saying, you must go out and buy products X, Y and Z. But that will work itself out. The beauty of the market is, that will work itself out. The products that consumers want are the ones that will be produced.

Again, turning to the long term, investment is the key to long term growth. That investment has to be financed somehow. When we save more as a Nation, that provides the funds for financing investment. That is why I think national saving is an important focus for policymakers over the long term.

The CHAIRMAN. You have done a lot of work that backs up some of the statements you just have made during this hearing. You have written that unemployment benefits are good economic stimulus, because those who are unemployed will spend money.

While this might be true in some areas, when you consider the fact that 70 percent of the households with unemployed workers have another family member who is employed, it is not entirely clear that every family would respond in the same way.

For example, some families with unemployed workers might choose to spend less because of the uncertainty about their future job prospects.

I recently asked the Bureau of Labor Statistics to use the Consumer Expenditure Survey to compare the consumption and savings of households with or without unemployment benefits. According to their analysis, there is no statistically significant difference between these two groups.

Given that fact, would you agree that the impact of extending or expanding unemployed benefits is not as simple or straightforward as you have taken a position on, that it directly benefits the economy?

Mr. ORSZAG. I would certainly agree, Senator, the effects will vary from household to household. I am not familiar with the Bureau of Labor Statistics study that you mentioned.

I know research by Professor Jonathan Gruber of MIT and others show significant declines in consumption when a member of the family becomes unemployed. I think that sort of just strikes most people as being intuitively accurate.

I would also note that the argument that it is possible, especially during booms, by extending unemployment benefits to provide a discouraging factor from searching for jobs, is borne out by the evidence.

There is evidence that extending unemployment benefits, especially during economic boom periods, could dissuade workers from searching for jobs as effectively as they otherwise would. But I know that those research findings have not been specifically targeted to economic downturns.

I just want to emphasize one very important point about unemployment benefits that has not been adequately appreciated. It keeps workers attached to the labor force, to the workforce, rather than, for example, going on disability insurance or just leaving the labor force. That is a very important thing because, in order to be receiving unemployment benefits, you need to be searching for a job.

There has not been adequate academic research yet on this effect, but I think it is possibly quite important to keep those workers basically in the workforce looking for jobs so that they do not become part of a more permanent class of workers who have become divorced from the labor market and do not go back to work when the economy recovers.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Senator, following on the Medicaid questions posed by Senator Smith, I just have some concerns about the administration's Medicaid reform proposal to block grant the program and, at the same time, end entitlements.

I do not have the time now to explore it with you, but I would like your thoughts identifying areas where Medicaid could, or should, be more flexible. I say that because, frankly, I have real concerns about throwing the baby out with the bath water with this new administration's block grant idea in the name of flexibility. So, again, I do not have the time. I must leave at this point. But if you could, please just provide that.

Ms. MONSON. We will. We will be happy to provide that information.

Senator BAUCUS. Just exploring how we can make Medicaid more flexible.

Ms. MONSON. We share your concerns as well.

Senator BAUCUS. Thank you very much.

Thank you.

[The information appears in the appendix.]

The CHAIRMAN. Thank you, Senator Baucus.

Now, Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

Ms. Monson, I was very interested, and I am sorry I was not here, with Senator Smith's advanced refunding proposal for government bonds.

I know that currently in our State, our State's education system is facing a major restructuring. This proposal appears as if it would be very beneficial to our States and to our local school districts and their ability to meet the requirements of the Supreme Court decision.

Can you think of any negative implications from this proposal that Senator Smith has, and do you think it is really a win-win for the States and the Federal Government?

Ms. MONSON. I appreciate that question. No, I cannot think of any negative benefits or negative implications from the proposal. It does provide an opportunity for States to borrow at lower rates, to initiate capital improvements and capital projects.

It is very important. We talk about economic stimulus and ways to infuse new dollars in the economy, to create demand, to create standing. We think this is certainly one outstanding opportunity for States to do so. State budgets can be a drag on the national economic recovery.

As we continue to make cuts and impose new tax increases, we know that what we are attempting to do, what we talked about here, is increase or improve the economic situation that we face across the country. What States are doing now does not benefit.

These kinds of proposals, the proposal by Senator Smith and others, though, we know have a direct positive impact on State budgets and can certainly add to the economic recovery that we all look forward to.

Senator LINCOLN. Well, taking that into consideration, I know some of the other problems that we face in our States. I do not know if Oklahoma is in the same circumstances, but Arkansas is one of six States that, by law, is required to produce a 2-year budget.

Many of the issues that we are facing here, particularly welfare reform, without doing that prior to when our legislatures finish, they are having to devise budgets without any knowledge of what the Federal Government's role is going to be, and how much of that role they are actually going to play.

Ms. MONSON. It is even difficult with those States that have a 1-year budget cycle, but certainly those States that have a 2-year budget cycle. With the uncertainty that is around Congress now, the TANF reform, the reauthorization of the program, even the proposals surrounding Medicaid, but all those proposals, particu-

larly those that come with unfunded Federal mandates, we do not know exactly if there is going to be flexibility. That is still down the road.

We do not know what the funded level is going to be. We are not sure. Those kinds of uncertainties do present a very difficult situation for States. Because we are required to balance the budget, our only option is to continue to cut programs.

There is a real loss of revenue in States' budgets. It is not thought of or invented. There is a real loss of revenues. So, when we have that tangible loss of revenue with the expectation or anticipation, or failure to anticipate what the Federal Government is going to do, States must err on the side of conservative fiscal policy, therefore, we continue to cut budgets, therefore, the economy is continued to be slowed down.

So, it is important for us to have some assurance as to what the Federal budget is going to be, the implications for States, if we are going to make prudent decisions.

Senator LINCOLN. Does anybody else have any comments on the advanced refunding?

[No response.]

Senator LINCOLN. Well, as we have seen, I think many of the President's tax cut proposals, which, by their admission, are aimed at some of the wealthier taxpayers when you look at the brackets, and certainly the dividend deduction in terms of its portion of the overall tax cut, these will reduce the tax base in the States and force them really to raise taxes in order to balance their budgets, because you are going to see less money in the States. We already have seen that in the majority of our States.

The President's budget also aims to push funding for many of our social programs onto the States, whether it is their cost share in Medicaid, TANF, and some of these others.

In Arkansas, in order to make up for some of the shortfalls that we are faced with, our Governor, like some of the others, has proposed an increase in sales tax, which is not boding very well. Obviously, tax increases are not fun for anyone.

But to the extent that the Federal law is reducing income taxes, which are in effect being replaced by sales tax in these States, because we are really, I do not know, stepping down or abdicating from our responsibility on the Federal level, will the President's budget result, really, in higher or lower taxes for working families? Has anyone calculated that?

Mr. EDWARDS. I think it is a good thing if States move towards more of a consumption base in the long run. There is increasing tax competition between States, taxes on capital.

Capital gains and corporate taxes are really an inefficient way, and more so all the time, for States to try to raise money because businesses and wealthy individuals simply move to other States.

So, I think it is actually a good thing. Consumption bases are a lot more stable for State governments, so I think States should start planning now to avoid the next budget bust and the next economic downturn by moving away from capital gains tax bases that are very volatile.

Mr. ENTIN. Ultimately, the States will benefit if the economy can begin growing at 3 and 4 percent a year instead of 2 or 1 percent.

This is really something that will overwhelm the temporary effects of the changes in the definition of taxable income.

Also, if a State does not want to, for example, allow its taxpayers to get a dividend exclusion, it can change its law to put that back into the tax base. But it might then be at a competitive disadvantage with the State next door that allowed it, and capital might flow more into that other State than the home State.

I think, though, that we should look beyond the initial impact of the tax changes. Granted, rate cuts, dividend relief, and so on help people who currently have dividends. But, over time, young people who do not save yet but will save in the future will have dividends.

Over a lifetime, a lot more people will have benefitted.

But, even beyond that, for each dollar of additional GDP that faster capital formation makes possible, the split is roughly as follows. After taxes, workers receive over half. The government takes a little bit over a third, federal, State, and local tax revenue. Depreciation eats up 10 or 12 cents. The owners of the capital get only about a nickel.

When the trucking firm buys another truck, it has to hire another truck driver. The truck driver benefits a lot from capital formation. That is what all of this is really all about.

Senator LINCOLN. Well, can I just say that there is not as much argument over whether we can look at dividend deduction and the reforms of how those are treated.

I guess really the question is, is this the time to devote that much of our resources towards that, and is it not something that we should be dealing with in the future, or maybe incrementally?

Because, Mr. Edwards, your point that the burden should be put on the consumption, at a time when most of our consumers, or a good bit of them, are unemployed at this point and the economy is slow, you are going to put the burden of not only resurrecting the economy, but also carrying the burden of the tax implications on those working families who may or may not be in the workforce. Is that what I am hearing you say?

Mr. EDWARDS. Well, I think the overall cost of the tax system can be lowered, even for any given level of spending, if you move more towards a consumption base. For example, the United States is only one cog in the world economy now.

There are trillions of dollars of cross-border capital flows every year. If we move away from taxes on corporations, or high corporate tax rates, which are a real problem, away from capital gains taxes and other taxes on capital, we will get large net inflows of capital from abroad that will help stimulate the U.S. economy and create long-term growth that will benefit everyone, particularly wage earners.

Wage earners' wages are determined by how much capital they have to work with. If we get large net inflows of capital from abroad, that will be great for all American wage earners in the long run.

Senator LINCOLN. I just wonder. As we look at these working families, two working parents with two or three children, you are saying that the burden on those individuals, by the taxes you place on their consumption of a microwave or shoes for their children, should be the equal burden that anyone in a tax bracket that is

20 times what they make, this is supposed to equalize the responsibility? I am concerned.

I do want to give Mr. Orszag an opportunity to respond, if I may. But, Mr. Edwards, did you have a comment?

Mr. EDWARDS. More and more, the corporate income tax, for example, falls on wage earners. Just because it is hidden, it does not mean it does not fall on them. With regard to the current tax burden, there are 142 million tax filers in the United States now, according to JCT figures, and about 50 million do not pay a dime in income tax.

Senator LINCOLN. So they are not taxpayers?

Mr. EDWARDS. They are payroll taxpayers. But, as Senator Grassley pointed out, the EITC offsets a lot of the payroll tax for people at the bottom. So I think we have really got to look at the real problem here, with over-taxing folks at the top who, frankly, are the entrepreneurs.

Senator LINCOLN. Thanks.

Mr. ORSZAG. Senator, I think this raises a very important point. A lot of the theoretical benefits associated with either addressing the dividend tax issue or moving towards the consumption tax assume that the changes are revenue neutral. So, people will trot out estimates of how much you gain from doing that. They assume that it is revenue neutral.

That is not what these proposals are. These proposals are not revenue neutral. They would expand the budget deficit. In that context, you need to weigh any potential benefit against the loss from the reduced national saving.

Again, in many cases the net effect may well be negative. So even if you are just looking at spurring economic growth, moving to a consumption tax by just cutting taxes does not actually necessarily achieve the purpose of a consumption tax, which is to raise saving, raise national saving. It could actually reduce national saving.

So, one has to be very careful that the theoretical arguments that are sometimes made about consumption taxes or dividend taxes not being misapplied to a specific policy proposal that is completely inconsistent with the assumptions behind those analyses.

Ms. MONSON. Senator, if I could add, too. I know your time has expired.

The CHAIRMAN. That is all right. Go ahead.

Ms. MONSON. But just in terms of the implications for State budgets, these tax policies we have been talking about, one might argue that there are national benefits to some of these dividend proposals, et cetera, et cetera, but there is a direct impact on State budgets, our inability then to generate the kind of revenue that citizens expect because of the services they anticipate that we would deliver.

So, please understand that States may not even have an opportunity to decouple from some of the Federal tax proposals, and we may be, again, left holding the bag with reduced revenue that we had no control over.

Many of the citizens that we have talked about, the additional consumption taxes that could potentially be placed upon them would add a substantial burden to very hard-pressed family in-

comes now. These are taxpayers. They may not, to some extent, pay Federal taxes, or even some State taxes where State income taxes are imposed.

But they certainly pay gasoline taxes and they pay other kinds of consumption taxes that have to be figured into the equation, and the implication for those families is substantial. The implication for State budgets is also substantial.

So, we just encourage you, when you talk about these Federal tax policies, to really take under consideration the implications and the direct impact that they have right now on State budgets.

Senator LINCOLN. Thank you.

The CHAIRMAN. Thank you, Senator Lincoln.

If any of you have to go, we are just about done, so feel free to go. I did want to, after Mr. Entin comments, give Mr. Edwards an opportunity to react to the last exchange from Mr. Orszag, if you would like to.

Mr. ENTIN. Thank you, Mr. Chairman.

Look at the estimates in the literature of the benefits of shifting from a tax system which repeatedly taxed capital, which is very sensitive to tax, to a tax system which is more consumption based. Even that is perhaps a misnomer, because you would deduct saving and tax all the returns, including the super-normal returns to investments that really pay off magnificently.

Those other types of tax systems that are less income-based and more consumption-based would add something like 5, 6, or 7 percent to the national income. I have seen estimates up to 10 percent if you went all the way.

This means that the family's income goes up by a considerable amount. Now, if they pay a bit more under the consumption tax than the income tax, but their pre-tax income has gone up substantially, they come out ahead. There are a number of studies which suggest that the excess tax burden put on capital so reduces the incomes of workers by reducing productivity that, even though their income tax may be lower or the consumption tax may be a bit higher initially because of the corporate tax, their pre-tax income falls by more than they pick up on the tax relief by shifting some of it to the corporation.

If that is the case, they are better off if we reduce taxes on saving and investment. It raises their wages by more than it raises their tax liability. We can avoid, however, the increase in their tax liability even from the start if we can be in a situation of budget surplus and spending restraint at the government level so that we can have a net tax cut.

The transition, as I think you are pointing out, is much, much easier if the government is in a good fiscal situation to begin with and can afford to have a net tax cut, because that way there are no short-term losers as we move to making everyone a winner over time.

I do not think there is too much quarrel among economists that, ultimately, taxing a sensitive factor like capital which promotes productivity, ultimately costs the people who are working with that capital a good deal of income, and that a so-called consumption-based tax system gives you a higher level of income all across the

board than an income tax-based system of taxation. It is inefficient to do what we are doing.

The CHAIRMAN. Mr. Edwards, you did look up during the conversation that was going on. If you had any comments, I would like to have you make those. If you do not, we will adjourn the meeting. Well, first of all, did you want to comment?

Mr. EDWARDS. I must say, in terms of Keynesian stimulus, if Keynesian stimulus really worked, we should have an economy going gangbusters right now with a $300 billion deficit and large increases in Federal spending every year the last few years. But I think the fact that the economy is in a slow-down does show we have to look at the investment side.

The CHAIRMAN. Keynesian economists are not much of a profession anymore, but they have still got a lot of disciples and believers in Congress.

Senator LINCOLN. May I ask one more question, please? Mr. Chairman, thank you. I just wanted to follow up with what Mr. Entin had said.

I guess my question is, if you think that this trickle down is going to get to the worker, particularly the minimum wage worker that has got a family of two and is working two jobs, if you could just help me better understand, what reason does the business owner have to pay higher wages when they can just apply this tax windfall that they have to their bottom line?

Mr. ENTIN. Trickle down is a Keynesian concept that suggests, if you give the upper income money to spend, they will go out and consume and that will cause people to be employed, or they will hire servants. It is a spending concept.

The concept of reducing the tax wedge on workers by lowering their marginal rates means they can keep a higher after-tax wage, while their pre-tax, their gross wage, can go down a bit. Their after-tax wage can go up a bit because the government is taking less out of the middle.

Senator LINCOLN. We are talking about people that do not even file those.

Mr. ENTIN. And look at investment. If you take some of the tax off capital formation, then capital investment projects currently need to yield a 9 percent return in order to be undertaken, because the government takes 3 percent inflation, 3 percent in taxes, and the owner only gets 3 percent now. If you take some of that tax wedge out, then maybe a 7 percent return is all right. So, an extra trillion dollars of capital can be put in place.

Senator LINCOLN. Maybe.

Mr. ENTIN. Well, estimates of the elasticity might be $800 billion or one point two trillion dollar, but it is a big number. With the added capital in place, productivity rises and the market forces cause employers to want more workers to go with the added capital, and they are willing to pay them their higher productivity.

Productivity and wage growth are very closely related, and have been for centuries that we have data. If that is not true, then markets do not work at all and we are living in some sort of very strange world.

Senator LINCOLN. Mr. Chairman, this is so theoretical. I just want us to be encouraged by this gentleman who is thinking in a

very theoretical way. For the minimum wage worker that is making under $11,000 a year, in 5 years they have not seen an increase in minimum wage.

If all of a sudden this tax windfall comes to the business owner, they are going to see to applying that to the income of that low-income earner as opposed to their bottom line that is going to, again, as you say, increase maybe the value of this capital, or this industry, or business to a dividend individual who is in a different boat.

Mr. ENTIN. Individuals who can only produce enough to earn the minimum wage can profit through getting their productivity up to the point where they are producing more so that employers are trying to bid them into their company because they are so valuable.

And to get a worker's skills up or his productivity up, you need either to train him better, to give him more education, or to give him someone else's capital to work with if he cannot save and buy his own small business, which these people mainly cannot.

So anything that promotes capital formation or enables people to get more training will raise their productivity and will raise their wage above the minimum, and that is what all of this is about.

The markets will do it if they are given a chance. The reason the theories are the way they are is that we have seen this happen so many times. We are not getting our theories from outer space. We are trying to base theory on historical evidence.

Senator LINCOLN. I thank you. The Chairman has indulged me tremendously, and I do appreciate it. He is a kind gentleman, and he always has been.

The CHAIRMAN. We thank the panel, Senator Monson, and all the rest of you, for your kind attention for two hours of very important testimony as we go one more leg down the road to solving this issue as we attempt a jobs bill to be approved by this Congress.

Thank you all very much.

[Whereupon, at 12:10 p.m., the hearing was concluded.]

EXAMINATION OF PROPOSALS FOR ECONOMIC GROWTH AND JOB CREATION: INCENTIVES FOR INVESTMENT

WEDNESDAY, FEBRUARY 12, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:39 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Nickles, Kyl, Thomas, Santorum, Bunning, Baucus, Rockefeller, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good morning, everybody. We are very happy to have you here as we continue what is a third in a series of hearings that we are having on revenue proposals in the administration's budget.

We had John Snow. Yesterday, we had a panel to examine incentives for the demand side. Today, we turn to incentives for the investment side.

No one would dispute the fact that it has been a very rough period, almost 3 years, for the investment side. I think Senator Kyl had a chart yesterday that demonstrated that very clearly: investment is very flat, consumer expenditures have been fairly healthy over the last 3 years. Obviously, though, the economy is not so good.

The Stock Exchange is a good example, led by the NASDAQ, followed by the Dow, and the S&P tumbling. The NASDAQ peaked at 5,000 March 10, 2000. Yesterday, 1,295. so worth about 25 percent of what it was about 3 years ago. The Dow is about 67 percent of 3 years ago; the S&P about 54 percent.

Everyone acknowledges the effect of the bubble of the late 1990's. No one can mistake the impact of the corporate scandals of the late 1990's in the early part of this decade.

Clearly, the tragic events of September 11 and the war on terror have had effects. There is not doubt investors, large and small, institutional or individual, have had a rough 3 years.

So we need to ask the question, what, if anything, can government generally, this committee specifically, do about it? Is there a fiscal policy that can help right the ship for the capital markets?

Now, over the last few years, the stock market drop has been accompanied by decline then in business investment. Commerce Department data show that business investment peaked the second quarter of 2000, 3 years ago.

Purchases of equipment and other business assets have flattened out and dropped. Too many factories are dark, or at least parts of them. Too many workers are idle. Too many workers worry their jobs might be the next one lost. I think 1 in 4 workers are worried about losing jobs.

So, ask the question, what can we, as the Finance Committee, do about it? Is there a fiscal policy that can help move up the level of business investment? I guess I believe very much, in my votes recently, that there is much we can do.

The good news, is that we have both political parties recognizing the problem of dramatic decline in investment. There are differences, hopefully bridgeable, in how we tackle the problem of declining investment.

The President's package is, as he told me at the White House just yesterday, bold on investment incentives. The President is breaking new ground on proposing elimination of double taxation of dividends.

It could be argued that the President's boldness has made his growth proposal an attractive target for his detractors. Many of the alternative proposals are, by design, thin on the investment side and are short-term.

As we begin to examine the investment side, I would like to say to the skeptics out there, think about the numbers that are recited above. Think about what has happened to the stock market. Think about the impact on investors, retirees, and all those who invested in the stock market. Think about the factories that are not working at capacity.

As you criticize the President's plan then, and that plan aims to improve market capitalization over the long term, I would like to ask what alternatives on the investment side do those skeptics propose.

In today's hearing, we will focus on the status of the investment side of the economy. We will examine proposals for raising the level of investment. The witnesses will testify to the efficiency of these proposals, their short-term benefits, and long-term implications.

Today, as you can see at the table, we have two distinguished former members of Congress who have played key roles in making fiscal policy over the last two decades.

It is my first opportunity to welcome Citizen Gramm to the podium; also, a former colleague of mine on the House Agriculture Committee, Leon Panetta, all people who have distinguished themselves very well, speaking very forcefully on TV regularly about positions that they hold, and helping to educate our electorate. I think you both do a very, very good job.

Both of these long-time public servants have moved on to the private sector. Our former colleague, now Citizen Gramm, is vice president of UBS Warburg. Leon, now co-director of the Panetta Institute for Public Policy, is serving on many boards, including the board of directors of the New York Stock Exchange.

In addition, we have two distinguished veterans of economic policy on the next panel, Kevin Hassett and William Gale. So, I look forward to their testimony.

It is my privilege to call upon my colleague, Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I join you in welcoming two good friends, and two very astute observers of the national scene, particularly the economic scene, and I thank you very, very much.

Senator Gramm, welcome back. We have engaged several times. It is good to see you again. And Chairman Panetta, thank you so much. Thank you for all the roles that you have performed over the years.

Both of you very much believe in public service and have served our country very, very well, both of you, and I thank you very, very much. I know our American people do, too. Those that know you, anyway, certainly do thank you.

Mr. Chairman, as you know, yesterday we focused on consumption with respect to the President's stimulus plan. Today, we are looking at ways to increase investment. But I must begin by saying I am, frankly, quite concerned. I am concerned about where our country is headed.

Two years ago, we were squarely on a path of fiscal discipline. In fact, we were, even then, if you will recall, worried about what we were going to do after we paid off the national debt. It was incredible. That was the discussion. I wish we still had that worry, but we do not. It is much different today. I need not give you the figures, but it is almost dramatically the opposite compared to what it was 2 years ago.

So why are we here today? We are here to talk about investment because investment creates economic growth. I believe there are two ways we should do this. First, incentives for investment in the Tax Code, particularly for small business.

Small business is still the backbone of the American economy, creates the most jobs. There is more innovation in small business. The vast majority of new jobs, as I said, are created there.

In my State of Montana, small business comprises 98 percent of all business. They employ 70 percent of Montana's employees. So, if we want to create new jobs through economic growth, we must help, certainly, small business.

We can help them by increasing the amount small business can expense immediately when they buy new equipment. This would create strong incentive for business to purchase new equipment by increasing the rate of return.

I believe we should also help small business provide health insurance for their employees. We do not know the solution for rising health care costs in the long term. But in the short term, small business owners have told me that health insurance premiums are going through the roof.

Increases are hitting small businesses much harder because they do not have the bargaining power that large companies have, and these costs take money away from investing in new facilities.

Right now, small businesses are forced to make choices they do not want to make. Do they shift more of the cost of health insurance to employees? Do they provide health insurance at all? If they do, will they be able to afford to make new investments in business?

Our colleague, Senator Snowe, held a hearing last week on this subject and the testimony was very troubling. Health insurance premiums for companies with 10 or fewer employees grew by 16.5 percent in 2001. According to the SBA, high premiums are the reason that only half as many small firms provide health insurance coverage compared with large firms.

We need to help small business keep health insurance coverage, at least during the next several years, pending a better solution to the health care problems that we are facing generally in our country.

We should decrease the depreciation deduction for a year that a business purchases new equipment. In 2001, we saw a sharp drop in direct investment by business. In 2002, we changed the law to give a larger first-year deduction.

The drop in direct investment leveled, and even increased slightly. I believe we need to provide an increase in the bonus depreciation deduction for 2003 to encourage more direct investment.

The second way to encourage investment is by being fiscally disciplined with our Federal budget. That means we increase our National savings, which is the sum of savings in the private sector and savings by government, or we prevent our National savings from decreasing.

One of the best ways to prevent reductions in national savings is to avoid large, long-term budget deficits. But the budget recently proposed by the President is in deficit each year, not only in deficit, it is in deficit significantly, and does not yet include any fund for war with Iraq. That is not included in the proposal.

If we go to war, how long will it be? A month? A year? What about the costs after the war, the occupation costs? What about other costs that will certainly rise on account of war?

We cannot ignore the possibility of war. It is looking more likely it may occur, and we have to leave ourselves room in the budget to cover these potential costs.

It is also critical that we extend the three key 60 points votes of order which are set to expire in just a few months, on April 15. Extension of these points of order ensures fiscal responsibility by preventing enactment of legislation that would substantially increase budget deficits in the near term and the longer term.

So we can encourage investment with tax cuts, especially tax cuts for small business that take effect immediately. We can encourage investment by reducing deficits and being fiscally responsible. I believe deficits do matter. I believe they do affect long-term, and therefore even shorter term, interest rates.

As we all know, when interest rates go up, our economy is in much more difficult straits. I am very heartened by Chairman Greenspan's testimony yesterday when he made it clear that, in his judgment, deficits do matter.

He believes—and I do not want to put words in his mouth—that it does not make sense to pass a tax cut now, he says. I think we

should take those words to heart. After all, I do not know anybody who is a better student of the American economy than Chairman Greenspan, and I urge us, as we go forward, to pay close attention to what he said.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

It is normally our procedure just for the two of us to make opening comments. Senator Nickles asked for a point of personal privilege. If there is no objection, I would like to ask him to speak, then go to our panel. Mr. Panetta has to leave by 11:00, so we have to move this first panel along very quickly.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you very much. I will not be long. I just wanted to say welcome to our two friends and distinguished guests. Mr. Panetta was, when he was head of OMB, and also his service in Congress, certainly a friend. We value his contribution today, as well as our former friend—former colleague. [Laughter.]

I had this vision. This is what I had to relate. Not only did Phil sit adjacent to me in this committee, but I had this dream, I looked on a big screen just recently and saw these big sideburns, and that he was participating in a rebellion against our Nation, participating in a movie called "Gods and Generals," and I did not know which one he was. [Laughter.] But I enjoyed the movie and his participation, and just wanted to say welcome to both of our friends and colleagues.

The CHAIRMAN. Thank you.

I usually go left to right. So, Senator Phil Gramm, would you start out, please? Then, Mr. Panetta.

STATEMENT OF HON. PHIL GRAMM, VICE CHAIRMAN AND MANAGING DIRECTOR, UBS WARBURG, NEW YORK, NY

Mr. GRAMM. Well, Mr. Chairman, let me first thank you for honoring me by letting me be here today. I am also especially proud to be here with Leon Panetta. I served on the Budget Committee in the House with Leon. While we have disagreed on many subjects, we have never been disagreeable and I have never doubted the sincerity of his opinion. I am honored to appear with him.

You have gathered today, it seems to me, to talk about something vitally important to the American people. That is, how do we get the economy in high gear? How do we put our people back to work? How do we revitalize the capital market which is a foundation of our retirement programs and our financial security?

I think, looking at this problem, we need to begin to understand that the current downturn we are in is very different than anything we experienced in the 19th and 20th century. In the 20th century, we basically had two kinds of downturns. In the latter part of the century, we had a series of inventory cycles.

Basically what would happen, is signals would get crossed, there would be over-production, you would have the build-up of inventories, retailers would discover the inventory build-up, they would cut back on their orders, there would be a retrenchment in the

economy, people would be laid off, we would go into a recession. The inventory overhang would, over time, be sold off, orders would reignite, and the economy would recover.

In that environment, it was literally true, the bigger the boom, the bigger the bust. The bigger the bust, the subsequent boom. In that era, we talked about pump priming, basically to reignite consumption.

In the early part of the 20th century and throughout the 19th century, we had a series of financial panics. They basically were triggered by a difficulty, in a short period of time, of converting demand deposits into currency. They were exacerbated by the fact that we had a great seasonal variation in the demand for money because of an agricultural economy.

It is not an overstatement to say that, in all the 19th century and the early part of the 20th century, we had financial crises that were a byproduct of the agricultural era.

In the middle part of the 20th century and the late 20th century, we had inventory cycles that were a byproduct of the industrial era. I do not think it is being overly dramatic to say that the current recession is the first post-industrial recession in American history.

Now, why is that important? I think it is important because our current downturn is largely the result of a speculative bubble. It is very different than the recessions of the 20th century, which we could never predict but we knew an awful lot about.

And in a very real sense, we are in uncharted waters. We do not know for sure that all the gas is out of the bubble. We do not know what the recovery pattern for speculative bubbles is like.

So, I think that there is a great deal of uncertainty. I think that should lead us to be cautious in terms of being proactive in trying to buy an insurance policy in dealing with this recession.

Our current downturn is almost totally the product of a collapse in investment, a dramatic turnaround in investment over the last 2 years. The interesting thing about our current recession, is consumption has never declined. We have had a housing boom in the middle of this recession.

Normally, declines in housing start up and housing is identified with the beginning of recessions and with the recovery. Wages have continued to rise. The total amount of wages paid in the economy has continued to rise, even as unemployment has gone up.

In short, this is a very, very different recession. If we are going to have an impact on it, in my opinion, since consumption has never declined, since government in the last 18 months, in terms of its spending, has been a stimulant through the level of spending it has had, the area where we have a problem is investment.

If we want to affect the economy, if we want to stimulate the economy and put people back to work, we have got to do it by affecting investment.

The President has made two major proposals that, it seems to me, will have an immediate, important, and positive impact on investment. The first, is the proposal that the President has made dealing with the double taxation of dividends. There is a long list of reasons why this is good policy, both in the short term and the long term, but let me just touch on a couple.

First of all, eliminating the dual taxation of dividends will raise the rate of return on investment and directly encourage investment. I am vice chairman of UBS Warburg. We employ more economists than any other investment bank in the world, do more research than any other investment bank in the world.

Our economists believe that, by eliminating the dual taxation on dividends, that we will produce a one-time up to 5 percent increase in the valuation of American equity markets of about 5 percent. Now, that does not sound like a lot of money, but that is $350 billion of equity value.

By eliminating the dual taxation on dividends, it will eliminate the inefficiency of the capital market where, because of the Tax Code, companies have an incentive to retain earnings and invest them internally, even when the rate of return in the marketplace is greater than the rate of return inside the company.

Companies are discouraged from paying dividends, but the payment of dividends, the exhibiting of cash flow, makes the books of companies more transparent and gives investors greater information.

The double taxation on dividends discourages American business to incorporate even if, by incorporation, they would have greater access to capital. It biases the development of companies in favor of debt, which is deductible, instead of equity, which is double-taxed.

So the elimination of the dual taxation on dividends is good long-term economic growth policy. It will stimulate investment in the short term, and it seems to me that it is very sound policy and it should be undertaken.

Let me remind you that we are not talking about, in terms of the overall budget of the government, a lot of money. If we simply took the President's stimulus package and put the money in airplanes and went out and dropped it around the major cities of the country, it is 2.4 percent of projected current services spending.

In terms of fiscal impact, it is very small and we might never notice it if we simply dropped it out of airplanes. The only way stimulus packages work is if you change incentives and get people who have real money who are not putting it to work, to put it to work by investing it. I think that is critically important.

If we were really talking about stimulating the economy by spending money and we were not trying to change other people's behavior, we would be talking about packages that would be $500 billion, or a trillion dollars over the next 5 years.

So what we are counting on, is changing behavior. I think it is very important to look at that. If you are not changing behavior, you are not having much of a positive effect.

The second part of the President's proposal that I think is critically important, and I hope will end up not being a partisan issue, is the proposal to accelerate the tax cut that is going into effect anyway in 2004 and 2006. Accelerating that tax cut does not change the intermediate or the long-term revenue picture that the Treasury faces.

The most important part of it, is the highest tax rate. Now, why is it the most important? Because the highest tax rate is the tax

rate for small business. The highest tax rate is the rate that proprietorships, partnerships, and subchapter S corporations pay.

As Senator Baucus has said, and as a press release by Chairman Grassley and Senator Baucus back in August of last year said, 80 percent of the tax relief associated with the top bracket goes to small business: proprietorships, partnerships, subchapter S corporations.

Now, let me make it clear. We are not talking about giving people relief. We are talking about providing incentives for investment, and speeding up the reduction in that top rate will cut the effective tax rate of every small business, every proprietorship, every partnership, every subchapter S corporation in America.

It seems to me, per dollar spent in terms of giving up revenue in the short term, that is the most effective policy that can be followed.

I think the policy of enhancing expensing is a good policy, but I would note this caution. Anything that is very short term is probably going to induce people to invest what they would have invested anyway, only change the timing of it.

If you want to change behavior, you need to make permanent changes. That is why I think accelerating the Tax Code, the tax reduction, and eliminating the dual taxation on dividends is a critically important policy.

I think the uncertainty that surrounds the current recovery and the lack of predictability of its behavior strongly argues for the passage of a stimulus package, and the sooner the better. It will be better if you make the whole thing retroactive to January 1.

If the recovery could be accelerated, net additional job creation over the next 3 years in the range of maybe two million jobs, I think, is achievable. Anything that helps to restore the $6.7 trillion of equity values that have been lost in the last 3 years is going to have a dramatic impact on the economy and on the Federal Treasury. So, Mr. Chairman, I think this committee is in a position to have a substantial effect.

I would like to conclude by making a little bit of a comment about crowding out. Obviously, one of the things we have to be concerned about is that our actions could crowd out private investment by driving up interest rates.

In the short term, we are now looking at Federal debt of about 35 percent of gross domestic product, far below the 50 percent we faced in 1993. So, in the short term, I do not think we face an imminent problem of crowding out.

But I would say, for people who are concerned about the cost of the stimulus package, the President's stimulus package costs $390 billion over 5 years. His budget, which is written for 5 years, which is why, Senator Nickles, I used that number, increases spending by $427 billion.

So I guess I have to pose the question, I do not understand being concerned about the tax cut and its impact on the deficit at $390 billion over 5 years and thinking it should be cut, and then believing that spending, which is $427 billion new spending, should be increased. I do not think you can have it both ways. I think that that is something that ought to be looked at.

Finally, I think there are two areas of spending that need to be looked at. I think we need to look at defense spending. I think, after the war with Iraq is over, that we have got to come to grips with the fact that we have new and emerging needs in defense that have got to be funded.

But old programs that were aimed at old needs that no longer are imminent, I think they need to be reevaluated. I think the current rate of growth in defense is largely unsustainable.

Finally, I think Medicare and Medicaid expenses are beginning to grow. You are going to add a prescription drug benefit this year. I would urge you to use co-payments to promote efficiency, and to have a sliding scale on the deductibles so that higher-income people have to have higher levels of costs to get into the system. I think if you can do those two things, that it will be very important.

I think, if a bad job is done in adding prescription drugs when medical costs are rising, the current rate of growth in defense and the rate of growth in health care could produce a real crowding out problem in 2006, 2008. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Gramm appears in the appendix.]

The CHAIRMAN. Mr. Panetta.

STATEMENT OF HON. LEON PANETTA, THE PANETTA INSTITUTE, CALIFORNIA STATE UNIVERSITY, MONTEREY BY, SEASIDE, CA

Mr. PANETTA. Thank you very much, Mr. Chairman, and distinguished members of the Finance Committee. It is an honor to be able to come back to this committee and to share thoughts with all of you. It is also an honor for me to appear with Senator Phil Gramm.

We served together in the House, and when he was both in the House and the Senate we spent a lot of time negotiating on budgets and reconciliation, as well as the Gramm-Rudman-Hollings bill that was implemented to try to deal with the deficit. So, I am honored to have this opportunity.

Let me submit my statement for the record, and I will summarize it very briefly.

I think that there are two fundamental principles that have to support whatever incentives for investment this committee and the Congress decide upon. The principles are drawn, obviously, from my experience as Chairman of the House Budget Committee, and member of the House Budget Committee for almost 20 years, and also as Director of the Office of Management and Budget.

I do not think it is any secret that I come to this table feeling very strongly that it is important to maintain fiscal discipline on both the spending side, as well as the revenue side.

If you take the attitude that somehow one can simply get a blank check, and the other is the one you are going to control, you are not going to get anywhere. Both have to be considered, both have to be dealt with if you are serious about fiscal responsibility.

I also address these issues based on my experience now as a member of the board of the New York Stock Exchange, and I serve as a co-chair of the Corporate Accountability and Listing Standards

Committee, which basically has had the responsibility of developing new listing standards, based on the scandals that took place in the corporate arena.

So, with that as a background, let me just indicate the two principles that I think are important. I do not think there is a Federal incentive for investment that can produce sustained economic growth unless it is accompanied by strong fiscal discipline. The two have to go hand in hand.

If you are going to put something into a budget resolution, if you are going to put it into reconciliation, then at the very same time that you decide whatever incentives you are going to provide in reconciliation, you had better, in the budget resolution and reconciliation, also provide for some kind of clear path that indicates we are returning to fiscal discipline.

The second principles relates to a great deal of what Chairman Greenspan mentioned yesterday, which is, everywhere I have gone—and I think all of you are aware of the uncertainty that now prevails—no matter what you do in terms of investment incentives, if you do not deal with some of these great uncertainties that are out there, people are still going to be hesitant to try to go out and invest if they do not feel that some of these uncertainties have been dealt with. And the uncertainties are both in the foreign and domestic area.

So it seems to me a guideline ought to be that you do no harm in terms of whatever you put in place, that you do not add even greater uncertainty to what is already a nervous investment environment.

So the danger, it seems to me, that you want to avoid is rushing to judgment, to try to develop either a temporary or permanent solution dealing with a weak economy, and then at the same time excuse exploding future deficits on the basis that somehow they are either insignificant or they will take care of themselves.

The lesson of the last 25 years—and as I look at this panel, every one of you have gone through those experiences in one way or another—is that deficits do matter and that they can only be reduced, they can only be dealt with, if there is unified action by the President and the Congress.

All of you know the history, but I think it is worth touching on some of the more important lessons that we learned over these last 25 years. In the 1980's, we knew that we were looking at what David Stockman said were "deficits as far as the eye could see."

We were looking at $200 billion by the end of the 1980's. We were looking at $300 billion by the early 1990's. We were looking at as much as $600 billion as we entered a new century.

The national debt quadrupled. The economy clearly wa being impacted by long-term interest rates that were high, increased government borrowing, crowding out capital, and obviously significant interest payments on the debt being handed on to our children.

In a word, I think the deficit was out of control. Both political parties, to some extent, did not have the will or courage to directly confront the problem. So, rather than making the tough decisions that had to be made, Congress passed budgets based on a combination of smoke-and-mirrors accounting, rosy-scenario economic projections, funding shifts from one fiscal year to the other in order

to hide spending, exaggerated savings from project reductions that few believed would really be realized.

In the midst of that, Congress decided that there had to be a better way to try to confront the deficits. Senator Gramm knows better than anyone the effort that was made by he and Senators Rudman and Hollings to basically apply an across-the-board automatic cut in order to meet deficit reduction targets.

Even with the exceptions that were built into Gramm-Rudman, Congress kept changing the targets for fear of what an across-the-board cut would do and the political ramifications of that.

So the bottom line was, none of the steps that were put in place really worked, and all of the projections, particularly on the supply side, that said that somehow all of this would take care of itself, never happened and we had a continuing growth in deficits.

In the end, I think it was finally recognized that the key to reducing the deficit was not gimmickry or artificial legislative or constitutional mandates. No one could resolve budget priorities by putting the whole process on automatic pilot.

Political leaders are elected to make hard choices, to set priorities, and to discipline the budget. There just are no magic answers out there. It takes tough, hard choices.

In 1990, former President George Bush did exactly that with the 1990 budget agreement. It established not only significant deficit reduction, but it put caps on discretionary spending and it implemented a pay-as-you-go discipline that required any new proposal for tax cuts or for spending on the entitlement side to be fully paid for.

I have to tell you, as Chairman of the Budget Committee, if it were not for those tools, you would have never seen a balanced budget. Those tools were absolutely essential to achieving a balanced budget.

In 1993, President Clinton passed his economic plan, with $500 billion in deficit reduction. But, again, the most important part of that was that the budget disciplines that were implemented in the 1990 agreement were also continued in that plan as well.

Then when Congress came together on a balanced budget agreement in 1997, I think it could be said that former Presidents and Congresses sent a very important signal to the financial markets that Congress was serious about implementing fiscal discipline.

Those credible efforts, combined, obviously, with actions by the Federal Reserve, combined by tough decisions by CEOs and those in business who had to invest in new technologies, who had to basically lay off employees in order to tighten up their operations, all of that helped produce what I think was the strongest economic growth and job creation in the history of the country.

Now, those are the facts. Those are the lessons that hopefully are not now going to be ignored. Many of you, as I said, played very important roles in the tough decisions that had to be made, and I commend you for that. There is not a member among you who, at one time or another, has not criticized uncontrolled fiscal deficits, and you were right to do so. Nothing has changed that reality. Nothing.

Deficits do matter. Increased government borrowing provides a drag on the economy by reducing national savings. If you try to

provide incentives to increase savings on one hand, and then at the same time increase deficits that basically drag down national savings, both are considered. It is not just private savings, this is public savings.

So, it clearly is going to impact on national savings. It is going to increase long-term interest rates ultimately. It is going to crowd out capital spending. It is going to reduce investment in capital stock to improve productivity. It is going to increase the debt that we owe to foreign investors, because they are the ones that usually are the ones that go out and buy our bonds and we borrow the money from.

It jeopardizes the social safety net for retirees. It reduces future income and living standards for American households. And, most importantly, it does place a tax burden on our children. We have a responsibility to future generations to make sure that any incentive for investment is accompanied by strong fiscal discipline.

The second principle I want to mention is this "do no harm" principle. Chairman Greenspan, again, pointed out the uncertainty that obviously is out there in the investment community as it relates to the war in Iraq, but there are other uncertainties as well.

Let me say that my experience in talking to corporate leaders is that they are not pessimistic about the long-term future of this country and its ability to confront these crises.

But what concerns them right now is the growing number of problems that the country needs to deal with in order to provide what Phil Gramm said, which is a stable environment for investment and growth. That is what you look for.

The list of challenges is long. It is not just the war in Iraq, it is the turmoil in the Middle East, the impact on oil prices. You are seeing what is happening with energy prices right now. It is the growing conflict in North Korea. It is terrorism alerts that impact on business and consumer fears.

The hospitality industry in my home town is down 25 percent, and it continues to be down. It depends a great deal on people feeling confident about being able to go out and enjoy themselves.

There is continuing concern over corporate scandals. There is a confused enforcement and regulatory environment right now that is affecting CEOs and boards of directors, even though we have issued new listing standards.

Even though you passed Sarbanes-Oxley, there are a lot of questions about its implementation that have not been resolved, and that is creating a lot of consternation among CEOs and boards of directors.

The losses on retirement income, the escalating foreign trade deficit, and, of course, the budget crisis that is impacting on State governments that looks like it is somewhere between $60 and $80 billion, collectively. All of this in a volatile market, unemployment going up, costs of health care, obviously produces a very unpredictable world.

So the point is, this is not the time, in light of all of those uncertainties, to add even greater uncertainties to that by adding to cumulative deficits over these next 10 years. And $2.1 trillion is a lot to add to the debt.

The national debt is expected to exceed $10 trillion by the end of this decade, $1.1 trillion in spending for interest on the debt, and an unfunded liability for Social Security, Medicare, and other retirement programs that OMB itself projects to be near $25 trillion.

All of that, plus the costs, obviously, of whatever is implemented on a tax cut agenda, is creating even greater anxiety about our economic future.

So, recognizing those principles, I would just advise you to take into consideration these issues. Number one, do not dig the deficit hole deeper. Any costs for an incentive package, very frankly, ought to be paid for under the budget rules.

This idea that you are going to put in place pay-go, but somehow exempt tax cuts, is wrong. If you are going to do pay-go, the fundamental purpose of pay-go was to make sure that, whether you did tax cuts or whether you did spending on entitlements, you paid for them in order to make sure that the deficit would not be harmed for the future.

Second, and again I kind of share this concern about whether or not you should advance a stimulus program right now to begin with in the present uncertainties. But if you do, better that it be temporary rather than permanent, only because, again, of the impact it will have on the long-term budget situation.

Tax cuts should be targeted, I think, to be effective and fair. Clearly, consumers in working families ought to be able to have a piece of the action in order to invest, in order to spend, and businesses obviously have to have direct incentives.

I like the expensing idea. I like the idea on depreciation because I think those kinds of things will drive businesses to invest soon and try to hire new workers.

Last, I am going to say that you recognize the trouble States are having right now. California has a $35 billion deficit, and other States are facing serious deficits across the board.

Any Federal effort to promote growth in jobs could very well be undermined by States who have to, as you know, get a balanced budget. So, they are involved in cutting spending, raising taxes, and laying off employees in order to balance their budgets.

It would seem to me that anything you do to try to provide an incentive could backlash against you by what the States are currently doing. So, it does make sense to try to provide some assistance to the States, certainly on homeland security and for other programs, particularly for the needy, so that both State and Federal Governments are walking in the same direction.

The President said, and I agreed with him, we must not pass along our problems to other Congresses, other Presidents, and other generations. He was absolutely right.

But if you enact a permanent, new tax cut in the face of large new spending pressures such as the prospect of war in Iraq, homeland security needs, and a major prescription drug benefit, that is living beyond our means and it is passing the IOUs on to our children.

If incentives are to provided that support economic growth, then hard choices have to be made to make sure you implement budget discipline and restore a sense of confidence in the economic stability of this country.

That will require both leadership and sacrifice, and you all know it. This is the clear lesson of the past, and it is also the lesson of the present, if we are going to secure a strong economy for the future.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Panetta appears in the appendix.]

The CHAIRMAN. Thank you very much. Thanks to both of you.

I am going to start my questioning, and we will have five-minute rounds. That applies to the Chairman as well.

I am going to challenge you, Mr. Panetta, on a couple of points you made. That would not be arguing with you about hard choices and the need for budget discipline, but whether or not those, in and of themselves, were solely responsible for the surpluses of the 1990's.

While there were some tough choices made in 1990 and 1993, I believe that, following the enactments of the two budget agreements, CBO and OMB both continued to forecast deficits as far as the eye could see.

I am handing you out some charts. The dramatic shift from deficits to surplus that occurred during the 1990's, I believe, were primarily due to two factors: an unexpected revenue windfall from individual income taxes, and the peace dividend resulting from the end of the Cold War.

These two factors, along with the resulting interest savings, accounted for almost 85 percent of improved budget outlook during the period of 1990 to 2000.

These same two factors, obviously, are now working against us. The most recent recession has caused decline in income tax revenue. The war on terrorism, of course, has reversed the decline in defense spending.

Given these figures, I hope you would agree that returning the budget to surplus largely depends upon restoring economic growth and winning the war on terrorism. That is my point, and that is my question for comment.

Mr. PANETTA. I do not deny, obviously, the impact of the increase in investment, the revenue windfall that came back to the Federal Government, and obviously, the results of the peace dividend.

As Chairman of the Budget Committee, and also as OMB director, one of the things that obviously helped in terms of reducing spending was the fact that we had a peace dividend that resulted.

But I do not believe that we would have had a strong economic growth period in this country if the Federal Government, and particularly Congress and the administration, did not send a strong signal to the money markets that they were serious about controlling deficits.

If you combine the 1990 budget agreement, plus the 1993 economic plan, plus the 1997 Balanced Budget Agreement, all three of those made commitments that were implemented and that were credible in terms of reducing the deficit.

I think, based on that, it created stability on the fiscal side. When you combined that with stability that was obviously helped by the Federal Reserve, by business people and CEOs, all of that contributed to the success of that period.

So, I guess what I am saying is, if you believe that that is the case, then go back to those same elements go back to those same principles, and put them in place because they worked.

Do not ignore the deficit side and think that you can suddenly gamble on producing tremendous growth by adding huge amounts, trillions of dollars, to future deficits. That is not going to work.

Mr. GRAMM. Mr. Chairman, could I respond to that?

The CHAIRMAN. Please respond.

Mr. GRAMM. Well, Mr. Chairman, I do not think there is any doubt about the fact that, looking back now from about 1982 when the Reagan tax cut took hold until 2000, it may not have been clear then, but it is clear now, we were in a golden age. Prices are probably lower today, when you adjust for quality, than they were in 1982.

I think there is no doubt about the fact that the very strong economic growth, more than everything else combined, produced a deficit. I think that we also did have some spending restraint, in part because you had a Republican Congress. One of the things they were willing to do, was to say no.

But I think economic growth is critical. I guess the thing that tips the scales for me, in terms of these incentives for investment, is that today we are losing five times as much in revenue from this recession as we would lose on our average annual cost of the President's economic stimulus package.

I think when Leon is talking about temporary things, speeding the tax cut up is a temporary measure because it is going to happen. When 2004 comes, that second phase will kick in; when 2006 comes, the third phase will kick in.

If we do it now and do it retroactively and cut that small business tax rate, we are going to have an impact on investment in proprietorships, partnerships, and subchapter S corporations.

I do not think consumer spending is irrelevant, and it will be affected by the rest of the Tax Code. But I would reiterate, in this downturn, consumer spending has not been the problem.

It is not as if consumers have got all this purchasing power that they are holding back. Investors have purchasing power that they are holding back. If we can induce them to use it, we are going to get a pretty substantial economic response.

The CHAIRMAN. Thank you.

Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I would like you both to address the pay-go points of order. You made the point, Mr. Panetta, that the so-called pay-go rules should apply both to tax cuts, as well as to spending increases. Could you explain why you think that is important?

Mr. PANETTA. Yes. The obvious reason is that, if you are looking are revenue loss that is going to add to the deficit, it happens two ways. It happens through when you cut taxes and reduce revenues, and it happens through spending, particularly on the entitlement side, which is an area, when you build in a new entitlement program, it is not just a 1-year cost, it is a cost that adds up in 5, and 10 years, and into the future.

When we sat down on the 1990 budget agreement, the sense was we were going to take some tough steps on discretionary spending.

We were going to put caps on discretionary spending and we were going to put them in place over 5 years.

But discretionary spending alone would not solve the problem. You had to deal with entitlements and you had to deal with the whole issue of, how do you protect against significant revenue loss if you just implement broad tax cuts.

So, both had to be part of the pay-go discipline, and that basically said to members, if you have an idea for a brand-new scheme on entitlement spending, then tell us how you are going to pay for it. Where are you going to cut spending, where are you going to raise taxes, to pay for it? The same thing was true with cutting taxes.

If you are going to cut taxes, where are you going to cut spending, or where are you going to raise other revenues in order to ensure that it is deficit-neutral for the future? That was the whole theory, and it worked.

Senator BAUCUS. Do you think we should have those same pay-go rules, Senator?

Mr. GRAMM. Let me say, I think Leon and I were both out at Andrews Air Force Base when we negotiated this, and the negotiation came when they cut off the food and the water. [Laughter.]

I think pay-go restraint is important. I think, in some form, we have to use it. But I would say this about it. Especially in a period where we had a surplus, we waived it over, and over, and over again on spending. I think it is very clear that pay-go restrictions work much better in controlling tax cuts than they do spending increases. I think that is something that we have got to be concerned about.

Senator BAUCUS. Well, Senators can always, by 60 votes, waive. My main question is, should the rules be there, that is, pay-go?

Mr. GRAMM. Well, I think in some form the rules should be there. They are going to expire in April.

Senator BAUCUS. In April, I think.

Mr. GRAMM. I think they should be part of our new budget. I think, under the current circumstances with uncertainty, that we ought to do a stimulus package before then. I think we ought to reinstitute those restrictions in the budget.

So, I am for pay-go. But I would say that it did bother me, especially in those 3 years where we had surpluses. As far as I am aware, we have never waived pay-go on a tax cut, but we have waived it over and over again on entitlement spending.

Senator BAUCUS. Let me ask this question. I know you anticipated this because it was in the news yesterday, as well as today. But let me just read the lead on CNN "Money Line," I guess. "Federal Reserve Chairman Alan Greenspan dealt a blow Tuesday to President Bush's hopes for massive tax cuts by stressing the need for budget discipline and saying economic stimulus efforts should be put on hold until uncertainties about Iraq dissipate."

It sounds like a pretty reasonable statement to me. What do you think, Mr. Panetta?

Mr. PANETTA. I think Chairman Greenspan has done a service to the country by suggesting that because, very frankly, as I said, I think right now, even if you passed a new investment bill tomor-

row, I think people would still be very hesitant to do anything until they know how the war is going to be resolved.

I think once the war is resolved, and obviously we are hopeful that it is resolved in the right way, if that is the case, I think it would provide this committee and the Congress the opportunity to look at a broad scope of tax reform that needs to be considered. Not just pieces of a stimulus, but broad tax reform.

On the dividend issue, very frankly, I think dividends ought to be looked at. But they ought to be looked at as part of a reform on the corporate side, looking at areas such as tax shelters, looking at tax avoidance, looking at other pieces that need to be considered as part of overall corporate tax reform. That is being responsible, not just dealing with one piece and letting others be ignored.

Senator BAUCUS. You also said that the dividend proposal should be paid for, either by cutting spending or by raising taxes.

Mr. PANETTA. Of course. With all due respect to Senator Gramm, you cannot let the horse out of the barn and then shut the door. If you are suddenly going to let a huge tax cut bill go out there and be added to the deficit, then say, oh, in the future we will then pay for it, you have missed the whole purpose of the pay-go discipline. It is supposed to apply to everything.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

Our order would be: Senator Nickles. Senator Thomas is the next Republican that was here, then Senator Rockefeller would be the next Democrat. Then let us go from there.

Senator Thomas.

Senator THOMAS. Thank you both for being here. It is great information. It is sort of interesting that people who are experts in economics, there is no agreement among them. It is kind of confusing that you hear two experts have approached the same problem and have quite a different notion.

Senator Gramm, you have, I think, always indicated that the government as relatively ineffectual in terms of the economy. It is a private sector kind of a thing.

Does your position now change that?

Mr. GRAMM. Well, let me say this. I think that the economy overcomes not only the disease, but the absurd prescription of the doctor. I think the economy is going to recover. I think people who invest in the long-term future of America are going to be successful investors.

I think that, clearly, there are periods of time—and I personally believe this is one of them because this recession is different than what we have experienced.

If this were an inventory cycle, I could never have predicted when it was going to happen, but I and other economists could tell you a lot about how it was going to behave once it started.

The problem here, is there is some uncertainty. If we were talking about a great, big fiscal package, if we were talking about 10 percent of current services spending, or 20 percent, I would agree with Leon and with Senator Baucus.

But we are talking about a very modest proposal. We are talking about a long-term and a short-term policy on double taxation of dividends, which should be done because it is good economic policy.

Simply moving the rates forward does not change the long-term deficit.

It is exactly the kind of fiscal policy, it seems to me, that both political parties should agree on. I hope, when people talk about rich folks and poor folks, and all that business, that they will remember the figures that the Chairman and the Ranking Member put out, that 80 percent of the tax relief in the highest bracket goes to proprietorships, partnerships, subchapter S corporations, small business. That is the effective business rate.

I would also say that the thing that concerns me about the deficit talk, is that we have got so many people who are alarmed about a stimulus package at $390 billion, and say it needs to be reduced, but the increase in spending during the same period of $427 billion that the President has proposed is deemed totally inadequate.

Now, I think you can use the deficit, but you cannot have it both ways. You have got to either be pure on it, or you have got to leave it alone. I think that is the problem with a lot of these proposals that say, for God's sake, do not provide incentive for investment, but, oh, by the way, let us spend more money.

Senator THOMAS. That is certainly right. In our supplemental, I think there were amendments for $500 billion additional spending in the course of that.

Leon, you talk about fiscal discipline, and all of us agree with that, I think, and do no harm. Do you think there is a need for some kind of a short-term impact to kick the economy some? If so, what do you suggest?

Mr. PANETTA. I have always been hesitant to say that you can develop a quick-fix stimulus to the economy in the Congress. I felt that way in the past, and I feel that way in the present in the sense that, by the time you pass these bills out and by the time they take effect, I think the reality is that the economy is starting to move in the right direction to begin with. So, you have to be a little bit careful.

Now, that is not to say that you ought not to consider whether or not you ought to take steps to do that. But if you do, it seems to me that, again, I would be very concerned that the size of that package is such that it does not contribute to these huge out-year deficits, that then would work against, it seems to me, any stimulus that you might provide in the short term.

Senator THOMAS. It seems that you are suggesting, and I understand what you are saying, that for the Feds to have to supplement the State budgets, now, could be a big contributor to that deficit. Are they not in charge of their own activities, and their own taxes, and their own spending?

Mr. PANETTA. Well, let me say what I think is the problem now. Senator Gramm says that on the one side there is concern about not spending enough, on the other side there is concern about the deficit. That works both ways.

You cannot increase and provide significant amounts for defense and for homeland security and then provide a huge tax cut in addition to all of that, and then say we are going to shut down everything else government does in order to pay for it.

The reality is, if you are going to approach these issues, you have got to approach them with some degree of fairness and balance in

which you have got to look at everything on the table if you are really serious about fiscal discipline.

In the 1980's, as you will recall, Republicans basically said we ought not to, obviously, raise taxes, we ought not to cut defense. Democrats basically said we ought not to cut entitlement programs and we ought not to cut discretionary spending. Well, if you do not deal with any of that you are not going to reduce the deficit.

The only way we got it, is when we put Democrats and Republicans in the same room and everybody gave a little bit in order to achieve deficit reduction. That is the only way you are going to do it.

Senator THOMAS. Thank you.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Good morning. Welcome back, Senator Gramm.

It occurs to me that one of the things that is beginning, as we are talking, now they have stopped a bus on the Whitestone Bridge in New York, or a truck that looks suspicious, maybe that is something, maybe that is not, but I think that we are not just talking about fairness here, we are talking about common sense, looking at the next 5, 10, 15, 20 years.

My own view is that the level of poverty in this world, and the hopelessness that accompanies that, the desperation, and the examples now that have been provided by those who are groups that carry out acts of terrorism, which to people who have nothing else in life to look forward to, at least they become something, that there is going to be an enormous increase. It is going to be part of our way of life for years to come.

People got all excited about the Osama bin Laden tape. But I also noticed that the threat alert that we increased the standing of really had nothing to do with Iraq, which is what everybody is talking about, in my judgment, at least.

It had much more to do with the nature of Al-Quaeda, which has its own timetable regardless of anything else. They plan, they decide when they are going to do something, and they do it soft, they do it hard, whatever. But they do it on their terms.

They are on six of the seven continents in the world. They are throughout America. Their only business is that of hurting, destroying, killing Americans or American infrastructure.

Now, why do I say that? I say that in terms of budget consequence. In the stimulus package, there is nothing for homeland security. The wildest worry that some of us have, is that we are mouthing the words of concern about our future and damage to infrastructure in our country, and yet we are not either psychologically prepared, or in reality or in terms of policy, prepared to face up to the consequences of that.

So my question to both of you is, just taking that factor alone, the probability, at least in my judgment, of the next 20 or 30 years of dealing with Al Queda. Now Hamass has changed from basically going after Israelis to coming after us, too. That list is going to continue to grow.

I remember, the Wall Street Journal three or four weeks ago, had a chart above the fold in the front page which showed, I think,

a less than 1 percent effect of the stimulus package, substantially less than 1 percent.

How can we afford to let these other things go by the wayside? On the one hand, you are talking about how much money people have in their pockets. On the other hand, you are talking about whether people have any pockets to have money in. Are they alive, et cetera? I do not mean to put it that grimly, but it is very much on my mind and I would appreciate your comments.

Mr. GRAMM. Well, let me first say that I think everybody is concerned about terrorism. My own view is, between the funding that we have provided in the last two years for our terrorist effort, the establishing of a new Department of Homeland Security, and the diversion of defense spending to the terrorist activity, at least right now, we probably have put as many resources into it as we can effectively absorb and use today. Now, that is not true for the future.

I would also have to say that I am deeply concerned about our ability to protect ourselves, given the openness of our society in something that we do not want to change. Over the long term, I think, obviously, we are going to have to find ways to do it better.

In terms of what drives people to be terrorists, I think basically it is people that do not find any meaning in their lives, so they are trying to find meaning in some cause.

It is like this book by Eric Hoffer in the 1950's that concluded that the extremists to the right and the extremists to the left are the same guy who just happened to stumble into a different meeting. And I believe that. But, in any case, I think a strong American economy, open trade, the development of prosperity worldwide, is, I think, a good return to that. Let me stop. If you could give Leon a little time, I would appreciate it.

Mr. PANETTA. Senator, I have always believed deeply that budgets are not about numbers, budgets are about priorities in this country. I have always had a great deal of confidence in the ability of both Republicans and Democrats to try to work together to try to determine what the priorities of this country ought to be.

So, as to homeland security, or our present defense situation, or whether we should put more in smallpox vaccinations, or whether we should put more into trying to deal with a weak economy, those are priorities that all of you are going to have to work through.

The most important thing that I would say to you, is as you develop those priorities, for goodness sakes, also take the time to think about the future and the burden that we are going to put on future generations by what you do today.

Just keep that in mind so that, whatever steps you take, they are at least part and parcel of a plan to try to discipline the budget for the future. You are going to have to spend up front. I know that. Everyone understands that.

But for goodness sakes, at least do it in the context of a 5-year plan, or a 6-year plan that gets you back to some kind of reasonable balance. If you do not, those problems in the future are basically going to destroy whatever good you do in the present.

The CHAIRMAN. Senator Santorum.

Senator SANTORUM. I am going to yield my few minutes for Senator Kyl, then go after him, if that is all right.

The CHAIRMAN. As long as no Democrat comes in.

Senator SANTORUM. So let us just pray for that. [Laughter.]

Senator KYL. Thank you. Mr. Chairman, I have an appointment at 11:00 that I have to be on time for, so I very much appreciate Senator Santorum yielding time.

Let me just say, first, that I very much appreciate both of you being here. It is a real treat. It is always a treat to hear our colleague Senator Gramm. And Representative Panetta, we have not heard you for a while, so welcome back.

Now, you have got a lot of credibility, I must say, even on this side of the aisle, because you have always been consistent. Not all politicians are always consistent. You have always urged fiscal restraint. So, I am going to ask you to be consistent for a minute. You have called for leadership, sacrifice. You have urged us not to dig the deficit hole any deeper.

We have got some hard decisions to make this coming year for fiscal 2004, between the tax relief that has been proposed and the budget that we are going to have to set. So, we have both spending and tax decisions to weigh there.

But regarding the fiscal 2003 budget and appropriations, which we are hopefully about to vote on now, leftover business from last year, we did not have any tax cuts in 2003. There was an agreed upon appropriations number of $751 billion in discretionary spending, roughly, and that was an increase, obviously, from the year before.

Would you agree that it was not responsible to attempt to add over $500 billion in additional spending above that $751 billion level?

Mr. PANETTA. I think it relates to the failure, very frankly, not to establish caps on discretionary spending that were enforceable. If you do not put caps on discretionary spending that are supported by a majority vote on both the House and Senate side, then you are going to have those kinds of increases take place.

So I guess I would take you back. The problem you had, I do not think you passed a budget last year.

Senator KYL. No, we did not. You are right, that is part of the problem.

Mr. PANETTA. I think that is part of the problem.

Senator KYL. Sure. But my question is not what it goes back to, but whether you would agree that, even increasing the discretionary spending to $751 billion, that it was an act of irresponsibility to vote for an additional $500 billion in spending above that.

Mr. PANETTA. Well, I can identify a lot of elements of irresponsibility on both sides of the aisle.

Senator KYL. Your credibility is based on your consistency, and I am trying to help you be consistent. I would really like to have you answer that. I mean, that was irresponsible, was it not?

Mr. PANETTA. Look, at a time when everyone is trying to operate as if there is a surplus, and therefore spend that surplus, the reality is, both sides went after that surplus and, instead of having one, it is gone now.

Senator KYL. All right. I understand. You are not going to answer that political question.

Let me ask Senator Gramm this. It seems to me that there is an error in thinking here, and Leon sort of got to this just now, that we have got to equate spending and tax cuts.

There is sort of an equation there that Democrats need to get their spending, Republicans need to get their tax cuts, they have to be equal if we are talking about the impact on the deficit. I want to go right to the core of that.

If, in the hierarchy of values, the highest value is economic growth, for all of the things that it brings to American families, to people, to the health of our economy, to the revenues of the Treasury and its impact on the deficit, incidentally, if that is our highest value, then should we not evaluate the effect of spending and tax relief on economic growth?

Is it not your message that you can impact economic growth positively with thoughtful tax policy which stimulates investment? Therefore, would you not agree that equating spending in an amount, and tax relief in an amount, is the wrong policy?

You ought to see which one works the best to promote economic growth, which not only therefore helps you reduce the deficit, but stimulate the economy for all the reasons that we have talked about.

Mr. GRAMM. Well, let me answer a couple of things. First of all, spending has been out of control in this Congress for the last 3 years and it is still out of control. The point I was trying to draw earlier, is that I understand consistency and I understand focus on deficit.

What I do not understand, is people who jump up and scream and holler and say that the stimulus package, which in static revenue terms costs $390 billion, is too much, and then in the same breath they jump up and scream and holler and say, by the way, the increase in spending the President has proposed during the same period of $427 billion is too little. You cannot have it both ways.

Second, when we are talking about something like dual taxation on dividends, it is so corrosive to economic growth, it is so inefficient, it is so unfair to use a term that is often used to tax the same income twice, that this is a policy that ought to be fixed.

Third, when we have got economic uncertainty—and I am afraid that our terrorist problems only exacerbate that. I agree with Leon, the sooner this war is over the better, economically, in clearing the air as to where we are. But I think, when we have got this kind of uncertainty, that the kind of targeted, modest measures that the President is talking about, especially the dual taxation on dividends and accelerating rate cuts that are going to occur anyway, that that is something we ought to do. I think it represents a good policy.

I also think the idea of saying that $500 billion of spending, as compared to lowering tax rates on small business and eliminating a massive inefficiency and unfairness in the Tax Code are equal, especially when you look at the growth of spending over the last 3 years, I think it just makes no sense at all.

Senator KYL. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Santorum.

Are you going to be able to stay for maybe 10 minutes, Mr. Panetta, while the other two people ask questions?

Mr. PANETTA. I can stay for just about 10, but I have got to make an appointment.

The CHAIRMAN. All right.

Senator Santorum.

Senator SANTORUM. Thank you, Mr. Chairman.

I have had the honor of serving with both of these gentlemen with them being my chairman. I was a new member of the House when Chairman Panetta was the Chairman of the Budget Committee, and I served with Chairman Gramm as the head of the Banking Committee. So, it is great to be with both of you again.

I just want to follow up. One thing has not been talked about, and I just want to make sure that this fits in to Leon's box of deficits, and that is prescription drugs and adding to Medicare.

You mentioned entitlements. Senator Gramm has mentioned $400 billion in new spending on discretionary programs, talked about $400 billion in tax relief. There is another $400 billion looming out there on the issue of Medicare, and I do not hear anyone talking about paying for that.

What is your feeling on that?

Mr. PANETTA. If you are going to reinstate pay-go, then that ought to be covered by pay-go as well.

Senator SANTORUM. Any suggestions on how that might be done? I mean, that is a pretty big nut to add to Medicare. How do we do it?

Mr. PANETTA. It is. But I recall something that I think was a disaster in the Congress when we adopted, during the Reagan years, something called catastrophic health care. Catastrophic health care was paid for. It was paid for by premium increases, by ensuring that people at the upper income level would contribute to it.

Then, because of the outrage that suddenly flew back to the Congress, we eliminated catastrophic health care. If we had kept catastrophic health care in place, we would have prescription drugs today.

Mr. GRAMM. Let me respond to that by saying, I am proud to say I voted against catastrophic health care.

Senator SANTORUM. So did I.

Mr. GRAMM. But Leon is absolutely right. What the catastrophic health care proved, is that people love entitlements when they think somebody else is paying for them and they hate them when they have to pay for them.

What can we do about Medicare? I think there are some things we can do. I think if we are going to add a prescription drug, we need to reform the Medicare program itself. We need to bring efficiency and competition in to Medicare to help hold down costs.

You are more familiar than almost any member of the Senate about how inefficient the current system is, about how we pay nonmarket prices because of the structure of Medicare. I think if we are going to add a prescription drug benefit, we need to reform the whole system as part of it. I think, in adding that benefit, that we need to focus it on people that are the most needy.

I am worried that it is going to be added in such a way that we are going to crowd out private health insurance that our better-off

retirees already have, and we are going to be substituting tax dollars for benefits they have already earned and their company has already paid for.

So I think it is a very, very real concern. But, again, it is almost as if, when we talk about these kind of programs, that it is two completely different worlds. There is an thought process and a system that should be in place when it is that we trying to make the economy work stronger and eliminate inefficiencies to the Tax Code. But, when it comes to spending, none of these restraints apply.

I think you are going to see a demand that we keep Medicare exactly as it is, that we provide prescription drugs directly through the government. I can assure you, if we do that, that by 2006 we will be rationing health care in America and we will be cutting other parts of the system to pay for these pharmaceuticals.

If we just simply add that benefit and we do not reform the system, we will not be able to pay it. No country in the world provides pharmaceuticals that way and does not ration health care. We will end up doing it, too.

Senator SANTORUM. Leon, do you agree that we need to do some reform of Medicare, or find some savings? How else would you suggest that we offset the cost of providing this new benefit? I think everybody agrees we need to do this. So the question is, how do we do it in a responsible way?

Mr. PANETTA. Well, Senator, you have provided some leadership on this. I think you know that this baby boom thing is just a huge disaster out there in terms of unfunded liabilities.

It really does mean that you have got to reform Social Security and you have got to reform Medicare, and you have got to deal with both. The longer you delay on both of those, the more trouble you are going to run into in terms of this exploding liability that is out there.

So, yes, you have got to deal with both of them. I do not have any magic answers, but I think, clearly, the Congress has a responsibility to deal with those.

Senator SANTORUM. Well, I appreciate your answers. I think, just as a new member of this committee, I want to say that I think both of them have added insight. I am hopeful that we just do not follow the sheep on this one and just say, well, we have got $400 billion in the budget and we are going to spend it all, and maybe we will spend even more than that, and we will push to spend even more than that.

When you look at the long-term problem of Medicare and the liabilities that are out there, and the baby boom generation, the complexity of that, and Social Security on top of that, and the problems, the idea that we are just going to go willy-nilly and throw another benefit onto Medicare and not really care about the financial impact long term—and I have got the second-oldest State per capita in the country in Pennsylvania, only Florida is older than my State, so I know the importance of this issue.

But I also know the importance of having this benefit there for the long term. If we continue down this path—I think the two gentlemen here have laid it out very clearly—we are not doing a service to this country.

The CHAIRMAN. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Just to refresh the committee's memory a little bit, it seems to me that every time we went to war, or were at war, that we had deficit spending. It was just a matter of how much.

So if we are at war with terrorists and we are possibly going to war with Iraq, we will face larger deficits because of our spending on defense, because of our homeland security, and things like that. So, I just wanted to put that in the thought process.

I would like to talk about something that Senator Baucus talked about. I was at the Banking Committee hearing yesterday where Chairman Greenspan spoke. The quotes that you have read, he may have said them to someone else and I may have missed them, but whoever was the questioner, he said exactly what they wanted to hear as an answer.

Even my good friend, Phil Gramm, would have disagreed heartily yesterday with Alan Greenspan and his assessment of the tax stimulus package, and whether it was stimulus or whether it wasn't.

To me, he said it was stimulus. As soon as Senator Bayh or someone else asked the question he said, well, it could be, but long term, and he went on as only Alan Greenspan can do.

My question to you is, if we are going to have a country in 2010 or 2020 and we are weighing the differences about spending now or defending our Nation, I think it is worth going into deficit to do that.

I would like your opinion.

Mr. GRAMM. If I could respond, Senator Bunning. I have always believed in a strong defense. I am proud that I served on the Armed Services Committee. I have always felt, even in a world where the lion and the lamb were about to lie down together, that we need to be the lion.

But I would say this, that I do believe that we have not done a good enough job in going back and looking at expenditures that carried over from the Cold War and that are there because they have always been there, and the military has defended its own turf and prerogative.

I think, when this war is over in Iraq, as we build our long-term structure because a war with terrorism—I hope I am wrong, but I am afraid—will be a long-term struggle.

As we look at the new and emerging needs, we have got to force ourselves to go back and look at these old programs that made sense in the Cold War, but that do not make sense now. I think that kind of setting priorities is very hard to do. It is hard to do in health care, it is hard to do in defense.

But I think the kind of growth we have got in defense today is unsustainable. When people talk about crowding out—look, I take a back seat to nobody in concern about the deficit—there are two areas where crowding out is going to ultimately hurt us and it is going to happen sooner than 2010. One, is defense, if we do not start reordering priorities.

The other is Medicare and Medicaid, as prescription drug benefit is low-balled in terms of costs, as we get into competitive bidding about who is willing to give the most, and then, as we get into

higher utilization, as people do that as part of buying pharmaceuticals.

So, yes, we need to defend the countries, and deficits if we need it to do it. But we have got to start looking back at defense spending that no longer meets an imminent threat.

Senator BUNNING. I agree with you. I think that the Secretary of Defense agrees with you 100 percent.

Mr. PANETTA. I would reaffirm what Senator Gramm said, and I commend him for saying it. It is not easy to do. But any time you blank-check any area of the budget, there are real dangers associated with that.

People kind of take for granted that they can basically spend it on whatever they want, and it does demand that you have to look carefully at how defense monies are being spent and how they are targeted for the future.

But to go back to the basic point, yes, clearly, you run deficits when you have wars. That has been the history in the past. But what is not history of the past, is the fact that at the same time that you have war and deficits, you provide a huge tax cut.

That is a concern, because then you are not only having a deficit based on the security needs of the country, but you are adding a huge tax cut which is going to create that much more of a deficit in terms of the future. That is what I am asking you be careful of.

Senator BUNNING. I understand that. But there are some of us who feel that if we do not do something, the economy will sputter and stop. Then we will not be able to produce the goods and services that are necessary to defend this country. We will be more in debt than we are. That is something I am very concerned about.

Thank you, Mr. Chairman.

The CHAIRMAN. Thanks to each of our panelists for your kind cooperation in being with us and giving us very important information.

Senator BAUCUS. And I want to second that. Both of you, very much, thank you for taking the time. We appreciate it very much.

The CHAIRMAN. Thank you.

Now, would Dr. Gale and Dr. Hassett come to the table, please? I have already introduced Dr. Hassett and Dr. Gale, so we will start with Dr. Hassett, then go to Dr. Gale.

STATEMENT OF KEVIN A. HASSETT, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. HASSETT. Thank you very much, Mr. Chairman. I would like to thank you, Mr. Chairman and Mr. Baucus, for inviting me here today. I feel a little bit like the warm-up band that has to play after the Beatles, coming after such distinguished panelists.

My remarks will be brief. I have given you my written testimony, and will attempt to summarize it in a quick fashion so that we can move on to questions.

I, Mr. Chairman, am an economist at the American Enterprise Institute. I have spent most of my career studying the effects of taxation on investment. I have written a book with that title.

Prior to being at the American Enterprise Institute, I was the person in charge of forecasting investment for the Federal Reserve Green Book Forecast for a number of years.

I focused my remarks, as you know, on the impact of the President's proposal and alternatives on investment, and I have tried to put all of the pluses and minuses that I could think of out on the table.

I would have to say, as a person who has been studying this for many years, that I find the President's dividend tax proposal to be one of the best proposals of any form in tax policy that I have ever seen. I think that the double taxation of dividends has a significant negative effect. My testimony outlines those.

Very briefly, when you double tax dividends, first of all, as Mr. Gramm mentioned, you make it harder for firms to raise money and invest in new projects, raising the costs of buying new machines and decreasing capital formation and job creation, and so on.

These effects are quite large. By my estimation—I have got this in my testimony—Chairman Hubbard's estimate that the President's plan would reduce the cost of capital for firms by 4 to 7 percent is probably conservative. It could be as much as 10 percent quite easily, which means that the current system really does harm investment, and that is not good.

The second, is that by having a double tax on dividends and having interest deductible at the same time, we have got a very strong incentive in our Tax Code for firms to be more leveraged. Mr. Gramm alluded to this as well.

But I think it is important to note, first of all, that the statistical relationship between taxes and debt equity ratios is very solid. There is a very large literature that now shows decisively that debt/equity ratios increased because of this weird feature of our Tax Code. We also have a very large literature that shows us that, when debt/equity ratios are higher, that bankruptcies are higher. When firms go bankrupt, people lose their jobs, and so on.

So by having this uneven playing field between equity and debt finance, what we are basically doing is subsidizing American firms to become riskier and to subsidize an increased bankruptcy rate, basically, subsidizing increased job loss.

The next thing that the double tax on dividends does, is it encourages firms not to pay dividends, of course, because whenever you tax something a lot, then people try to do something to avoid the tax.

This is another area where there is strong evidence that the Tax Code has an effect on behavior. Because the tax on dividends is so high and firms retain earnings, it adds a big problem to financial markets, which is that, instead of mailing checks to shareholders, which is an endeavor that makes the cash flows of firms pretty easy to verify, firms are piling cash up inside the firm because they are trying to not pay too much tax, and therefore we have to really monitor them carefully and trust that management always has shareholders' interests as heart.

I do not think that it is even debatable that this very strong, large distortion in the Tax Code contributed significantly to the type of accounting crisis and loss of faith in markets that we saw in recent years.

In order to get a feel for how strong this effect is, just look at the relative performance of firms that pay dividends compared to

firms that did not. Firms that paid dividends, especially healthy dividends, did not decline in price nearly as much as everybody else.

So, because of these theoretical effects, Mr. Chairman, that double tax on dividends makes investment go down, makes debt/equity ratios go up, and increases what economists call agency problems, then it is not really subject to significant debate that the double tax on dividends is bad.

I would note that, while philosopher Bentham said that appeal to authority is the lowest form of argument, that Mr. Greenspan, yesterday, even said that he supports a repeal of the double dividend before he qualified it with the other things that we were talking about.

Indeed, just about every country, every trading partner that we have, has a significant integration of the Code that is analogous to what the President is proposing.

Indeed, if you look at the international data, Mr. Chairman, you would be startled to find that the United States has the second-highest composite tax on dividends amongst our trading partners.

Our tax on dividends is higher than everybody, except for Japan. Needless to say, we do not want to try to repeat the Japanese experience. The difference in tax rates is significant.

In order to provide an after-tax return to a U.S. shareholder that is the same as that provided by, say, a Norwegian firm, then a U.S. firm has to be twice as profitable.

Now, that is the kind of uphill battle that our Tax Code is creating for our firms that I think is not advisable. I think we need to catch up with the rest of the world that has already recognized what Chairman Greenspan acknowledged yesterday, that double taxing dividends is silly.

I would encourage you, Chairman Grassley, to support strongly the President's proposal. Thank you.

The CHAIRMAN. Thank you, Dr. Hassett.

[The prepared statement of Dr. Hassett appears in the appendix.]

The CHAIRMAN. Now, Dr. Gale.

STATEMENT OF WILLIAM G. GALE, DEPUTY DIRECTOR AND SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. GALE. Thank you, Mr. Chairman and Mr. Bunning, for inviting me to testify. It is an honor to appear before this committee. I will make five broad points in my testimony.

The first, is that in considering policies to spur the economy, it is important to distinguish the short term and the long term. In the short term, the problem we have right now is that capacity utilization is low. That is, businesses have a lot of equipment, structures, and other capital that they are not using.

The way to get them to use it, is to boost aggregate demand to encourage them to use and produce their existing capacity.

It is hard to see why any business would build more capacity when they are already not using a substantial amount of the stuff that they actually have.

In the long term, economic growth depends on the extent to which productive capacity, broadly defined to include physical cap-

ital, human capital, economic institutions, et cetera, expands. The best way to do that in the long term is to raise national saving on a permanent and sustained basis.

The second point has to do with the effect of tax cuts on economic growth. Tax cuts have two effects and they tend to work in opposite directions. One effect is the one we always hear about, which is that they encourage incentives to work, save, invest, take risks, et cetera. The other, is that they reduce the government revenues, and as a result they increase the budget deficit.

The issue with the budget deficit is not so much its effect on interest rates, although we can have a discussion about that if you want. The issue with budget deficits is that it reduces national saving.

Permanent budget deficits eat into the amount of capital available for investment, they reduce national saving, and therefore they reduce the future national income of American households. Just like if a household saves less it has less income in the future, if a country saves less it has less income in coming years.

The third point has to do with the 2001 tax cut. The tax cut was poorly designed to increase economic growth. According to estimates from the Treasury Department, 64 percent of income taxpayers will get no cut in marginal tax rates from the 2001 Act.

That is because of the 15 percent bracket and because of the AMT. But that means they get no marginal incentive to increase their work, their labor supply, their risk-taking, et cetera.

At the same time, the tax cut and the debt service will reduce revenues by $1.7 trillion. The estimates of how deficits affect interest rates that were published in this week's economic report of the President, if you use those estimates, it shows that the 2001 tax cuts will raise the cost of capital for small business investors.

That is because the tax rate reductions are not very big, even relative to the very modest interest rate increases that the ERP estimates would occur.

A variety of other researchers have basically found that the positive effect of the 2001 tax cut on labor supply, saving, investment, et cetera is either completely offset, or more than offset in the long run by the reduced budget surplus, which reduces national saving and reduces future national income.

So of the studies that are out there typically show that the 2001 tax cut is a wash in the long run at best, or that it reduces economic growth in the long term because of the budget deficit effect.

Now, even if it is a wash, that does not mean that it is neutral, because, remember, it has created $1.7 trillion more of debt that we pass along to the next generation. So being a wash is not good enough because of this added debt burden.

Because the 2001 tax cut is so poorly designed to stimulate economic growth, accelerating the cut is a bad idea, and making it permanent is a bad idea.

My fourth point has to do with the President's dividend capital gains tax proposal. Let me say at the outset that I think almost all economists agree that integrating the corporate and personal taxes would be a good idea.

There are questions about how you design that proposal, and the administration's proposal is both complicated and does not resolve corporate sheltering issues.

But there are also questions about the fact that you could integrate the tax system without providing a big tax cut for high-income taxpayers. In fact, the plan designed by Glen Hubbard at Treasury in 1992 did that.

I am not advocating that particular plan, I am trying to separate the notion that we should integrate the taxes, which most economists, including myself, favor, from the notion that we should have a big, regressive tax cut.

You can separate those two notions. What the administration has done, is try to talk the tax reform language at the same time that it pushes through a regressive tax cut. That is what people object to.

The last point has to do with small businesses. The acceleration of the tax cut may well reduce investment by small businesses, because a small business that invests now would be able to take depreciation deductions at a higher rate than it would if the tax cut were accelerated. That would increase the cost of capital for the investment.

Also, the dividend proposal will shift funds to the corporate sector and away from the unincorporated sector, and that will also impose a negative impact on the unincorporated sector, and even S corporations and the like.

So, in closing, I think there are a lot of key issues here regarding tax cuts and economic growth. I do not think the path that the administration is proposing is the best in the short run or the long run, and I would be happy to answer any questions that you have.

[The prepared statement of Dr. Gale appears in the appendix.]

The CHAIRMAN. Thank you both very much for your testimony. I will take a five-minute round, then Senator Bunning wants questions. Then we also have a hearing this morning yet on some nominees, so maybe the questions will not be so long as they normally would be.

I think, first of all, I am going to take advantage of a point you made, Dr. Gale, and something that I think Mr. Hassett has an opposite point of view on, to challenge you on something that obviously might be a disagreement between you and Chairman Greenspan.

At least, I am sure that Chairman Greenspan is aware of the existing capital that is unused that you spoke about. Yet, Chairman Greenspan recently testified that household spending has been, in his words, "reasonably vigorous, while business investment has been sub-par."

Then I would quote Commerce Department data that is showing that consumption has risen throughout recession and the short recovery now, whereas, investment fell 15 percent between 2000 and 2001, and it remains below pre-recession levels.

Would you like to comment on where you might seemingly disagree with Chairman Greenspan? As I said, I think he would say what he says, understanding that existing capacity is unused. Then maybe Dr. Hassett can respond, because I know you have written on this subject.

Dr. Gale.

Dr. GALE. Thanks. I do not think there is any disagreement between Mr. Greenspan and me on this particular issue. I agree completely that business investment has fallen. There is no question about that. I agree completely that consumption remains strong. Those are well-documented facts.

The question is, what do you do about it? We had a tax cut in 2001. We had a stimulus package in 2002 specifically designed to boost investment. We have got low inflation, we have got low interest rates. The cost of capital is low for all of those reasons.

Yet, investment is not recovering. The reason why, I think, it is not that hard to understand. It is, why should a company buy all these new things when they are not even using the stuff that they have? So, I do not disagree with the facts at all.

I do not think I disagree with Greenspan's conclusions at all. But the fact that business investment is what fell does not mean that tax incentives for business investments are going to be successful in boosting investment.

The CHAIRMAN. Dr. Hassett.

Dr. HASSETT. Thank you, Mr. Chairman. This is one area that has been studied quite a bit. In fact, I did a lot of work on this while at the Federal Reserve. The fact is, capacity utilization, which is low right now, does not improve the performance of the type of investment models that we use that map tax policy to what happens.

It is wrong to say that the typical effects that you see in the literature, which are the effects that I based my favorable testimony on, go away somehow if capacity utilization is low.

First of all, most studies incorporate measures of the capital stock and of output in their estimating equations, so they are implicitly accounting for capacity. So if you add capacity after that, it is not surprising that it does not have much of an effect.

But, second, if you look at the history of investment and tax policy, you find a pretty startling thing, which is that you tend to get really big investment responses precisely when capacity utilization is low.

In fact, I do not know about my good friend, Dr. Gale, but I always am very careful to read The Brookings papers when they come out. There is a paper by Ricardo Caballero, a former colleague of mine at Columbia, and some co-authors, that identified years where there were big investment responses to tax policy and years where there was small investment responses to tax policy. He found that the big investment response years were years when there was low capacity utilization.

He argued that what happens is—and this is what we have just seen—that firms put off their capital spending plans, because perhaps they are nervous about Iraq, or because they do not know what oil prices are going to be, or for whatever reason.

But, ultimately, as happens if you do not buy a new car, the thing wears out and you have got to get a new one, and then you get a big burst of activity. Right now, we have seen investment basically not happen for two years, although it did actually increase in the fourth quarter, which is a somewhat favorable sign.

So, I think we are pretty much about where we have been in the past when we have started to see a big investment response to tax policy. Thanks.

Dr. GALE. Could I just follow up on that?

The CHAIRMAN. Yes, please.

Dr. GALE. The 2002 stimulus package, remember, provides partial expensing for 30 percent of investment. If people are waiting for the uncertainty with Iraq to be resolved before they respond to investment, then they will respond to that 2002 stimulus when the war with Iraq is taken care of. It is not evident that we need additional stimulus, though.

The CHAIRMAN. All right.

Dr. Gale, my last question to you would be another follow-on of Chairman Greenspan. He seems to be a crutch we use when we agree with him, I guess. He recently testified that lower taxes have been one of the factors that has helped support the economy over this past year.

Now, in your testimony I think you claimed that higher taxes would bolster economic growth. Now, my question comes from kind of a rhetorical question I would ask probably during a political speech. You always hear that we should not lower taxes.

Some people say you raise taxes. I always like to have somebody in Washington, DC tell me how high taxes ought to be when they would be satisfied. How would you have to raise taxes to satisfy certain people?

I am not saying you are extreme in that, but I think that is what I read you to say, not in the extreme, but just generally that taxes would be higher and you would have optimal economic growth.

Dr. GALE. Again, there is an issue between the short run and the long run. I do not claim to read Alan Greenspan's mind. I do read his testimony, but I am as befuddled by some of the statements as everyone else is.

But my understanding of the economic situation is that a tax increase in the current year would not be a good idea. Right now, what we need—to the extent that we need anything—is a boost in aggregate demand, and for the same reason the deficit this year is not a big deal.

If it were followed by surpluses as far as the eye can see, we would not care that we had a $300 billion deficit. It is the deficits down the road that make a difference. So, in the short term, I would not advocate tax increases at all. I think that would be a very bad idea with a slack economy.

In the long term, one way or another, we need to get our fiscal house in order to boost national saving and encourage economic growth.

Now, that does not mean punitive tax rates. There are lots of ways to raise revenue without imposing much higher tax rates. You could broaden the base, for example, which I think is another thing that most economists favor.

But I do not think there is a contradiction between saying in the short run we have a demand problem, and in the long run we have a supply problem.

The CHAIRMAN. All right.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Mr. Hassett, you mention briefly in your written testimony that many countries have already enacted similar policies that were proposed by President Bush with regards to capital income taxes.

I would like for you to elaborate on that a bit for us. What type of tax structures do many of our international competitors now employ? Could you cmoment on how these differ, and tax systems affect our international competitiveness?

Dr. HASSETT. Yes. Thank you very much, Senator Bunning, for the question. In fact, I brought an article written by my colleague at The Cato Institute, Mr. Chris Edwards, on this exact topic which I will hand you after the answer. It is a very interesting question.

Senator BUNNING. Thank you.

Dr. HASSETT. The fact is, there are many different ways to eliminate double taxation. We are pursuing one. Whether you should do it this way or that way in terms of a credit or a deduction, and so on, is kind of a wash in terms of economics.

The bottom line is, what is the combined or composite tax on capital? If you add State and local taxes, then in the U.S. that combined tax is well up in the 60 percents for people in the top income bracket. That is double what it is in a lot of our trading partner countries.

The thing that I find most interesting is that, first, if we look at the countries that have experimented with big reductions in capital income taxes, and an extreme example, which you would not want to get too carried away saying that is what is going to happen here, because it is a small country, is Ireland.

Basically, they lowered their corporate income tax from 50 percent to 20 percent, and now it has gone down to 12 percent. When they did that, their GDP growth went up to almost 8 percent a year, real, for a decade. Interestingly enough, their corporate tax revenue—corporate tax revenue—relative to the GDP about quadrupled.

This experience is something that many other countries in Europe have seen, to the point where I reference in a recent Tax Notes article that I wrote with my colleague Eric Yangen, an IMF report that shows the Laugher curve, the idea that you get more revenue when you cut these capital income taxes is clearly evident in the data now. We put a chart in our Tax Notes study about that.

The reason that is, is not that you get necessarily miraculous effects that are home-grown out of capital tax reductions, but rather that multinational corporations are smart and they go where it is attractive to operate.

Just as States compete with one another in order to lure the BMW plants, nations compete with one another to lure multinational businesses. Right now, in the world tax olympics, we did not even qualify. We are not even in the game.

The only country that is looking as silly as us, I believe, is Japan. I think that it is a pressing problem. There are a lot of advantages to America. I do not want to say this is the only thing. But I think it is really almost reckless to ignore this.

Senator BUNNING. In other words, because of the tax structure we have, are you indicating that we have job flight out of this country?

Dr. HASSETT. Yes. At the margin, certainly. Certainly, we do.

Senator BUNNING. Is that because of the multilateral trade agreements that we have come up with, whether it be free trade in NAFTA, whether it be the Caribbean initiative, or what?

Dr. HASSETT. I think, Mr. Bunning, that I would say it is because of the relatively high tax rates. The fact is, if you locate abroad, then you defer taxes in the U.S. and your foreign subsidiary has a significant tax advantage.

Because of this, you see lots of unintended consequences, like, for example, the legislation last year to stop what international tax people call inversions, or the idea of moving your headquarters abroad.

These problems were not pressing seven or 8 years ago because everybody else had not lowered their corporate tax rates to way below ours. But I think they are becoming more pressing.

I just have to say that I think that the European nations that are doing this, they are not doing it because they are to the right of President Bush. They are doing it because they have seen what happens to workers' wages, and so on, when they have lower corporate taxes.

Senator BUNNING. Mr. Gale, tell me about consumption taxes. I know a lot of our trading partners are using consumption taxes. Would they make us more competitive in the marketplace?

Dr. GALE. That is a good question. That is also a very broad and difficult question to pin down. Generally, the notion of international competitiveness is a slippery one. For example, there is this big issue about border adjustability of consumption taxes.

Economists will tell you that, in theory, it does not matter. Practitioners say, well, if it does not matter, then let us do it, just because they think it does matter.

The one study I have seen on this issue suggests that border adjustability does not make a difference to the "competitiveness" of the U.S. system.

Generally, a move toward a broader-based tax system with lower rates would be an improvement, regardless of whether it is a consumption tax or an income tax.

Senator BUNNING. To the current one.

Dr. GALE. An improvement relative to the existing system. That is absolutely true. I think everyone would agree with that.

The other point to make, is you can get there without having large tax cuts that are regressive. You can do that pretty closely in a revenue-neutral, distributionally-neutral way. One of the benefits of that would be improved business environment.

Senator BUNNING. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Bunning, did you finish your questioning? Because if you had another question or two, until Senator Baucus gets here, we would have time.

Senator BUNNING. No.

The CHAIRMAN. All right. Then I have some questions that I would like to ask.

The first one, Dr. Gale, would follow up a little bit on where I left off. Your testimony states, "Higher tax rates reduce the investment risk faced by entrepreneurs because higher rates increase the

value of deductions. But higher rates also reduce the return on investment."

You have a scenario of a tax rate of 100 percent that would reduce risk to zero, but it would also reduce the return on investment to zero, and thus eliminate incentive to invest.

What do you think would be the tax rate that we should adopt to strike some sort of a balance then between risk and return?

Dr. GALE. I do not think I would want THE tax rate. I am not in favor of a flat tax system. I favor graduated rates. I would be quite happy with a system, again, that changed rates in a manner consistent with changing the tax base as well that did not undercut the revenue stream and did not provide big tax cuts to the highest-income households.

Another way of saying that, is if you want to broaden the base and lower the rates, I would be all in favor of that if we did it in a way that was affordable and responsible. But I do not have a single number that I can tell you is THE tax rate that I think is ideal. A lot of it would depend on how serious Congress was about base-broadening efforts.

The CHAIRMAN. All right.

Dr. Hassett, in regard to the President's growth and job package, it did not include a provision for enhanced bonus depreciation. I have heard a lot about, we ought to do more to encourage investment, and through the corporation and depreciation is a very good way to do it.

In your estimation, has the 30 percent bonus depreciation enacted last year been effective in softening the decline in investment spending? Do you believe that the additional bonus depreciation as part of a growth and jobs package would assist further economic recovery?

If you said yes to that, would you recommend increasing the percentage of first-year deductions?

Dr. HASSETT. Thank you, Mr. Chairman, for the question. I have not done the study yet, but as soon as the data are available I will, in order to be able to answer directly, do I see typical effects in the data of the stimulus that was adopted last year?

The reason why it is a difficult question that requires actually getting the computers humming, is that you have to compare investment to what it would have been absent the thing, and look at differential impacts of the Tax Code across different types of assets, and see if the ones that were helped the most by the plan were the places that recovered the quickest, and so on.

But if history is a guide, then I would expect that investment last year was between 2 to 4 percent higher because of the package and the 30 percent partial expensing, and that it will be this year as well about that much.

Now, I think one of the interesting things I found when I ran the numbers, and I would have to say that one of the things I found disappointing in the debate amongst economists in the newspapers about this is that so many people have clearly not run the numbers, the fact is, the President's dividend proposal, if you just plug it in to the formulas that the economists used to study this issue, has somewhere from between exactly about the same effect as the

30 percent partial expensing to maybe about double the effect of the partial expensing.

So, if you thought that the partial expensing was a good idea for "short-term stimulus," then you have a hard time arguing that the dividend tax thing is not if you are going to be consistent, because the same model says that you have got to get maybe perhaps double the effect out of the dividend tax thing that you get out of the partial expensing.

That said, they are both good ways to reduce what we call the user cost of capital. You can do it through dividend tax or you can do it through partial expensing. You could even—and I know this is something you folks have talked about—consider doing both or increasing the partial expensing.

I favor the dividend approach of the President's. The reason is, I get, from a revenue comparison basis or bang-for-the-buck basis, about the same investment response out of the dividend proposal.

But then, in addition to that, I get these other effects that figured so prominently in the testimony of Mr. Gramm and myself, with the effect on debt/equity ratios, lowering the riskiness of U.S. corporations, the effect on payout which makes firms more transparent and makes accounting issues less serious, and so on.

So I think the dividend thing is where we should focus our guns right now, but partial expensing is a worthy pursuit as well. Thanks.

Senator BUNNING. Mr. Chairman?

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Could I inquire once again?

The CHAIRMAN. Yes.

Senator BUNNING. There are two things I would like to ask about. I am curious about both of your views on capital gains tax reform. Do you support lowering or repealing the tax? Would you address the impact of a capital gains tax cut or repeal on the economy in short and long term, first?

Second, the deductibility of capital losses up to $3,000. In my opinion, right now, if that were changed, doubled or tripled, we would get more money put into the economy and probably have a larger deficit because of it, because I am sure, over the last two and a half to three years, that there has been an accumulation of capital losses to surpass the $3,000 that is permissible in a 1-year period of time.

I would like for you to address both of those questions.

Dr. HASSETT. Thank you, Senator Bunning. The President's proposal does likely reduce the effect of the capital gains rate, as you know, and perhaps even very much to zero to the extent that we think that expected capital gains come from profits that firms actually make.

I think, therefore, that if you have been a proponent of reducing capital gains taxes in the past, then that aspect of the President's bill should be attractive to you.

I think that taxes on capital income are going to ultimately, by this international tax competition that I have been talking about, be pushed to zero. I think that that is a good thing.

I think that economic theory suggests that that is where these rates should be, and that we should have a consumption tax. So, yes, I like that part of the plan.

That part of the plan is an under-appreciated reason why you get the investment stimulus effects that I was talking about, that is certainly at least the same size as that that you would get out of the partial expensing we had last year.

The capital loss offset issue is a complex one and really worthy of a whole hearing because of the enforcement issues that arise along with it. The fact is, you do not have to pay capital gains tax until you sell the thing.

If we allow capital losses to offset, say, labor income, then really clever people can think of ways to do things that, when we looked at them, we would not want them to be able to do that in terms of taxes.

Senator BUNNING. In other words, you are not for raising the $3,000 limit for individuals. I am talking about individuals.

Dr. HASSETT. For individuals. That is correct. Yes. I think that if we could tax capital gains and losses on accrual so that when they happen each year you sort of figure that you had a low rate that applied to whatever the change was, then it would be a slam-dunk to support such a thing.

I am more wary of them until I speak to the very competent tax lawyers in the back of this room and have them assure me that they are not concerned that it arouses enforcement problems.

Senator BUNNING. Dr. Gale.

Dr. GALE. Thank you. The treatment of capital gains and losses is, I think, emblematic of the bigger issue of sort of the patchwork way we treat capital income generally in the country.

Right now, the effective tax rate on capital gains is well below the effective tax rate on any other form of asset income, both because the tax rate is lower than other asset income——

Senator BUNNING. Except on home ownership.

Dr. GALE. That is quite possible.

Senator BUNNING. There is none up to $500,000.

Dr. GALE. Well, capital gains on home ownership is exempted up to a very generous level.

Senator BUNNING. $500,000.

Dr. GALE. But it is still capital gains. The tax can be deferred indefinitely without selling the asset. When it is sold, you can time it with your losses, as Kevin mentioned, to offset some of the liabilities. So most economists who have looked at this issue think the effect tax rate on capital gains is around 5 to 7 percent rather than the statutory 20 percent.

What to do about that, is an interesting question. It might be most useful to think of this in the context of the President's dividend proposal. Let me take a step back. About a quarter of corporate income, as far as I can tell, is double taxed, about a quarter of income is never taxed, and the other half is taxed once, either at the corporate level or the individual level.

A plan that taxed all corporate income once at a non-preferential rate would probably raise the net tax burden on dividends, capital gains, and corporate earnings. As I said before, that would be a fully integrated system.

The tax on corporate capital gains could then be applied either at the corporate level or the individual level, and it could be applied as the gains accrue. That would be a more consistent, well-defined system than the system that we have right now.

On the capital loss issue, the only thing I want to add about that is, if you expand the capital loss provision, you have this problem that you encourage people to sell their losers. You encourage them to dump the stocks that they own, and not just any stocks that they own, but precisely the ones that have already lost the most in value.

So, if you had a really big increase in the capital loss provision, you would get sort of a second wave of selling of precisely the stocks that have already done badly. That cannot help those companies, and I do not see the economic benefit in that.

Senator BUNNING. It could help the investor, though.

Dr. GALE. It could help the investor, that is right. But remember, the investor is already benefitting from a wide variety of tax preferences on capital gains. This issue about sort of sticking in a price support for an investor because their stock fell, I think, is really risky.

For example, if you want to talk about Social Security privatization and have privatized accounts, think about what is going on now. We have people who have lost money that is not in their Social Security, not in their 401(k), not in their defined benefit, not in their house. It is purely discretionary investment.

We are talking about potentially bailing them out because they lost money in the stock market, which was a risk they took completely voluntarily. How much more pressure would there be to bail out people who had private retirement accounts, their Social Security nest egg that had substituted for a guaranteed benefit?

How much more pressure would there be to bail out those investors if you went to a privatized system if you, right now, bail out investors that took voluntary risks completely at their own discretion?

Senator BUNNING. Well, you are missing a big point there, though. Most of the money that is put in 401(k)s are invested for pensions and is not taxed before going in. It is non-taxed.

Dr. GALE. I am aware of that.

Senator BUNNING. Where, in investment, a private investment is all money that has been taxed once, and then it is put into an investment account.

Dr. GALE. I agree with that.

Senator BUNNING. I do not want to fight with you on that. The fact of the matter is, if we are going to have a consistency, we have had it at $3,000. If we just adjusted it for inflation since the $3,000, it would be much higher now.

The CHAIRMAN. I think we have all made our points.

I would like to call on Senator Lincoln for her five minutes. Then when she is done, I am going to recess for, hopefully, no more than two minutes and then we will reconvene for our hearing on the six nominees that we have before the committee.

Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman. I promise to be prompt and on time this go-around.

To these gentlemen, I just apologize for being late, but would like to throw out just a couple of questions to get your interpretation.

My State has worked diligently over the past several years trying to entice and attract different types of jobs to come into our State. They have thrown out every incentive that they could and they still did not entice the companies to build in Arkansas.

They had some great competition in a lot of different ways, but they still did make some awfully good offers. It unfortunately happens to all of our States, but we have had our fair share recently.

I guess my question is, what are the assurances I can give my constituents that a tax package to spur investment, even if it does work, will result in jobs for Arkansas, or for Arkansans?

I mean, as we are looking at what your suggestions are to spur investment and for corporate entities to re-invest, and to hopefully not put it against just their bottom line but to do something that is actually going to generate jobs, how do we convince our constituents that this is really the way to go? I guess, should Arkansans be willing to go into debt to provide businesses a tax windfall that they may or may not invest in Arkansas?

Dr. HASSETT. Thank you very much for your question, Senator Lincoln. I can think of a very careful and sound way to address the question, but I cannot do it here without my laptop. It is very simple, and I promise you I will have a look at this issue.

What we could do, is we know proposals like the President's have a positive effect on aggregate investment like I describe in my testimony. So then the question is, historically, when U.S. investment has gone up by that percent, how much did Arkansas investment go up?

To really address this question, I would also have to look, is there a trend away from investing in Arkansas that suggests we would want to pull away from that first-pass effect that I described. I will try to get those numbers to you very, very soon.

Senator LINCOLN. I appreciate that.

[The information appears in the appendix.]

Dr. GALE. I think that the people of Arkansas are probably going to get a raw deal if that package gets passed. I would think that they would benefit more from a Federal package that helped support things like education, health, and infrastructure in Arkansas, on the grounds that that would not only improve Arkansas' prospects in general, that would make it a more attractive place for businesses to invest.

So I think that you have raised a very good question that sort of cuts to the core of the debate right now. The key question the economy faces is not what is best for Arkansas, but what is best for Arkansas is likely also to be best for other places. That is, stemming the flow of education cutbacks, stemming the flow of health care cutbacks.

The budget has proposals to cut funding for low-income programs, children's programs, which I think are anti-growth. I think the cutbacks are anti-growth policies and they hit people at a very, sort of, gut, kitchen table-type level. I think that that is important in the Arkansas context, as well as the national context.

Senator LINCOLN. Well, I just think that is important. Because, when we look at the context of the growth package, or tax package,

or whatever stimulus it is being called, it is important to note that well over half of the cost of that package, only 8 percent of the people of Arkansas, roughly, have any dividend reported on their income tax.

The problem becomes then, even those that do report it, it is a minimal amount, in many cases. That is important to know, that we are putting a lot of those resources towards something that we are going to have to, I think, convince people that are going to actually produce the kind of job growth.

I guess, in that context, is the last part of my question. When you have got industry that is at over-capacity and a company receives a tax windfall, what are the incentives? What are the incentives that that company has to invest that money in new production and jobs rather than applying it to the bottom line.

Dr. HASSETT. Senator Lincoln, I think that, while 8 percent of the folks in Arkansas receive dividends, I would guess that probably 80 percent of the folks who have a job in Arkansas work for a company that pays dividends.

I do not know what the real number is, but it is probably a very large proportion of the folks who have a job that are working for a public company, and that company pays dividends, in all likelihood. So the question is, will the President's proposal help those companies? I believe strongly——

Senator LINCOLN. The question is, will the tax package help those workers in those companies.

Dr. HASSETT. Right. Well, generally when a company stays in Arkansas and does not go out of business, and so on, that is good for workers.

I think the point I would like to make from my testimony, is that is why I think other countries, who I believe generally are more favorably inclined towards redistribution than the U.S., on average, have adopted proposals like the President's, is because they recognize this feedback.

Senator LINCOLN. But what is the incentive for the company in terms of the fact that we have not increased minimum wage in 5 years?

If the company is at over-capacity now, what is the incentive for the company to apply those gains if, in fact, those dividends are paid and it is a positive net for the company, to not put it towards their bottom line, but to put it into increased production, increased wages, or better benefits for their employees? What is the incentive there as opposed to putting it towards the bottom line?

Dr. HASSETT. Senator Lincoln, we were able to discuss that a little bit earlier. The capacity utilization is probably low in Arkansas, as it is everywhere else. But that is a typical pattern that we see in recessions. It does not mean that all recessions continue forever.

Senator LINCOLN. I hope not.

Dr. HASSETT. Very often, the big investment booms that we have seen in the past have begun and been the most striking at points where capacity was very low. The fact is, firms in Arkansas and elsewhere have been postponing their capital spending plans for many reasons, and while they have been doing that the machines have been wearing out.

There is a natural cycle of replacement that is just waiting to happen if this recovery is like every other. Capacity utilization right now is low, but not way lower than what we have seen in past recessions. So, I would not think that it would be correct to argue that the President's proposal could not have a stimulus effect now because of that.

The CHAIRMAN. Thank you, Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

The CHAIRMAN. I thank our panel for appearing. Thank you all very much.

The hearing is adjourned.

[Whereupon, at 12:00 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. MAX BAUCUS

(FEBRUARY 11, 2003)

The President and Treasury Secretary Snow have said that they want to see more employers put "Help Wanted" signs up. I agree, but all across this nation there is a different kind of "Help Wanted" sign out.

Our nation's businesses continue to operate at three-fourths of their capacity. That means that they are not producing all of the goods and services that they can. And, last week the private outplacement firm, Challenger Gray & Christmas, reported that layoff announcements at U.S. firms surged 42 percent in January over December's levels. We simply will not see the "Help Wanted" signs that the President wants until we do something about the "Help Wanted" signs that are already out. Sow hat do we do?

The Federal Reserve has done its best to revive the sluggish economy. Last year, the Fed lowered the short-term interest rate eleven times, down to 1.25 percent. There is not much more rate to cut. So, we turn to fiscal policy—tax cuts and spending increases.

Today we are focusing on ways we can strengthen the economy by increasing consumption. Tomorrow, we will look at long-term economic growth by examining incentives to increase investment.

It is important to recognize that there is no one size fits all solution for the economy. When the economy is weak—as is the case right now—stimulus is needed. And stimulus can only come about if consumers and businesses spend more money now. Consumption—not savings.

To encourage spending may sound wrong. We have been taught the virtues of saving. But when the economy is not operating full capacity, only increases in spending will increase demand, so that businesses hire more workers and produce more goods and services. Now when the economy gets back to full employment and peak capacity, the situation will be completely different. Everyone who wants to work will have a job, businesses are producing all they can.

To avoid inflation and encourage economic growth, we need higher productivity and new capacity. That is when we need to provide savings which businesses can use to invest in new facilities and equipment. And the new plant and equipment can produce more goods and services. Savings—not consumption.

Last year there was bipartisan agreement from both the House and Senate Budget Committees on a set of principles for short-term stimulus. They agreed that any economic stimulus proposal must be: Timely. Take effect quickly. Be sizable. Be targeted at consumers and businesses who will spend it. Get the most bang for the buck. End in a year. And *not* increase longer-term budget deficits.

These are good, common-sense principles. And we should use them to guide our choices for economic stimulus right now. So what are the best ways to stimulate consumption? There are three that stand out.

First, get aid to the states. When there is a recession or a weak economy, states face large deficits. Starting in 2002, states are facing deficits of at least $171 billion. For the current fiscal year, the projected deficits for the states are $70–85 billion.

Almost all states have balanced budget requirements. So when faced with deficits, they must lay off workers, cut spending on programs, or raise taxes. These actions only make the economy weaker. And states are being forced to take such actions: Sixteen Governors—Republicans and Democrats—have already proposed tax increases to keep their upcoming budgets in balance.

States are cutting Medicaid. Massachusetts will cut about 50,000 people from Medicaid coverage. And California is considering eliminating Medicaid health care coverage for 500,000 low-income parents. Of these, 200,000 have income levels below 60 percent of the poverty line. Oregon has not only cut education funding and Medicaid funding, but they have let prisoners go free in order to balance the budget.

We need to get aid to the states. We can pass all of the Federal tax cuts we want, but what good do they do for the American taxpayer if we are forcing states to raise taxes or cut education funding.

Second, we need to extend unemployment benefits to the people we left out in January. We know the labor market is tough right now. There simply are not enough jobs. More than 2 million jobs have been lost since March of 2001. One sign of the sluggish economy is, according to the Conference Board, that the number of help wanted ads in newspapers is at the lowest level since the Kennedy Administration. Let me repeat, the fewest help wanted ads in newspapers since the Kennedy Administration. Forty years.

When the economy is bad, we extend unemployment benefits. America has a tradition of helping those in need. We extend unemployment benefits to help these families pay the rent and put food on the table. It is the compassionate thing to do. It is also good for the economy.

We are talking about families on the edge, just barely getting by. When we give them aid, they spend it quickly. In fact, a Department of Labor study found that every dollar in unemployment benefits results in $21.5 in GDP. For every dollar spent on unemployment benefits—we more than double the impact on the economy.

In January, we extended unemployment benefits through the end of May. Unfortunately, we left out about one million Americans. These are displaced workers who have already received an initial round of extended benefits and still cannot find work. They have exhausted their eligibility. We should extend their benefits.

Third, we should give a tax cut to those who will spend it. I want to get money to the schoolteacher in Shelby, Montana and the police officer in Billings. taxes are taxes whether they are payroll taxes or income taxes. We must get money into the hands of all consumers.

We should eliminate taxes on the first $3,000 of wage income. 110 million working taxpayers would see their paychecks increases. Forty-one billion dollars would be put into the economy.

I know there will be a lot of talk about accelerating many of the tax cuts that were enacted in 2001. Let me be very clear, I am not opposed to accelerating some of the tax cuts. But any plan to accelerate the tax cuts must include acceleration of marriage penalty relief for earned income tax credit recipients and the refundable portion of the child tax credit so that we can expand the group of consumers who will pump money into the economy.

So, there are three ways we can stimulate the economy. Aid to the states, extend unemployment benefits to those we left out in January and give a tax cut that will stimulate consumer spending.

With these proposals in mind, it is my hope that the Finance Committee can put together a broad, bipartisan plan to strengthen the economy. This is no time for partisanship.

PREPARED STATEMENT OF HON. MAX BAUCUS

(FEBRUARY 12, 2003)

Senator Gramm, welcome back to the Finance Committee. And Chairman Panetta, thank you for sharing your views with us today.

Yesterday our hearing focused on consumption. Short-term spending incentives to boost the economy. Today, we are looking at ways to increase investment. But frankly, I first want to say that I'm worried. I'm worried about where we are heading. Two years ago we were squarely on a path of fiscal discipline. In fact, we were worried about what we were going to do after we paid off the national debt. I wish we still had that worry. But we do not have that luxury.

So, why are we here today. We are here to talk about investment because investment creates economic growth. And I believe there are two ways we should do this.

First, we should provide incentives for investment in the tax code for small businesses. Small businesses are the backbone of the American economy. The vast majority of new jobs are created by small businesses. In my state of Montana, small businesses comprise 98 percent of all businesses. They employ 70 percent of Montana's employees. So, if we want to create new jobs through economic growth, we must help small businesses. We can help them by increasing the amount small busi-

nesses can expense immediately when they buy new equipment. This will create a strong incentive for small businesses to purchase new equipment by increasing their rate of return.

We should help small businesses provide health insurance for their employees. Small business owners have told me that health insurance premiums are going through the roof. The increases are hitting small businesses much harder because they do not have the bargaining power that large companies have and these high costs take money away from investing in new facilities.

Right now, small businesses are forced to make choices they do not want to make. Do they shift more of the cost of health insurance to employees? Do they provide health insurance at all? If they do, will they be able to afford to make new investments in the business?

My colleague, Senator Snowe, held a hearing last week on this very issue. The testimony was troubling. Health insurance premiums for companies with ten or fewer employees grew by 16.5% in 2001. According to the Small Business Administration, high premiums are the reason only half as many small firms provide health insurance coverage compared to large firms. We need to help small businesses keep health insurance coverage.

We should increase the depreciation deduction for the year that a business purchases new equipment. In 2001, we saw a sharp drop in direct investment by business. In 2002 we changed the law to give a larger first year deduction. The drop in direct investment leveled, and even increased slightly. We need to provide an increase in the bonus depreciation deduction for 2003 to encourage more direct investment.

The second way is by being fiscally disciplined with our Federal budget. That means we increase our national savings—which is the sum of savings in the private sector and saving by governments—or, we prevent our national savings from decreasing.

One of the best ways to prevent reductions in national savings is to avoid large long-term budget deficits. But the budget recently proposed by the President is in deficit each year. And it does not yet include any funds for a war with Iraq. If we go to war, how long will it be? One month? One year? Two years? We cannot ignore the possibility of war. We need to leave ourselves room in the budget to cover these potential costs.

It is also critical that we extend the three key 60-vote points-of-order which are set to expire in just a few months—on April 15th. Extension of these points-of-order ensures fiscal responsibility by preventing enactment of legislation that would substantially increase budget deficits in the near-term and the longer-term.

So, we can encourage investment with tax cuts. Especially tax cuts for small businesses. And we can encourage investment by reducing deficits and being fiscally responsible. I believe this is how we can improve our nation's long-term economic growth.

Mr. Chairman, thank you for holding these hearings on ways to strengthen the economy. I look forward to hearing from today's witnesses.

PREPARED STATEMENT OF HON. JIM BUNNING

Thank you, Mr. Chairman.

I look forward to an informative discussion of the recent proposals for economic growth. I was pleased to see that the tax plan contained in the President's budget includes an acceleration of many of the important provisions that Congress passed in 2001.

Almost one-half million married couples in Kentucky stand to benefit from the acceleration of the scheduled reduction of the marriage penalty to this year and almost 300,000 Kentucky taxpayers will benefit from the acceleration of the marginal rate reductions.

These changes, along with many others that have been proposed by the President will result in important, meaningful, and immediate relief to the taxpayers in my state and across the country.

As the focus of today's hearing is incentives for consumption, I look forward to an examination of the impact on personal economic behavior of the various proposals for individual tax changes that have been put forward in recent weeks.

In particular, I am interested in hearing the comments of today's witnesses on the issue of the potential affect on the economy of temporary tax cuts or one-time tax rebates versus permanent individual tax cuts.

I thank our witnesses for taking the time to come before this committee today so share their expertise and opinions with us as we examine these important policy matters.

Thank you.

Statement of Stephen J. Entin

President, Institute for Research
On the Economics of Taxation

Senate Finance Committee Hearing on the
Consumption Impact of Proposed Tax Reductions

February 11, 2003

Mr. Chairman and Members of the Committee,

Thank you for the opportunity to testify before you this morning. My views are my own, and do not necessarily reflect the opinions of everyone at IRET.

The debate over the right tax policy response to the slower than desired economic recovery seems to be focused on a number of inappropriate dichotomies. Some people favor tax changes aimed at boosting consumption for the short run. Others favor tax changes that promote long run growth of saving and investment. Some want some of each. Some worry that temporary tax reductions are unlikely to change behavior, and want pending tax reductions (and any new ones that might be enacted) to be made permanent. Others worry that any permanent tax reduction will interfere with investment by boosting deficits, or perhaps they worry it would interfere with future government spending. Many of these conflicts stem from a misunderstanding of how tax and budget changes affect taxpayers' behavior and the economy, and lead to poor analysis and poor policy choices.

Let me note first that the focus on consumption is misplaced. Consumption has been strong throughout the business cycle. The 2001 recession was due to a slump in investment spending, and that spending has been slower than normal to recover, which is the source of the current unsatisfactory rate of economic growth and job creation. More fundamentally, we need to focus on production, not on spending, to create growth and jobs.

As for policy changes that would improve the economy, let us get the analytical framework right. Let me assert, up front, that there is no meaningful distinction between tax changes that are good for the economy in the short run and the long run. Only policies that are good for long run growth and economic efficiency have any favorable short run effects.

In particular, there are no tax changes that would succeed in "pumping up consumption" in the short run by "giving people money to spend", because the Treasury would have to immediately borrow the tax cut back to cover its outlays. Furthermore, tax changes that promote work, saving, investment, and long run growth actually start to work immediately, although they build over time. Fine tuning is impossible. Temporary tax cuts are not generally effective at much of anything. Permanent tax cuts can promote growth in the near term and the long term, but only if they are of the right sort. The deficits associated with the various saving, investment, and work incentive tax changes proposed by the Administration are manageable, and would not raise interest rates by enough to dampen investment.

Changing views of economics and tax policy.

There was a time in economics, from the mid-1930s to the mid-1960s, when economists believed in the "pump priming" efficacy of rebates, credits, rate cuts, or any old tax reduction. But that time is long past. Or it should be.

The old view was that a tax cut worked by giving people money to spend. Supposedly, if a tax cut boosted "disposable income" by a dollar, some of the dollar would be saved, but most would be spent. Whoever received that round of spending would owe some tax to the government and would put some of the receipts into saving, but would spend the rest. That would lead to yet another round of spending, and so on. This led to the old notion of "Keynesian multipliers", that a dollar of tax cut might lead to $2 or $3 dollars of increased "demand" for goods and services. The effect was supposedly even higher if the initial impetus was a dollar of additional government spending, because none of that first dollar would be saved.

Traditional economists were never comfortable with these notions. In the mid-1960s, the Keynesian theory was called into question by the monetarists, led by Professor Milton Friedman at the University of Chicago. It was also opposed by "neo-classical" economists such as Norman B. Ture, a long-time tax advisor to the Congress.

Friedman made two key contributions. In his "permanent income" theory, he demonstrated that people do not rush out and spend as soon as their disposable income increases. It takes them time to become certain that the change in their income is permanent, and they increase their spending only gradually in line with their view of their "permanent income". Meanwhile, the increase in income is saved. The corollary is that permanent tax changes have a much greater impact on spending than temporary ones, and neither will have much impact on "demand" in the short run.

Later, Friedman went further to observe that a tax cut or a government spending hike that increased the deficit would not stimulate spending or demand unless the Federal Reserve "monetized" the added debt. In one of his famous Newsweek columns, Dr. Friedman asked, "If the government cuts taxes from $500 billion to $450 billion without cutting spending, where does the $50 billion come from, the tooth fairy?" His point was that, if the Federal Reserve did not pony up the money to buy the extra Treasury debt, the government was simply borrowing the tax cut back from the public. And if the Fed did monetize the debt, that was a change in

monetary policy, not the consequence of the fiscal policy. He reiterated this point last month in a Wall Street Journal editorial, pointing out that tax cut recipients keep more of their money, but they, or others, must lend a similar amount to the government to cover the additional federal borrowing, and the lenders have that much less to spend. Whether total "demand" goes up or down is uncertain and unlikely to have much impact.

It may be argued that, insofar as foreigners buy a portion of the added federal debt, then U.S. residents may in fact have some of the tax cut to spend. But foreigners who buy the added federal debt either have fewer dollars to lend to other U.S. residents or to spend on U.S. goods. Another way to put this is, if more foreign capital flows in, induced by higher U.S. demand for credit, the dollar will rise on the foreign exchange markets, imports will become cheaper and U.S. exports will become more expensive, and there will be a drop in foreign demand for U.S. goods. Again, there is no initial gain for "demand" from the tax reduction.

Conclusion: the government cannot pump up consumption, either in the long run or the short run, merely by cutting taxes or by increasing government spending, because of the government budget constraint. There is no first order demand effect from a tax cut.

If tax cuts do not work by giving people money to spend, then how do they work? In neo-classical thinking, **tax cuts improve economic performance and raise individual and national incomes if and only if they reduce tax barriers to producing more income by working, saving, and investing more than before.** That is, as marginal tax rates are reduced on incremental income, and the tax rules governing the level of tax on additional investment are made less restrictive, the after-tax rewards to labor and capital inputs will rise and their pre-tax costs will fall. As people are given the incentive to offer more labor and capital services than before, the supply of labor and capital inputs to the production process increases, and so does output. Labor and capital are paid for their effort, and they can then buy the output they have created. Supply creates its own demand. As Ture pointed out time and again, unless there is a supply response to a tax change, there will be no added output and no demand response. The two rise together or not at all. The added output comes from an expansion of productive resources, and is not inflationary. Indeed, more goods are chasing the stock of money, and the Federal Reserve can be more generous with money growth without triggering inflation.

Events in the 1960s and 1970s bore out this neo-classical view. The Kennedy marginal personal income tax rate reductions, corporate tax rate cut, and investment tax credit boosted real output and employment. The Johnson income tax rate surcharge led to the 1969-70 recession. Several increases in the personal exemption and standard deduction in the 1970s, which were not at the margin and did nothing for incentives, did little or no good. Inflation-induced bracket creep, which sharply raised the tax burden on additional labor and capital income, led to stagflation.

These lessons helped shape the Economic Recovery Tax Act of 1981. It provided personal marginal income tax cuts, combined with tax indexing effective in 1985, which lowered the marginal tax rates and reduced the cost of labor while raising the reward to incremental work, saving, and investment. At the same time, lower inflation due to more effective monetary policy on the part of the Federal Reserve boosted the real value of the allowances that businesses may

claim for the cost of their outlays on plant, equipment, and buildings. Because of these positive developments, the 1980s saw a return to job and income growth and price stability. Real after-tax incomes, which had been falling in the late 1970s, turned around and began to rise at all income levels.

Failure of rebates.

Rebates, by contrast, have a long history of failure. President Ford proposed, and the Congress enacted, the Tax Reduction Act of 1975. It contained a retroactive tax rebate of 10% of 1974 tax liabilities, with minimum and maximum bounds of $100 and $200, paid in May and June of 1975. It also included a $30 tax credit per personal exemption for 1975 (later raised to $35 and made effective for two years) and a one-time $50 bonus for Social Security and other income maintenance programs to fight recession. The view at the time was that the tax cut did no measurable good.

When President Carter proposed an even larger rebate in 1976, Senator Russell Long laughed the idea out of the Finance Committee, and replaced it with a modest, and more effective, tax rate reduction (a credit of 2% of income up to $9,000, effectively cutting marginal tax rates on incomes up to that size, which was middle income at the time) and an investment credit.

A subsequent study by Franco Modigliani and Charles Steindel (Brookings Institution, 1977) concluded that less than 25% of the Ford rebate was spent. They wrote, "We conclude that there is strong, though not uniform, evidence that a rebate is not a particularly effective way of producing a prompt and temporary stimulus to consumption." Alan Blinder (later appointed to the Council of Economic Advisers and the Federal Reserve Board by President Clinton) conducted a study in 1981 which concluded that temporary tax changes, such as the 1968 income tax surcharge (a rate hike) and the 1975 rebates (lump sum hand-outs), have less than half the impact of permanent tax changes of similar magnitudes, and that rebates have the least benefit, yielding less than forty percent of the "kick" of a permanent tax cut.

The 2001 rebates of $300 per adult taxpayer (actually a down payment on the new 10 percent tax rate bracket) were about 80% saved, creating a very visible jump in the personal saving rate in the last half of that year. There was no noticeable lift to the GDP.

Conclusion: Permanent tax cuts that work at the margin to raise rewards to additional work, saving, and investment expand economic capacity, output, employment and income. They begin to work at once, and build over time as the additional capital is put in place. The primary beneficiaries are the workers, because they get additional capital to work with, which increases their productivity and wages. Workers capture over half of each added dollar of GDP made possible by added investment. Federal state and local governments capture about a third of each dollar of added GDP via higher tax receipts. A bit over 10 cents is used up by depreciation of the added capital stock. Capital owners gain too, but much of their gains are competed away as the "new" capital competes with the old, and the after-tax returns are driven down to normal levels as the capital stock expands. They get about 5 cents, net, of the added national output.

<u>President Bush's growth proposals.</u>

President Bush's proposed new tax reductions would do much economic good. Major provisions would encourage work, saving, and investment at the margin. They would add nearly a million and a half jobs over two years, according to the CEA, and would boost GDP by several percent over the next decade.

• <u>Dividend and capital gains relief.</u> The Bush plan would eliminate most of the double taxation of corporate income via dividend exclusion and capital gains relief, and increase small business expensing. These proposals would reduce the cost of capital, meaning that it would reduce the gross return that investment in capital assets must earn in order to pay the associated taxes, replace the plant, equipment and buildings as they wear out, and still yield an acceptable after-tax return to the owners. The proposals would trigger a substantial increase in capital formation over the next decade, boosting GDP in the near term as the capital is created, and in the long term as it is employed. Associated productivity gains would raise employment and labor income.

• <u>Accelerated reductions in marginal income tax rates.</u> The Bush plan would advance the remaining marginal income tax rate reductions scheduled under the 2001 tax cut. These rate cuts would reduce the cost of capital and increase after-tax rewards to affected workers, especially small business owners, sooner rather than later. There would be an immediate, rather than a delayed improvement in GDP because of these economic incentive effects. The improvement would not be do to any impact these provisions would have on aggregate consumption.

• <u>Enhanced and simplified saving incentives.</u> President Bush has unveiled three new proposals to promote saving: new Lifetime Savings Accounts (LSAs) useable for any purpose, Retirement Saving Accounts (RSAs) which would replace deductible, non-deductible and current Roth IRAs, and Employer Retirement Savings Accounts (ERSAs) which would enormously simplify defined contribution plans. They would replace 401(k), 403(b), and government 457 plans, SARSEPs and SIMPLE IRAs. More saving would be eligible for tax favored treatment than under current law. The tests and restrictions required for such plans under current law would be greatly simplified and relaxed, reducing legal and compliance costs to enable more companies to offer such plans to their employees.

LSAs would be of great benefit to lower income savers who cannot afford to save separately for retirement and emergencies, such as being laid off, and who are therefore afraid to use ordinary IRAs because of their penalties for early withdrawal. They put their saving into ordinary accounts that are subject to the full tax bias against saving, where the saving is taxed each year with no deferral and no exclusion, either at the time of deposit or withdrawal. Under the lifetime savings accounts, there would be no income limits on participation, no minimum holding period, and no restrictions on what the money could be used for. The LSAs would give lower income people who want to save the same access to tax-neutral saving that higher income workers currently enjoy.

These proposed saving plans are good tax policy, in that they remove one of the layers of tax bias that the income tax imposes against saving relative to consumption. Reducing the tax bias

against saving would in turn increase investment, productivity, employment, wages, and income across the board. Combined with Mr. Bush's other saving and investment proposals, the new saving initiatives constitute a significant step toward fundamental tax reform. All these features of the proposal would boost GDP and recover a good portion of their "static" revenue cost.

Social policies in the President's tax plan.

Not all of the President's tax plan is designed to boost economic performance, however. Several provisions are meant primarily to address social goals or attract political support for the bill by giving more money to lower and lower-middle income taxpayers. Among these are advancing to 2003 the effective dates set in the 2001 tax cut for widening the 10% bracket, for marriage penalty relief (making the standard deduction and 15 percent bracket for married couples twice that of single filers), and for raising the child credit to $1,000 (from $600 this year).

• Accelerated widening of the 10 percent bracket. The provision would have a small incentive effect for those who drop down from one tax rate to the next, but their numbers are few and they do not produce much GDP.

• Accelerated marriage penalty relief and accelerated increase in the child credit. The marriage penalty relief includes widening the standard deduction and 15 percent tax bracket for married couples to twice the amounts for single filers. These provisions should be viewed as social policy, not growth policy. For reasons described above, the provisions will not boost aggregate consumption. The wider 15 percent bracket would reduce marginal tax rates for those who drop down a bracket, but the expansion of the child credit contains some hidden marginal tax rate increases for some families.

The larger standard deduction and higher child credit would drop another three million people from the income tax rolls, and that would reduce their marginal tax rates. However, dropping millions of taxpayers from the tax rolls would be bad public policy, because it would increase the number of voters who think that general government (federal outlays excluding Social Security and Medicare) is a free good, and do not care how big the government gets or how high the income tax rates are pushed. Already, the bottom half of the income distribution pays only about 4 percent of the income tax. If we go much further down that road, the tax system will create a voting majority for the federal provision of food, clothing, shelter, and transportation, not to mention health care.

The child credit provision, as drafted, has the added drawback of raising marginal tax rates for many highly productive workers and savers. The credit is "phased out" for single filers with adjusted gross incomes (agi) over $75,000 and married filers over $110,000. The credit is reduced in $50 steps for each $1,000 or fraction thereof by which income exceeds the thresholds. This effectively boosts the taxpayers' marginal tax rates by 5 percentage points on average until the credit is gone. (The "excess" income is rounded up to the next $1,000. If income exceeds the threshold by $1 to $1,000, the taxpayers lose $50 of the child credit; between $1,001 and $2,000, they lose $100 of the credit; etc.)

Families subject to the phase-out were mostly in the old 28 percent tax rate bracket, now 27 percent in 2003 thanks to the 2001 Bush tax cut, and which his new plan would hasten to cut to 25 percent. Some are calling this rate cut a give-away to the rich. In fact, in the phase-out range for the child credit, the old 28 percent rate was implicitly bumped up to 33 percent. The new implicit marginal rate will still be 30 percent, even with the rest of the marginal rate cuts. That's before Medicare and state and local income taxes typically add about 8 points more, and several points more from the not-yet-expired phase-outs of personal exemptions and itemized deductions.

Furthermore, the phase-out range expands, boosting the tax rate over more taxable income. When the credit is $600, the phase-out range is $11,000 wide for one child, $23,000 wide for two children, etc. With a $1,000 credit, the phase-out range would be $19,000 wide for one child, and $39,000 wide for two, affecting many more families. For them, the 3 percentage point reduction in marginal tax rates in the President's 2001 tax cuts will be more than offset by the implicit 5 point rate hike in the enlarged penalty zone for the child credit.

Summary of tax rate effects of the child credit:

For 2003....................	2000 law	2001 law	Bush plan
credit/child.................	$500	$600	$1000
explicit tax rate............	28%	27%	25%
implicit rate w. phase-out...	33%	32%	30%
agi phase-out range for --			
1 child, from $110,001 to:	$119,001	$121,001	$129,001
2 children, from $110,001 to:	$129,001	$133,001	$149,001

How best to describe the President's proposals.

The Administration has spoken favorably about how much spending money these social provisions would put into the pockets of lower and middle income families to show that the tax plan is not just for the rich. As tax cuts meant to be made permanent, they would do more for people of all incomes than the one-shot rebates that have been offered by some in Congress. Indeed, they would be worth several thousand dollars over the decade for families with children. Further, by boosting productivity and wages, the growth-related provisions also raise pre-tax incomes and create new jobs. That all needs to be said, but carefully. It is one thing to point out that the President's tax plan is generous to a wide range of taxpayers. It is another thing to describe the tax cuts (even the good parts) as "giving consumers money to spend" in the aggregate to pump up the economy, which they certainly do not, once additional federal borrowing is taken into account.

Tax cuts improve economic performance and raise individual and national incomes if and only if they reduce tax barriers to producing more income by working, saving, and investing more than before. It is a technical and political mistake to allude to fictitious benefits from not-at-the-margin "demand-side" tax hand-outs. That improperly puts them on a par with economically

eneficial "supply-side" incentive provisions, giving ammunition to those who would substitute ıore of the redistributionist sort of tax changes for the ones that are good for the economy.

'he Administration bent over backwards to "spread the wealth" in its tax reduction plan. The ate cuts are modest; they leave marginal tax rates higher than after the Senior Bush tax hike. 'he tax code still has stealth tax rate spikes due to "phase-outs" of credits and deductions, one f which, due to the child credit, the plan makes worse. These considerations suggest that there ; no excuse to water down either the advancement of previously enacted marginal rate cuts or ıe newly-proposed relief from the double taxation of shareholders' corporate earnings that 'resident Bush has proposed.

\rguments over the deficit.

)eficits of the magnitude projected under the President's tax proposals would have only a modest ffect on interest rates. The CEA estimates that interest rates rise by only about 3 to 5 basis ›oints for each $200 billion in new debt. I have seen other estimates that an additional trillion lollars of debt over a decade would raise interest rates by between 5 and 20 basis points. The ffects on investment would not be large. They would certainly be an order of magnitude smaller han the effect of the reduction in the cost of capital from ending the double taxation of corporate ncome.

)ne reason for the small impact is that the United States is part of the global economy, and has ıccess to world capital markets. The other reason is that the supply of saving is not inelastic, ıs was once thought. Rather, people seem quite willing to add to their saving as after-tax rates ›f return rise by even small amounts.

ᐠote that it is the impact of deficits on the entire stock of existing debt, not just new borrowing ›ut of current saving, that determines interest rates and saving behavior. The value of world ›onds, stocks, mortgages, and other credit instruments will be approaching $100 trillion over the ıext decade. If the United States government were to borrow an additional $1 trillion, it would ›e adding only one percent to the stock of world financial instruments. To make people want o hold that much added debt in their portfolios, interest rates would have to rise by enough to lrive down the value of existing debt by about one percent, so that people would feel the need o replenish their assets by that amount. Long term interest rates might have to go from 6% to ›.06% to effect that adjustment.

'rovision for new temporary individual tax cuts.

\ number of Members of the House and Senate have introduced income or payroll tax reductions ›n the first few thousand dollars of income, or tax rebates of a specific dollar amount. Insofar ıs these proposals have little or no incentive effect at the margin to earn additional income in the 'uture, they would have no beneficial effect on employment or saving. They would not stimulate ıggregate consumption, because the amounts given out would be borrowed back by the Treasury.

• Senator Baucus has proposed to eliminate the income tax on the first $3,000 of wages earned in 2003, and to provide low income workers not subject to income tax with a $300 rebate. The plan is effective "at the margin" for only a handful of workers. He has also offered a temporary health insurance tax credit, which is primarily an incentive for employers to offer health coverage to their work force, not an economic stimulus program.

• Senator Daschle and Congresswoman Pelosi have offered two variations on tax rebates. For reasons described above, neither is likely to be successful in increasing consumption or employment. Even if made permanent, they are lump sum payments that are not "at the margin" and provide no incentive to work longer hours or save additional income. Each has also proposed increasing the 30 percent expensing provision of last year's stimulus package to 50 percent for 2003, but would drop the provision (Daschle) or reduce it to 10 percent (Pelosi) for 2004. These steps would borrow investment spending from next year, and simply be more ineffective fine tuning. The 30 percent expensing provision in current law should be expanded to 50 percent, or better, 100 percent, and made permanent. Many firms will not expand their factories just for a temporary improvement of the treatment of investment if they have to face old law when it comes time to replace the additional assets.

• Senators Landrieu and Corzine have proposed a refundable income tax credit equal to the payroll taxes on the first $10,000 of wages. For workers, it would be based on wages paid in 2001. Rebates on income earned in past years gives no incentive to earn additional income in the present. Witness the Ford fiasco. For employers, the credit would be based on payroll taxes paid in 2003. But even if the employers' tax relief were based on current wages, the cap would make it not "at the margin" for most employees. The one year relief would not give much incentive to take on a permanent employee, as it would not lower future year's labor costs. The best that can be said is that it might help cover the cost of training a new hire.

Fiscal relief for states.

Federal payments to aid state budgets will not boost aggregate "demand" because the federal government will have to borrow the funds transferred to the states. This is the same objection to "demand management" as applied to tax cuts or other government spending increases. The only economic benefit to aiding the states in the short run is that it might fend off state income tax or local property tax hikes, which would increase disincentives to work, hire, save, and invest. The drawback is that it will let the states delay dealing with their recent wave of overspending as good times brought a temporary surge in revenues.

Economic Growth, Job Creation, and Incentives for Investment

Testimony submitted to
United States Senate
Committee on Finance

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Mr. Chairman, Senator Baucus, and Members of the committee:

Thank you for inviting me to testify today. It is an honor to appear before this committee. President Bush and members of Congress have proposed several new tax-based incentives aimed to raise economic growth. My testimony is divided into two sections: a summary of the conclusions, and supporting analysis.

Summary of major conclusions

The first two conclusions focus on how to frame and consider policy questions relating to taxes and economic growth. The next four conclusions relate to specific policy options.

- In considering policies to spur the economy, it is important to distinguish short-term and long-term problems.

  --In the short-term, the major economic problem is inadequate aggregate demand, as evidenced in particular by low rates of utilization of capital among businesses. The key to boosting the economy in the short-run is boosting demand in order to fully utilize existing capacity.

  --In the long-term, the economic growth depends on the extent to which productive capacity (including physical capital, human capital, and economic institutions) is able to grow. Sustained increases in such capacity require increases in national saving.

- Tax cuts have ambiguous effects on economic growth in the long run.

  --Tax cuts can affect economic growth in the long run through at least two channels. First, a tax cut will affect labor supply, human capital accumulation, saving, investment, entreprenuership and so on. Second, the reduction in revenues will raise the federal deficit (unless matched by spending reductions) and hence reduce national saving.

  --The net effect on growth is the sum of the (generally positive) effects created by more favorable economic incentives and the (negative) effects created by the increase in the deficit. For the tax cut to have a net positive effect on growth, the effects on labor supply, saving, etc., not only must be positive, they must be larger than the drag created by the increased deficit.

  --Increased deficits reduce national saving and future national income regardless of whether deficits raise interest rates. One of the best ways to encourage economic growth is to keep national saving high, which in turn implies that public saving should be high.

- The 2001 tax cut was poorly designed to raise growth. Neither accelerating the tax cut nor making it permanent should be considered pro-growth strategies.

  --According to Treasury data, 64 percent of taxpayers will receive no reduction in marginal tax rates. But the tax cut will reduce revenues by $1.7 trillion through 2010 and

reduce national saving. Estimates of how deficits affect interest rates used by President Bush's Council of Economic Advisers imply that EGTRRA will raise the cost of capital for most investments.

--Researchers have generally found that the positive effects of the 2001 tax cut on labor supply, saving, etc., are likely to be offset by, and may well be outweighed by, the negative effects of the tax cut in reducing national saving.

--For the same reasons, accelerating the 2001 tax cut is unlikely to stimulate growth. An acceleration could raise the cost of capital on new investment for small businesses because it reduces the tax rate against which investment deductions may be taken.

--Making the 2001 tax cut permanent is neither affordable, nor would it do anything to spur growth currently. Given that EGTRRA as a whole probably had either a negligible or negative impact on growth, making it permanent is not a pro-growth strategy.

- The President's proposal to reduce taxes on dividends and capital gains is unlikely to generate much in the way of new growth.

--By reducing the double taxation of dividend income, the plan could reduce the cost of new corporate investments financed by new equity issues.

--It would not reduce the cost of investments financed by debt, and would likely reduce investment in non-corporate sectors, including housing and small businesses. It would also raise interest rates by encouraging investors to move from bonds to stocks. By raising deficits, it would reduce future national income.

--A study of all of these effects by Macroeconomic Advisers finds that plan would have no effect on average GDP between 2003 and 2007, would raise interest rates, and in the long run would *reduce* productivity.

- Increasing the temporary provision for partial expensing from its current 30 percent level is unlikely to spur much new investment.

--The primary problem that businesses face currently is inadequate demand, as evidenced by low capacity utilization rates. It is unclear why businesses would want to invest more, given that demand is so low they do not even use the capital they currently have.

- Small businesses would not generally fare well under the proposals under consideration.

--They would be helped directly by the proposed increase in expensing limits.

--But the acceleration of the tax cut, the dividend proposal, and the expansion of partial expensing would raise the cost of new investments and reduce the funds available for new investments by small business.

Supporting text

1. Description of proposals

The President's budget contains four major tax-related proposals aimed at increasing economic growth.

- Accelerate to January 1, 2003, some, but not all, of the income tax cut provisions that were enacted in 2001 and scheduled to be implemented in the future. The accelerated items include the reduction in the top four income tax rates (from current levels of 27, 30, 35, and 38.6 percent to 25, 28, 33, and 35 percent, respectively); marriage penalty relief for middle- and upper-income households; an increase in the child credit to $1,000; and expansion and indexing of the 10 percent tax bracket.

- Make EGTRRA permanent.

- Exclude all corporate dividends from taxation under the individual income tax provided that corporate taxes have been paid on the earnings generating the dividends. A related provision would allow companies to deem dividends without actually paying them, thus reducing eventual capital gains and capital gains taxes for shareholder.

- Increase the small business expensing limits to $75,000 from $25,000, and index for inflation.

Another proposal that has been floated is to increase the 30 percent partial expensing for corporate investments (which was enacted in 2002 and applies to investments made between September 11, 2001 and September 2004) to either 40 percent or 50 percent.

2. Relations between tax cuts, deficits, and economic growth

National income accounting identities go a long way toward framing the relevant issues. (For mathematical details, see the Appendix.) National saving is the sum of private saving (which occurs when the private sector spends less than its after-tax income) and public saving (which occurs when the public sector runs budget surpluses). National saving is identically equal to -- and is used to finance -- the sum of domestic investment and net foreign investment. Domestic investment is the accumulation by Americans of private assets at home, or of public (government) assets. Net foreign investment is the nation's investment overseas minus borrowing from abroad (foreign investment in the United States). An increase in net foreign investment may take the form of increased U.S. investment overseas, increased U.S. lending to foreigners, reduced foreign investment in the United States, or reduced U.S. borrowing from abroad. The composition of the change in net foreign investment is of secondary importance, and we will typically refer to an increase in net foreign investment as "increased borrowing from abroad." We refer to the sum of domestic and net foreign investment as "national investment."

In simplest terms, national saving must by identity equal national investment, and an increase in national saving must show up as an increase in domestic investment and/or net

foreign investment. Either way, the accumulation of assets due to increased saving and investment means that the capital stock owned by Americans is increased. The returns to that additional capital -- whether domestic or foreign -- raise the income of Americans in the future.

These macroeconomic building blocks highlight two key points (see also Figure 1):

- An increase in the budget deficit (a decline in public saving) reduces national saving unless it is fully offset by an increase in private saving, and

- A reduction in national saving must correspond to a reduction in national investment and in future national income, holding other things equal.

Barro (1974) demonstrates that if households are fully rational and take the well-being of their descendants into account in formulating their consumption and savings patterns, reductions in taxes today would be balanced by offsetting increases in private saving today. In particular, households would recognize that the reduction in taxes today would increase future tax liabilities and thus save the tax cut. Numerous tests of household saving behavior, however, conclude that households do not follow the dictates of this model (Bernheim 1987). The implication is that increased budget deficits are not fully offset by increases in private saving, and therefore result in a reduction in national saving.

A decline in national saving must reduce private domestic investment, net foreign investment, or some combination thereof. The reduction in investment reduces the capital stock owned by Americans, and therefore reduces the flow of future capital income. Either the domestic capital stock is reduced (if the reduction in national saving crowds out private domestic investment) or the nation is forced to mortgage its future capital income by borrowing from abroad (if the reduction in national saving generates a decline in net foreign investment). In either case, future national income is lower than it otherwise would have been.

Figure 1 illustrates this logic: The junction marked A highlights the relation between deficits and national saving. It shows that as long as private saving rises by less than 100 percent of the decline in public saving, national saving falls in response to a budget deficit, which in turn reduces future national income, other things equal. The extent to which the decline in national saving generates a response from capital inflows (junction B) or interest rates (junction C) or both may also be of interest in its own right, but it does not alter the basic conclusion that larger deficits reduce future national income, other things equal.

As shown in the appendix, these findings can be used to illustrate the potential longer-term consequences of the recent deterioration in fiscal prospects.

3. Changing EGTRRA

A. EGTRRA and Growth

The analysis above considers only the effects of reduced budget surpluses or increased budget deficits *per se*. It establishes the crucial observation that, other things equal, smaller

budget surpluses reduce future national income relative to what it would otherwise be, and do so regardless of how they affect interest rates. In this section, we point out that a full analysis of policies that raise deficits or reduce surpluses needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit, and (2) the change in the deficit.

The most recent prominent example of this issue is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its direct effect on changes in incentives and after-tax income and its indirect effect through changes in the budget deficits. The improved economic incentives from provisions of the 2001 tax cut, analyzed in isolation, tend to raise labor supply, human capital accumulation, and private saving. But these changes in incentives are financed by reductions in public saving. Thus, to gauge the full effect on growth, one needs to factor in the effect of lower public saving on economic growth.

Given the structure of the 2001 tax cut, researchers have generally found that the positive effects on future output from the impact of reduced marginal tax rates on labor supply, human capital accumulation, private saving and investment either substantially offset or even outweigh the negative effects of the tax cuts via reduced public and national saving (see Auerbach 2002, CBO 2001, Elmendorf and Reifschneider 2002, Gale and Potter 2002).

There are several factors that help show why the effects of EGTRRA on growth are likely to be small or even negative. First, Treasury data in Kiefer et al (2002) show that 64 percent of tax filers with positive tax liability, accounting for 38 percent of all taxable income, would receive *no reduction* in marginal tax rates under EGTRRA. Most of these households were either in the 15 percent bracket or on the alternative minimum tax. Second, the increase in the deficit could raise interest rates and that increase would raise the cost of capital on new investments. President Bush's Council of Economic Advisers routinely uses an estimate that a $200 billion increase in the deficit raises interest rates by 3-5 basis points. If so, the $1.7 trillion cost of EGTRRA over the next 10 years would be expected to raise interest rates by between 25 and 42 basis points. Gale and Potter (2002) show that if EGTRRA causes interest rates to rise by 30 basis points, then the net effect of EGTRRA--including reduced marginal income tax rates--is to raise the cost of new investments for sole proprietors, for housing, and for corporate investments in structures. Only the cost of corporate investments in equipment would fall, and by less than 1 percent. Third, the reduction in federal surpluses (or increases in deficits) of $1.7 trillion through 2011 will reduce national saving. The $1.7 trillion includes $1.35 trillion in tax cuts plus the additional debt service costs.

B. Accelerating EGTRRA

All of the reasons noted above, combined with the fact that accelerating EGTRRA is a *temporary* tax cut, suggest that accelerating the 2001 tax cut would have negligible effects on growth.

In fact, at least one aspect of accelerating the tax cut could *reduce* investment currently. The cost of capital that sole proprietors, partnerships, and S-corporations face on new investment depends in part on the present value of the depreciation allowances they are able to deduct. Thus, a business would like to deduct depreciation against high tax rates, since a $1

dollar deduction is worth more the higher the tax rate is. Right now, with tax rates poised to decline over time, businesses (other than C Corporations) face the rosy prospect of making investments now, taking the deprecation in the next few years at relatively high tax rates and then reporting the income in the future after 2006 against relatively low rates. Reducing tax rates now would reduce the benefit of the depreciation deductions and hence could reduce new investment by those businesses.

C. Making EGTRRA Permanent

Making EGTRRA permanent is unlikely to stimulate growth, for the same reasons that EGTRRA is estimated to have little impact on growth over the next decade. Still it is worth noting that the Congressional Budget Office (2003) has estimated that letting EGTRRA sunset would reduce GDP by 0.5 percent. Perhaps surprisingly, this estimate is fully consistent with EGTRRA having little or no impact on economic growth over the past decade and little or no impact in the future.

To see this, recall that taxes have two sets of effects--one on incentives and one on national saving via the deficit. The CBO estimate of the effects of letting EGTRRA expire is solely an "incentive" effect. Note that it implies that the cumulative value of the incentives in EGTRRA would be to raise GDP by 0.5 percent over the decade. That implies an increase in GDP of about $81 billion by 2011 (CBO 2003, table 1-2). But recall also that the full effects of EGTRRA are the incentive effects plus the impact on national saving. To calculate the latter effect, note that EGTRRA reduces budget surpluses by $1.7 trillion over the decade. Assuming that private saving rises by about one-third of this amount (based on Gale and Potter 2002), national saving falls by $1.13 trillion. With a 6 percent interest rate, the decline in national saving implies a reduction of $68 billion in income. That means that EGTRRA will raised GDP by only $13 billion (81-68) in 2011. This is less than 0.1 percent of GDP.

4. The dividend proposal

A. As corporate tax reform

The dividend tax proposal is intended to tax corporate income once and only once.[1] Three points are important to emphasize about this proposal. First, most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies and other factors.[2] Recent evidence

[1] The provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the Administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.

[2] Robert McIntyre, "Calculations of the share of corporate profits subject to tax in 2002." January 2003.

suggests growing use of corporate tax shelters.[3] Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits.[4] Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the non-taxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

Second, the Administration's proposal would have no effect on firms' incentives to shelter and retain earnings to the extent that firms are owned by non-taxable shareholders. To the extent that firms are held by taxable shareholders, the Administration proposal would reduce incentives to shelter somewhat, but firms would still maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the earnings -- the same strategy that maximizes taxable shareholders' after-tax returns under current law. Despite the Administration's claims to the contrary, the proposal therefore does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings.

Third, the Administration's proposal may result in a variety of new tax shelters.

A partial dividend exclusion is not a solution to these problems either. It just reduces both the benefits and costs of the proposal. Proponents of the dividend exclusion often note that many European countries have partially or fully integrated their corporate and personal tax systems. However, it is also the case that several European countries have recently moved away from integrated systems.[5] In addition, the large share of corporate equities are held by shareholders that are not subject to individual dividend and capital gains taxes appears to be much higher in the United States than in most European countries.

The bottom line is that the Administration's proposal does the "easy" part of tax reform: it cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts." The approach proposed by the Administration would also undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions, but the Administration's proposal simply gives the carrot away. Burman (2003) and Gale and Orszag (2003) discuss modifications to the Administration's proposal that would

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[3] Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.

[4] William G. Gale, "About half of dividend payments do not face double taxation," *Tax Notes*, November 11, 2002. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies the withdrawal. Also note that a substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death.

[5] Reuven Avi-Yonah, "Back to the 1930s? The Shaky Case for Exempting Dividends ," Tax Notes

represent a more balanced approach to changing the system of taxing corporate income.[6]

B. As a Growth Package

In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. That capacity, in turn, depends on national saving. Yet the Administration's plan will expand the budget deficit, which will have the effect of *reducing* national saving.[7] Only if the economic benefits of the policy changes generating the deficits *more than offset* the losses imposed by reduced national saving would the net effect be positive.

A study by Macroeconomic Advisers[8] reached the following conclusions regarding the growth and jobs package, including the dividend plan:

- The plan would have no effect on average GDP between 2003 and 2007.
- Employment would grow by an average of 21,000 per year over the next five years
- The yield on 10-year Treasury notes would rise by 23 basis points by 2004 and by about 50 basis points by 2007; and
- In the long-term, productivity would *fall* and the cost of capital would *rise*, due to the effects of increased deficits on national saving and interest rates.

It is worth emphasizing several reasons why the plan may not stimulate much if any growth. First, although the plan will help allocate an existing amount of investment more efficiently across sectors (though significant corporate tax reforms would do an even better job in this regard), by raising the deficit and reducing national saving the plan is likely to reduce the total amount of capital owned by Americans. Second, the impact on corporate investment will muted to the extent that interest rates rise (due to making equities more attractive) and the extent to which investments tend to be financed with debt or retained earnings. Third, to the extent the

[6] Leonard E. Burman, "Taxing Capital Income Once," Urban-Brookings Tax Policy Center, January 2003, and William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

[7] The reduction in national saving reduces the nation's future income. That is the fundamental cost of a failure of long-term fiscal discipline: All else being equal, it reduces the capital owned by Americans and the nation's income over time. For example, Gale and Orszag (2002) show that the deterioration in the fiscal outlook since January 2001, all else being equal and not including the Administration's most recent proposal, will reduce income in 2012 by the equivalent today of $1,500 per household per year. See William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center, December 2002. In recent months, Administration officials and others have argued that budget deficits do not affect interest rates. Gale and Orszag (2002) address this issue in detail. The important point to realize is that focusing solely on the connection between interest rates and deficits obscures the more important point: Unless an increase in the budget deficit is entirely offset by an increase in private saving, it must produce either a reduction in domestic investment or an increase in borrowing from abroad. All else equal, it must therefore reduce the capital stock owned by Americans and reduce future income.

[8] "A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003, Macroeconomic Advisers, LLC, www.macroadvisers.com.

proposal would attract funds to the corporate sector, those funds may simply generate one-time windfall gains in corporate stock without affecting investment. Any increase in stock values would raise consumption somewhat and would serve to reduce private saving. Fourth, to the extent that funds are channeled to the corporate sector, fewer funds may be available to finance investment by unincorporated business and S-corporations. To the extent that interest rates rise, investment in interest-sensitive sectors like housing may decline.

5. Increase in partial expensing

Expanding the partial expensing provision is unlikely to generate much in the way of new investment. Although there is an established research finding that, on average, cuts in the cost of capital raise investment, there is -- to my knowledge -- no evidence that demonstrates that such policies work well *in the presence of substantial non-utilization of existing capacity.* That is, the key question is not whether such incentives work well under average conditions, but whether they work well under acute conditions--with low investment and low capacity utilization.

Intuition suggests that under current circumstances firms are not likely to be very responsive to changes in investment subsidies. For example, despite generous subsidies to new investment embodied in the 2002 stimulus act (including the provision to allow 30 percent partial expensing in the first year), and despite low inflation (which reduces the cost of investing because it raises the value of nominal depreciation allowances in the future) and low interest rates, investment has remained constant or fallen over the last few years. If an increase from zero to 30 percent partial expensing had such a small effect on investment, it is hard to see how increasing it more would cause an investment surge.

6. Effects on small business

A key concern for policy makers is the impact of the tax cut plans on small businesses. The proposals in question would have a variety of effects on the small business sector and it is not at all clear that the sector would come out ahead.

- Under the President's growth and jobs more than half (51.6 percent) of tax returns with small business income would receive a direct tax cut of $500 or less in 2003.[9]

- The expansion of small business expensing options will undoubtedly reduce the cost of capital for some small businesses and encourage them to invest more. Note, however, that this occurs only a limited range of investment and the subsidies are taken back when investments reach a higher level.

- Lower marginal tax rates will improve cash flow and reduce taxation of income from old projects for some businesses but as noted above it will raise the cost of capital for new investments and thus may reduce new investments.

[9] For further discussion of the effects on small businesses, see Andrew Lee, "President's Radio Address and Other Administration Statements Exaggerate Tax Plan's Impact on Small Businesses," Center on Budget and Policy Priorities, January 18, 2003.

- The dividend proposal would divert capital from the small business sector and put upward pressure on interest rates, both of which would increase the cost of capital for small businesses and may reduce new investments by that sector.

- A recent study by Cullen and Gordon (2002) find that EGTRRA will reduce the level of entreprenuerial activity by reducing the tax benefits of entreprenuership relative to other economic activity. Accelerating the tax cut or making it permanent may therefore be unlikely to help the small business sector as a whole. Cullen and Gordon (2002) argue that--and present evidence that--incentives to engage in entrepreneurial activity fall when individual income tax rates fall because small businesses can shelter income more effectively than wage earners can. Also, lower tax rates make risky projects relatively less attractive because the government bears less of the risk.. Moreover, when personal tax rates are high, entrepreneurs have the advantage of being able to take losses at high personal tax rates, but if projects succeed they can incorporate and reduce their tax rate.

Appendix

A. National income accounting identities

We follow Mankiw and Elmendorf (1998) in the derivations below. The private sector's budget constraint is given by

(1) $Y = C + S + T,$

where Y is national income, C is private consumption, S is private saving, and T is taxes paid less transfer payments received. National income is also equal to national output, which is given by:

(2) $Y = C + I + G + NX$ {1}

where G is government purchases of goods and services, I is domestic investment, and NX is net exports of goods and services (exports minus imports). Substituting (2) into (1) yields:

(3) $S + (T\text{-}G) = I + NX.$

Another identity implies that

(4) $NX = NFI$

where NFI is net foreign investment, the difference between what Americans invest overseas and what foreigners invest here. Equation (4) simply says that the international flow of goods and services has to be matched by an international flow of funds. Substituting (4) into (3) yields:

(5) $S + (T\text{-}G) = I + NFI.$

The left-hand side of (5) is national saving, the sum of private saving and public saving. The right-hand side is the sum of domestic investment and net foreign investment, which we will call national investment. Thus, equation (5) is the key relation equating national saving and national investment.

Equation (5) can also be used to demonstrate the basic points of section I in the paper. If government saving falls, three things can happen. Private saving may rise to re-establish the equality in (5) at the original level of national saving and national investment. If it does not, however, then domestic investment falls, and/or net foreign investment falls. As long as less than 100 percent of the adjustment occurs via changes in private saving, both national saving and national investment will fall as the deficit rises.

A decline in either domestic investment or net foreign investment will reduce future national income. As Elmendorf and Mankiw (1998, page 17) note: "Reduced domestic investment over a period of time will result in a smaller domestic capital stock, which in turn implies lower output and income.....Reduced net foreign investment over a period of time means

that domestic residents will own less capital abroad (or that foreign residents will own more domestic capital). In either case, the capital income of domestic residents will fall."

B. A Quantitative Example of the Effects of Fiscal Deterioration on Future Income

From January 2001 to January 2003, the CBO's cumulative projected surplus for fiscal years 2002 to 2011 fell by about $5.6 trillion.[10] That reduction reflects the cumulative deterioration in government saving between 2002 and 2011 under the official forecasts. We assume that private saving would rise by about 25 percent of the decline in public saving.[11] This implies that the net capital stock owned by Americans will be $4 trillion (=(1-.25)*5.6 trillion) lower in 2011 than if the fiscal deterioration had not occurred. To translate this change in the capital stock into a change in income, it is necessary to assume a rate of return to the capital. We use an estimate of 6 percent.[12] This implies a decline of real national income in 2012 of about $252 billion (=.06*$4.2 trillion). The implied decline in national income equals about 1.4 percent of projected gross national product in 2012 or about $800 for each person in the United States.[13]

It is also possible to estimate the impact of GDP, which depends on the capital stock employed in the United States, which in turn is financed by national saving plus net capital inflows. The implied $4.2 trillion reduction in national saving above would generate some change in interest rates (possibly zero) and some change in capital inflows. We assume that 33 percent of the decline in national saving is financed by capital inflows.[14] This implies that the domestic capital stock would fall by $2.8 trillion (=(1-.33)*$4.2 trillion) and that GDP would therefore fall by about $168 billion (again assuming a 6 percent rate of return on capital). This decline is smaller in dollar terms than the GNP decline because the capital inflows mitigate the adverse impact on GDP (even though the repayment of those inflows in the future creates a mortgage against future national income).

[10] CBO (2001) projected a surplus of $5.6 trillion. By January 2003, the figure had fallen to $336 billion (CBO 2003).

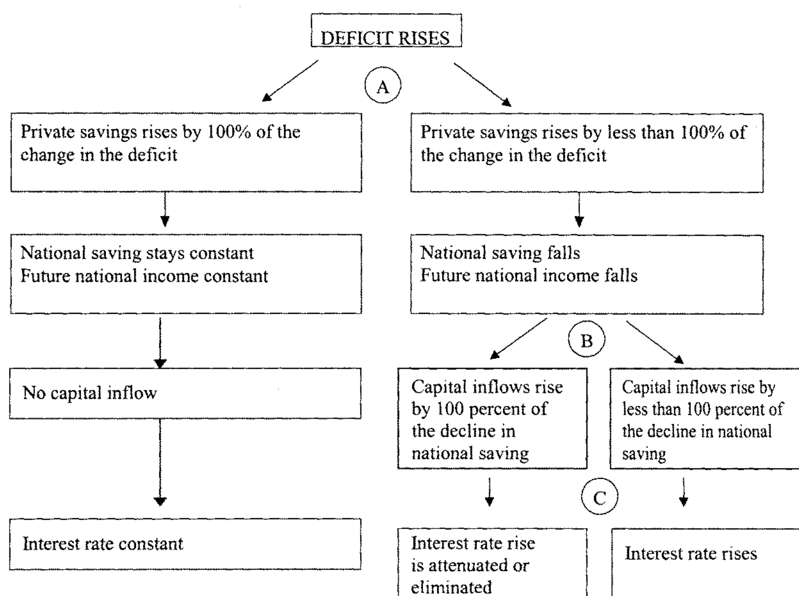
[11] The empirical evidence suggests only limited offsets from private savings in response to budget shifts. Although the precise amount of offset will depend on the specific policy that leads to the deficit, very few articles suggest that the offset will be complete or even close to complete. CBO (1998) concludes that private saving may offset 20 to 50 percent of a shift in the deficit. Elmendorf and Liebman (2000) suggest that private saving would offset about 25 percent of an increase in the deficit. Gale and Potter (2002) estimate that private saving will offset 31 percent of the decline in public saving caused by the 2001 tax cut, but the tax cut is only one or several reasons why the fiscal outlook deteriorated.

[12] Poterba (1998) estimates the pre-tax marginal product of capital to be 8.5 percent for nonfinancial corporate capital. Elmendorf and Mankiw (1999) suggest a more conservative estimate, 6 percent, for the return on aggregate capital.

[13] The projected U.S. population in 2012 is 304.8 million. (See www.census.gov/population/www/projections/ natsum-T1.html).

[14] Over the long-term, changes in net foreign investment flows are estimated to account for between 25 and 40 percent of changes in national saving, though that percent may be rising over time and may be higher for economically integrated European countries than for the United States. For specific studies, see, among others, Feldstein and Bacchetta (1991), Feldstein and Horioka (1980), Obstfeld and Rogoff (2000), and Blanchard and Giavazzi (2002). For an overview of such studies, see CBO (1997).

Figure 1: Deficits, national income, and interest rates



A: Evidence suggests that private saving rises by substantially less than 100 percent of the decline in public saving.

B: Most of the evidence suggests that most of the reduction in national saving manifests itself in reductions in domestic investment, though estimates vary.

C: The effects of deficits on interest rates are controversial. Our views are expressed in Gale and Orszag (2002). The main point for purposes of the current paper is that budget deficits that reduce national saving will reduce future national income (junction A) regardless of the relative strength of the effects of deficits on interest rates (junction C).

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Testimony Before the Senate Finance Committee
Wednesday, February 12, 2003
by
Phil Gramm

Vice Chairman, UBS Warburg

Mr. Chairman and Members of the Finance Committee, I am honored to have the opportunity to testify before you today on a subject of great importance to every American: How can we get the economy into high gear, how can we put our people back to work, and how can we rebuild confidence in our equity markets to strengthen the foundation of our retirement programs and our financial security?

The Downturn

In the 20th century, America experienced two basic types of recessions. In the second half of the century, we experienced inventory cycles. On a more or less regular basis, economic signals were mixed up and unsold inventories mounted. Orders were cut back, the economy retrenched, and over time the excess inventories were consumed. In time, orders would flow again and the economy would recover. In such an environment, it was literally true that the bigger the boom that built up the excess inventories, the bigger the bust that followed. The deeper the recession, the stronger the recovery would be when it took hold.

In the first part of the 20th century, America experienced a series of financial panics due to the difficulty of converting bank deposits into currency and variations in the demand for money generated by the seasonal nature of agriculture.

The downturn we suffer from today is quite different. It is largely the product of a speculative bubble in the equities market. In fact, it is only a small over-statement to say that the financial panics of the 19th and early 20th century were a by-product of an agricultural economy, and the inventory cycles of the middle and late 20th century were the by-product of an industrial economy. The current downturn can be categorized with only a slight exaggeration as the first post-industrial recession in American history.

This is relevant because while we know a great deal about financial panics and inventory cycles, we find ourselves today in less charted waters. Consumption spending has been largely unaffected by the downturn, and the housing boom continues largely unabated. Wage rates have continued to rise as have total wages, even as unemployment has gone up. The current downturn is almost exclusively a product of a collapse in investment.

All this suggests that since consumption has stayed strong throughout the downturn, traditional pump priming to stimulate consumption will probably be ineffective as an economic stimulant. Since weak investment spending is the problem, any effective stimulus plan should have stimulating investment as its primary goal.

The President's Stimulus Plan

By sheer fiscal size alone, the President's proposal will have a very modest impact, since over a ten-year period its aggregate value is less than 2.4% of projected current services federal spending. The strength of the President's proposal is largely in the incentives it creates for new investment spending -- investment funded by private funds that are not now being invested.

The elimination of the double taxation on dividends will have a positive and significant impact on private investment, raising the after-tax return on capital and increasing investment. The elimination of the double taxation on dividends in and of itself should produce a one-time increase in aggregate equity values in the range of up to 5%. The overall efficiency of investment expenditures in both the short and long-term will improve as the current distortions, which encourage corporations to reinvest earnings even when rates of return on investment outside the company exceed internal rates of return, are eliminated. Eliminating the current bias against the payment of dividends will increase dividend payments and make the internal condition of corporations more transparent. The elimination of the double taxation on dividends will help small businesses that are currently discouraged from adopting a corporate structure even if it would allow them greater access to capital. It will eliminate the current tax bias against equity investment, which has encouraged non-economic use of debt rather than equity and made many corporations more vulnerable during downturns. The elimination of the dual taxation on dividends is both an effective stimulant and sound economic policy, which will speed up the recovery and increase longer term growth.

The President's proposal to accelerate the tax cut scheduled to occur in 2004 and 2006 will not alter middle and long-term revenues but will stimulate the economy. The highest tax rate is, in reality, the small business tax rate since the earnings of proprietorships, partnerships and sub-chapter S corporations are taxed at the highest individual rate. Dollar for dollar, accelerating the reduction in the highest rate is probably the most effective stimulus in the President's plan.

Had Congress anticipated how sluggish the recovery would be, it almost certainly would have implemented the tax cut more rapidly, and I urge you to accelerate the entire tax cut and make it retroactive to January 1, 2003. In a static sense, revenues will fall this year, but the longer-term revenue picture, even in a static model, will remain unchanged since the tax cuts will occur anyway in 2004 and 2006. If the recovery can be strengthened, the mid-term revenue picture will be dramatically enhanced. With estimated revenue losses due to the recession this year projected to equal five times the average annual cost of the President's stimulus proposal, the potential gains to be derived from enhancing the recovery are obvious.

Tripling the level of investment expenditures by small business that can be expensed and charged against current earnings will encourage small businesses to retool and, in the process, help grow the economy now.

The uncertainty surrounding the current recovery and the lack of predictability of its behavior strongly argue for a more activist policy. If the recovery could be accelerated, net additional job creation over the next three years in the two million

range is not unachievable. Anything that helps to restore the $6.7 trillion decline in equity values, which has occurred over the last three years, will greatly benefit the economy and the federal treasury. The sooner a stimulus package is passed the better. All of its provisions should be made retroactive to January 1, 2003 for maximum short-term effect. Finally, let me reiterate that lagging investment is the problem and those provisions that directly affect investment will have the greatest impact.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

FEBRUARY 11, 2003

This hearing is the second in a series of hearings on economic growth and job creation. Last week, Secretary John Snow presented the revenue proposals in the Administration's budget. The budget proposals included the President's plan for economic growth and job creation. Today, we focus on the President's package once again, but limit our focus to incentives for consumption. We will expand our focus to cover not only the Administration's plan, but others put forward by members of the House and Senate.

It is clear that we have experienced a serious decline in investment. Everyone has heard the stories like those I've heard from folks in Iowa. Let there be no mistake about it, we face a heavier lift on the investment side. With few exceptions, manufacturing is flat. Everyone knows about the recent history of the stock market. In the meantime, as investment has sagged, the American consumer has kept the economy afloat. With the lowest interest rates and the largest tax relief package in a generation, the consumer fortunately has had the resources to counter the slowdown in investment.

In this hearing, we will focus on the status of the consumption side of the economy. We will examine proposals for maintaining the level of consumption. The witnesses will testify to the efficiency of these proposals, their short-term benefits and long-term implications. I would like to reiterate a couple of points from last week's hearing. One, all proposals are on the table as we seek a bipartisan growth package. Two, although we have split the topic into incentives for consumption and investment, the two are necessarily linked. We should not arbitrarily divide workers from the business owners, or consumption from investment. Capital is the life blood of businesses small and large. It is just as true that businesses need customers. As Secretary Snow put it, the two concepts form a circle that makes up the economy.

Federal fiscal policy does not exist in a vacuum. There are consequences from our actions in Washington that ripple through to the capitals of our 50 states. On the one hand, our system of federalism does not make the federal government the insurer of all fiscal decisions made at the state level. State and local officials make their own fiscal policy. It is their right and their responsibility. On the other hand, we in Washington need to be cognizant of those areas of fiscal policy where we are partners with state and local governments.

Today, we are pleased to welcome four distinguished witnesses. Addressing the issue of consumption incentives generally are two veteran participants in economic policy debates, Stephen J. Entin, and Peter R. Orszag. Addressing the issue of the state and local role are Oklahoma State Senator Angela Monson and Chris R. Edwards, another veteran of economic policy debates.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

FEBRUARY 12, 2003

This hearing is the third in a series of hearings on economic growth and job creation. Last week, Secretary John Snow presented the revenue proposals in the Administration's budget. Yesterday, we examined proposed incentives for consumption. Today, we turn to proposed incentives for investment. No would dispute the fact that it has been a rough period of almost three years for the investment side. The stock exchanges, led by the NASDAQ, followed by the Dow and the S&P, have tumbled. The NASDAQ peaked at 5048.62 on March 10, 2000. Yesterday it closed at 1,295.46. That means the NASDAQ is worth about 25 percent of what it was worth three years ago. The Dow is worth about 67 percent of what it was worth over three years ago. Today, the S&P 500 is worth about 54 percent of what it was worth about three years ago.

Everyone acknowledges the effect of the ″bubble″ of the late nineties. No one can mistake the impact of the corporate scandals of the late nineties and early part of this decade. Clearly, the tragic events of 9-11 and the war on terror have had their effects. There's no doubt investors, large and small, institutional and individual, have had a rough three years. I'd like to pause and ask a question. What, if anything, can we, as Finance Committee members, do about it. Is there fiscal policy that can help right the ship of the capital markets? Now, over the last few years, the stock market drop has been accompanied by a decline in business investment. Commerce Department data show that business investment peaked in the second quarter of 2000. That's almost three years ago. Purchases of equipment and other

business assets have flattened out or dropped. Too many factories are dark Too many workers are idled. Too many workers worry that their job might be the next one lost. Again, I will pause and ask a question. What, if anything, can we, as Finance Committee members, do about it. Is there fiscal policy that can help move up the level of business investment?

The good news is both Democrats and Republicans recognize the problems with the dramatic decline in investment. There are differences, hopefully bridgeable, in how we tackle the problem of declining investment. The President's package is, as he told me in the White House, "bold" on investment incentives. The President is breaking new ground by proposing elimination of the double taxation of dividends. It could be argued that the President's boldness has made his growth proposal an attractive target for his detractors. Many of the alternative proposals by are, by design, thin on the investment side and short-term. As we begin to examine the investment side, I'd say to the skeptics, think about the numbers I recited above. Think about what has happened to the stock market. Think about the impact on investors, retirees, and all those who invested in the stock market. Think about those factories and plants that are dark. As you criticize the President's plan, which aims to improve market capitalization over the long-term, I'd ask what alternatives on the investment side do you propose.

In today's hearing, we will focus on the status of the investment side of the economy. We will examine proposals for raising the level of investment. The witnesses will testify to the efficiency of these proposals, their short-term benefits and long-term implications. Today, we are pleased to welcome four distinguished witnesses. Two are distinguished former members of the Congress who had key roles in making fiscal policy over the last two decades. We welcome former Senator Phil Gramm and former House Budget Committee Chairman and Director of OMB, Leon Panetta. Both of these long-time public servants have moved on to the private sector. Phil is now Vice Chairman of UBS-Warburg. Leon is now co-director of the Panetta Institute for Public Policy and serves on many boards, including the Board of Directors of the New York Stock Exchange. In addition, we have two distinguished veterans of economic policy debates, Kevin Hassett and William Gale. I look forward to the their testimony.

Evaluation of Proposals for Economic Growth and Job Creation: Incentives for Investment

Testimony Submitted
to
United States Senate
Committee on Finance

February 12, 2003

Kevin A. Hassett*
AEI
Resident Scholar

*Dr. Kevin A. Hassett is a resident scholar at the American Enterprise Institute. Prior to joining AEI, he was a senior economist at the Federal Reserve Board.

Chairman Grassley, ranking member Baucus and members of the committee, it is a great honor to be afforded the opportunity to speak with you today. We come together at an important moment in the history of our great country. While the economy appeared to enter a recovery early last year, economic activity has subsequently slowed. As the Federal Reserve has noted, geopolitical risk is currently high and threatens to reinforce the negative momentum of the fourth quarter of 2002, perhaps even pushing our economy back into a recession. In addition, longer-term pressures provide strong economic headwinds. It is wholly appropriate that this body should meet at such a time and debate the potential of fiscal policy to soften or eliminate future hardships.

President Bush has proposed a significant change in the tax code in response to these current challenges. The President's plan has many components, but one---the reduction of the composite tax on corporate income---has ignited a great deal of conflicting opinion. I shall devote the lion's share of my remarks to the clarification of the plusses and minuses of eliminating so-called "double taxation." I also hope to indicate why I believe strongly that the proposed reduction in the composite tax on corporate income is a worthy and pressing objective.

Understanding the Economic Effects of the Current System

Under present law, a corporation that earns a dollar must pay 35 cents of corporate tax. If the company then remits the remaining 65 cents to a shareholder in the form of a dividend, the shareholder must pay an additional tax. Many dividends are received by those who pay the top marginal income tax rate of 38.6 percent, and the total tax paid on a dollar of corporate income can be more than 60 percent. If one accounts for state income and corporate taxes as well, the total tax can be much higher.

Should the tax be that high? Economists have employed sophisticated theoretical and computer models to study the optimal design of efficient tax systems, and have almost unanimously concluded that the optimal tax on capital income should be zero.[1] This result is quite simple. Taxes on capital have a significant effect on the change in capacity and economic growth, and even small growth distortions can compound into large disturbances. If one had to pick an area in our existing tax code where current practice was farthest from the accepted ideal, the double tax of corporate income would likely be one of the first candidates.

Economists do not occupy themselves with the study of optimal efficient tax systems for the mere pleasure of it. Indeed, I can report from the front lines that the endeavor is rarely pleasurable. But deviations from efficient design can have painful and significant real-world consequences. Surveying our own current system, a number come to mind.

First, the double taxation of corporate income discourages investment in equipment and structures. The high dividend tax raises the cost of funds to firms, increasing the hurdle rate for new projects. The accompanying reduction in capital spending reduces economic growth and interferes with the creation of new jobs.

Second, the especially high tax on dividends encourages firms not to pay them. Firms that accumulate significant internal cash must then be carefully monitored by

[1] For a recent review, see Judd, K.L. (2001), "The Impact of Tax Reform in Modern Dynamic Economics," in K.A. Hassett and R.G. Hubbard, eds., *Transition Costs of Fundamental Tax Reform.*

shareholders to make sure that the funds are allocated responsibly. As we have learned painfully in recent years, managers may not always act in shareholders' best interest. High dividend taxes exacerbate accounting problems.

Third, the asymmetric treatment of debt and equity encourages heavy debt loads and increases the overall level of risk in the corporate sector. Firms that borrow to finance investments are allowed under current law to deduct interest payments associated with that debt. Dividend payments are not deductible. This encourages firms to use debt finance whenever possible. When firms have large debt loads, they are much more likely to enter bankruptcy during difficult times.

Finally, the relatively unfavorable position of the U.S. relative to the rest of the world is a significant competitive disadvantage. The idea that high capital income taxes can be harmful to economies has received a fairly broad acceptance among our trading partners. Indeed, most countries have already enacted a policy similar to that proposed by President Bush. Since the U.S. has lagged behind, we now find ourselves in the uncomfortable position of being second only to Japan in the degree to which we tax corporate income. As can be seen in Figure 1, which plots the combined corporate and dividend tax across countries, the evidence is striking. As Figure 2 demonstrates, the result is not solely attributable to the double tax on dividends. The U.S. corporate tax rate is second from the top as well.[2]

These data should provide food-for-thought for those who would contend that the reduction in double taxation disproportionately benefits the wealthy. If that were true, why do Scandinavian countries with historically strong social welfare objectives tax corporate capital at a lower rate than ours? The answer is simple. High tax rates encourage firms to locate elsewhere. When this occurs, shareholders may come out ahead, but workers will not. The best policy for a country is to make itself as attractive as possible to capital. If it does succeed in keeping its own capital at home and luring foreign capital in large quantities, everyone will benefit. Workers will have higher wages, government will receive higher tax revenues, and investors will reap higher returns. The U.S. and Japan are among the few countries not to have recognized this.

One should not take these tax disadvantages lightly. Under current law, for example, a U.S. firm intent on paying dividends has to have more than double the after-corporate tax profit of a Norwegian firm in order to offer a taxable shareholder the same after-tax cash flow.

Understanding the Impact of the President's Proposal

The President's plan has an intuitive appeal to it. Corporate income that has been taxed once will not be taxed again. It will not be taxed at the shareholder level if the corporation uses its income to pay a dividend. Capital gains that are attributable to the retention of after-tax corporate income will also not be taxed. As such, the plan is not just an elimination of dividend taxes. Many capital gains will be untaxed as well.

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[2] A number of countries have recently stepped away from imputation systems, but after significantly lowering their corporate tax rates. These steps were viewed as simplifications. This highlights the fact that it is not the "double tax" that presents the problem, but the combined tax rate on corporate income.

The effect on investment. The literature relating tax factors to firm capital spending was reviewed recently by Hassett and Hubbard (2002).[3] We found that a large literature has often identified strong effects of tax policy on investment behavior. However, that conclusion relied on studies that mostly used corporate-level tax policies for identification, and does not necessarily imply that dividend tax reductions will have the same effect.

The literature on dividend tax policy and investment has had a rather contentious history. Theoretically speaking, it is possible to derive cases where dividend taxes have a large effect on investment, but other cases exist that are equally plausible that suggest that dividend taxes have a smaller effect. An early and pathbreaking study by Poterba and Summers (1985) concluded, "our results suggest that dividend taxes reduce corporate investment and exacerbate distortions in the intersectoral and intertemporal allocation of capital".[4] A more recent study that I coauthored with Alan Auerbach of the University of California at Berkeley found evidence that supported somewhat smaller economic effects of dividend tax reductions.[5]

Accordingly, it is appropriate given the academic literature to be somewhat cautious concerning the likely investment effect of the President's plan, and to account for the eventuality that perhaps as many as half of firms will respond in a small way. Calculations that I have performed confirm the recent testimony of the Chairman of the Council of Economic Advisors that the reduction in the net cost of a new equipment investment associated with the President's proposal is in the range of 4 to 7 percent.[6] If one is willing to assume that state and local taxes will also be eliminated in response to the federal action, the effects can climb higher. To put these reductions in perspective, the low end of Dr. Hubbard's range is approximately the same reduction in the cost of new investments achieved by last year's stimulus bill that included temporary partial expensing. The high end of the range provides about double the stimulative effect of the 2002 temporary partial expensing provision.[7]

In other words, the economic impact of the plan is clearly substantial.

The effect on debt-equity ratios. The effect of double taxation on debt-equity ratios has been recognized to be an important theoretical concern for decades. Remarking on the theory in their famous textbook, Atkinson and Stiglitz compare a classical system like our own to one that integrates corporate and personal taxes (an "imputation" system). They remark that "the switch from a classical system to imputation may make a substantial difference" and equity finance may be much more

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[3] Kevin A. Hassett and R. Glenn Hubbard (2002), "Tax Policy and Investment," in A. Auerbach and M. Feldstein eds., *Handbook of Public Economics*, volume 3, pp 1293-1338.

[4] Poterba, J.M., and L.H. Summers, "The Econonomic Effects of Dividend Taxation", (1985) in E. Altman and M. Subrahmanyam, eds., *Recent Advances in Corporate Finance*, pp. 227-284.

[5] Auerbach, A.J., and K.A. Hassett (2003), "On the Marginal Source of Investment Funds," *Journal of Public Economics*, 87, pp. 205-232.

[6] Testimony of R. Glenn Hubbard before the Senate Budget Committee, February 3rd, 2003. Other calculations suggest that the impact on incentives to invest in nonresidential structures is much greater than that, but the empirical link between the marginal incentive to invest and structures investment is much weaker.

[7] The incentive effects of the Job Creation and Worker Assistance Act of (2002) were discussed in , Cohen, D.S., Hansen, D.P. and K.A. Hassett (2002), "The Effects of Temporary Partial Expensing on Investment Incentives in the U.S.," *National Tax Journa,l* Volume LV, *No. 3, pp 457-466.*

likely.[8] Early empirical work failed to find a significant effect of marginal tax rates on finance, but recent studies have been more successful finding a link. In a recent review article, Duke economist John Graham notes that higher marginal tax rates tend to increase debt levels---the effect predicted by theory.[9]

One should expect the President's proposal to have some effect on debt-equity ratios and increase the reliance of firms on equity finance. The exact size of the effect, however, is difficult to gauge from existing work.

The effect on payout rates. Economist James Poterba has studied the effect of dividend taxes on payout rates.[10] He found that payout tends to respond sharply to swings in marginal tax rates. His estimates suggest that the increase in dividend payout that would occur following the adoption of the President's plan could be in the neighborhood of 20 percentage points or larger. Such an increase should make equities an interesting alternative to short term bonds for investors who are interested in a steady cash flow. Since the recent accounting scandals have already induced firms that do not pay a dividend to consider doing so, the likely increase in yields may be larger.

The effect on the financial markets. The value of a share of stock should be equal to the value in today's currency of all future after-tax dividend payments. Under these conditions, a reduction in dividend tax payments could lead to significantly higher valuations for equities. On the other hand, if the reduction in taxation stimulates a wave of new investment, new competitors may be encouraged to enter and compete away the profits of existing firms. If the plan is expected to have a large investment effect, then it will not have a large stock market effect. Conversely, those who claim the bill will not have a stimulative effect cannot at the same time argue that it will not influence the stock market.

Even accounting for this effects, it is easy to generate positive equity movements similar to those reported by various sources in the range of 8 to 10 percentage points.[11]

One other valuation point is worth noting. Some assets (real estate investment trusts, municipal bonds) currently have a special tax status. The proposal does not change that status, but it does reduce the differential advantage that these assets have over equities. In theory, this should not have a significant impact on the value of the assets in question unless they have a special "niche" value, as might be true if the asset's returns have a very unusual correlation with other assets. An asset's price depends on its own fundamentals. The cash flows of REITS and municipal bonds are not affected by the proposal. Accordingly, economic theory would suggest that we should see an equity price response for the assets that have the changing law, but not necessarily a negative response for those that do not see their tax rules changed.

The effect on the value of deductions and credits. A final and important complication is the effect of the President's proposal on the value of deductions and credits. A tax mechanism that shields income from taxation at the corporate level may

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[8] Atkinson, A.B., and J.E. Stiglitz (1980), *Lectures on Public Economics*, p. 141.
[9] Graham, J., "Taxes and Corporate Finance: A Review," Duke University (2003). Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=264516.
[10] Poterba, J.M., "Tax Policy and Corporate Saving," (1987) in *Brookings Papers on Economic Activity*, Volume 1987, Issue 2.
[11] For example, Ed Hyman, chairman of ISI Group, stated in an interview that his calculations suggested that the President's proposal would lead to about an 8 percent increase in the stock market. MSNBC transcript available at http://www.msnbc.com/news/856007.asp.

expose it to taxation at the individual level. As this effect may be important, a simple example is worth exploring in greater detail. Suppose that a firm has $110 in income, and it has a deduction that it can claim that is worth $10. If the firm claims the deduction, then it has lowered its corporate income to $100. It will then pay $35 in corporate tax, and it can distribute the remaining $65 as a tax-free dividend. Now suppose that it also distributes the $10. Since the $10 was shielded from the corporate tax (avoiding $3.50 of corporate tax liability), the shareholder must pay dividend tax. If the shareholder's tax rate is 35 percent, then the value of the deduction is zero. It just moves the tax liability of $3.50 from the firm to the shareholder.

This effect becomes an issue when the firm's true economic income is much different from the definition of income used by tax authorities. However, to the extent that the problem does emerge, my best estimate is that corporations will retain earnings that would create dividend tax liabilities if distributed. If this is true, then the value of a deduction becomes the difference between the corporate tax rate and the capital gains rate. Since capital gains are not taxed upon accrual, the appropriate rate to use for that calculation is the capital gains rate that is adjusted for the benefit of deferral (perhaps a rate of about 10 percent), so in practice this effect will likely be small. If, on the other hand, we observed firms paying significant taxable dividends after the President's proposal became law, then this effect might be larger.

One other fact is worth noting. The reduction in the value of a deduction does not increase the marginal tax rate faced by firms. Indeed, even firms with significant tax shields are better off under the President's proposal. A useful analogy would be a tax reform that lowered the income tax rate and removed a special education deduction. This would, if well designed, leave taxpayers with more cash in their pockets but a smaller incentive to spend money on education as opposed to some other good. As a general rule, economists have viewed such reforms favorably on efficiency grounds.

Alternative Investment Policies

A number of other tax policies have been considered that also work to stimulate investment.

Expensing and/or an Investment Tax Credit (ITC). Expensing and ITC's reduce the cost of purchasing a new investment. As mentioned earlier, the dividend tax proposal has conservatively the same effect on the incentive to invest in equipment as the recently passed 30 percent partial expensing provision. Expensing and ITC's have the benefit that one must purchase a new piece of equipment in order to qualify for the tax reduction, thus eliminating the tax benefit for "old capital" that is already in place. On the other hand, these provisions typically are too small to change the relative position of the U.S. in the world average tax hierarchy. Since that relative position can have an important impact on location decisions, the incentive for firms to locate profits abroad will remain strong. The other positive effects on debt-equity ratios and dividend payouts would also disappear if this alternative policy were adopted.

Some advocate *temporary* ITC's or expensing. When tax benefits for investing are temporarily high, a firm has an incentive to invest before the special provision expires. This effect can increase the short-run stimulus of the bill. Temporary tax reductions also have a smaller long-run revenue cost. It is my view, however, that

temporary provisions are unwise. This is because firms must keep an eye on their long-run trajectory when making capital spending plans and temporary cuts do not change the long run target capacity. Accordingly, there will be a large difference across firms in the ability to move investment forwards, and significant distortion associated with temporary measures. In addition, when the temporary measure is removed, a "hangover" wherein investment is temporarily lower is likely. Even after the hangover is over, firms may decide to hold off capital purchases in anticipation of a future adoption of other temporary measures. Such a world is best avoided.

As revenue costs are a concern, it is natural to compare the various alternatives with an eye on their costs. One must be careful comparing the revenue costs of dividend tax reductions and ITC's. A dividend tax reduction lowers dividend taxes paid forever. Thus, the decline in tax revenue associated with it in the eleventh year is likely greater than the decline in revenue in the tenth year. The present value (looking forward for all of time) of revenue reduction for the dividend policy must be greater than that for these investment policies because the dividend tax reduction is also granted to "old" capital. Since policy can change over time, the dividend policy might nonetheless be the more cautious way to reduce the cost of investment, since the revenue cost is spread out over so many years.

Corporate tax rate reduction. A more direct way to deal with the increasing pressure from foreign tax competition might be to reduce the corporate tax rate to a level more in line with those of other countries. A reduction in the corporate tax rate would diminish the benefit of interest deductions, but likely have little impact on dividend payout rates.

Conclusion

The economics of the President's proposal is very sound. While the package is not designed solely to be a short-run stimulus, it likely will have positive effects in the short run that may easily be larger than those of the recently passed stimulus measure. It would do so without introducing a longer-run investment "hangover" while at the same time correcting significant imbalances in the current financial structure of corporations. These imbalances---the subsidy to debt finance and penalty for dividends---are surely unintended consequences of current policy.

Figure 1[12]:

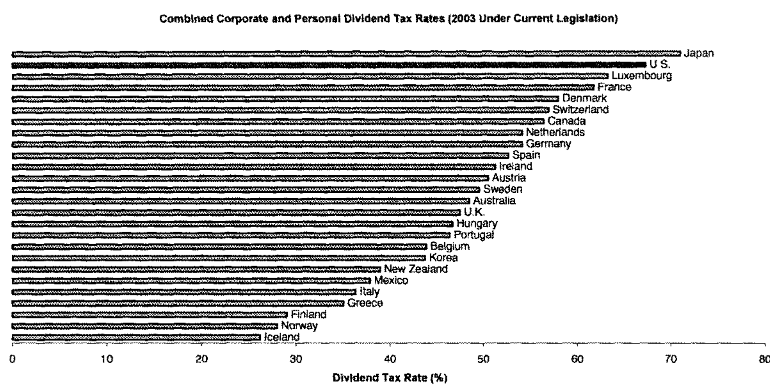
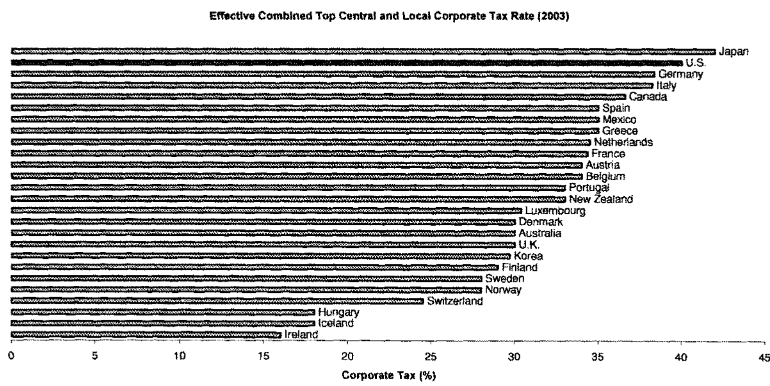
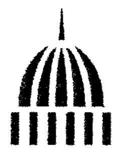


Figure 2[12]:



[12] Sources: Effective Corporate Rates are from the KPMG Corporate Tax Rate Survey (Jan 2002) and Personal Rates are from the OECD. 2001 Data Used: Australia, France, Greece, Japan, Korea, Luxembourg, Sweden, Switzerland, UK. 2003 data for Canada from The Finance Ministry of Canada, Belgian Data from Price Waterhouse Coopers and Italian data from Deloitte. I would like to thank Chris Edwards, Director of Fiscal Policy at CATO for supplying OECD methodology and data.



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TESTIMONY OF

SENATOR ANGELA MONSON

ASSISTANT MAJORITY LEADER,
OKLAHOMA SENATE

PRESIDENT,
NATIONAL CONFERENCE OF STATE LEGISLATURES

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING

DEVELOPING A PARTNERSHIP BETWEEN STATES AND THE FEDERAL GOVERNMENT TO SPUR ECONOMIC GROWTH AND JOB CREATION

BEFORE THE

FINANCE COMMITTEE

UNITED STATES SENATE

FEBRUARY 11, 2003

Chairman Grassley, Ranking Member Baucus and distinguished members of the committee:

I am Oklahoma State Senator Angela Monson, president of the National Conference of State Legislatures. I serve as Assistant Majority Leader of the Oklahoma State Senate, and have previously served as chair of the Senate Finance Committee. I am pleased to testify before you today on the fiscal condition of the states and to discuss how we can develop a partnership between the federal government and the states to spur economic growth and job creation.

INTRODUCTION

State budgets are under siege. The sluggish national economy, declines in the stock market, contraction in the manufacturing and high tech sectors and soaring health care costs have combined to undermine state revenues and place unprecedented demands on state spending. States have experienced three straight years of budget shortfalls, outpacing the rainy day funds that we had accumulated during the economic expansion of the late 1990s and requiring us to take extraordinary actions to balance our budgets. And the gaps keep growing. In a survey that we released last week, NCSL reported that the states' cumulative budget gap for fiscal year 2003 has grown more than 50 percent in the last two months to nearly $26 billion. This is only a few months after states had closed most of an estimated $50 billion gap. The projected gap for fiscal year 2004 looms even larger. With only 39 states reporting, the aggregate shortfall is more than $68 billion. Taken together, the multi-year cumulative budget gap from fiscal year 2002 to fiscal year 2004 exceeds $180 billion.

For the most part, the sharp decline in revenues and increased spending demands that states are experiencing are not unlike those facing the federal government. However, there is one critical difference. States, unlike the federal government, must balance our operating budgets and cannot carry a deficit over from one year to the next. As a result, states cannot afford to take farsighted measures that would temporarily cause a deficit but would improve the economy - and our own fiscal situations - over the long term. Instead, the actions we take to balance our budgets tend to counteract economic growth. As federal lawmakers attempt to spur economic growth, we find ourselves in the tragic position of working against you, eliminating jobs, cutting health and welfare programs just when our constituents need them most, raising taxes when more consumer spending is required, and reducing our investments in infrastructure and economic development.

It doesn't have to be this way. We commend you for holding these hearings and for seeking our testimony on how to design a partnership with states that will create the conditions for short-term economic recovery and long-term growth. I understand that the purpose of this hearing is to discuss means to boost consumer spending and I will focus my remarks on that point. I will also provide some brief comments on the purpose of tomorrow's hearing on stimulating business investment. First, however, I would like to discuss with you the fiscal conditions that I, and my colleagues across the country, are facing in our own states.

FISCAL CONDITION OF THE STATES

Last week, NCSL released a survey that shows states are facing a cumulative budget gap for the current fiscal year of nearly $26 billion. This is only a few months after states had closed most of an estimated $50 billion gap. Some states are still able to tap rainy day funds or can shift funds from other state accounts. Most states have cut spending. Twenty-nine states have imposed across-the-board budget cuts. No area of state spending has been spared; elementary and secondary education, higher education, Medicaid, corrections and funds to local governments have all experienced cuts. This year, eight states have already laid off state employees and five have enacted furloughs. Nine states reported that they have delayed planned capital projects. This information is for the current fiscal year and does not reflect actions taken to close prior-year budget gaps. As the fiscal year draws to a close, states face fewer and fewer options for raising revenues or cutting spending. The cuts that take effect the quickest - fee and tuition increases and cuts in benefit programs - take money directly away from consumer spending.

I would like to give you a few examples of the actions that states are taking to balance our budgets and that are countering your actions to provide economic growth. Arizona has eliminated 1,800 full time positions.

Connecticut has laid off 2,800 state employees and is expecting to layoff another 1,000. Maine is requiring all state employees to take three furlough days. Wisconsin has placed a hold on all new construction projects and declared a moratorium on requests for new space or renewal of space leases. In Nevada, the governor has proposed increasing cigarette and liquor taxes, the business license tax and fees that are paid to the Secretary of State. Maine has assessed Medicaid providers and delayed the filing period for its business equipment tax reimbursement program. In addition, Maine - one of only three states that explicitly passed legislation to provide the bonus depreciation allowance under last year's economic stimulus legislation - reversed course and has since decoupled. In my own state of Oklahoma, state employees have been furloughed and all state agencies have been subject to an across-the-board reduction of 6.5 percent. Because of declining revenues for a dedicated education fund, the K-12 education budget has taken a hit of almost eight percent.

There is no light at the end of the tunnel. For the 36 states that reported a budget gap for fiscal year 2004 -- eleven states have not calculated their gaps and three did not report a gap -- the cumulative shortfall is more than $68 billion. Half of these states are facing gaps of more than 10 percent of their entire general fund budget. Oklahoma is better off than most, with an anticipated gap of 6.7 percent of our general fund. In addition to spending cuts, in at least half of the states, the governor or a member of the legislature has offered a proposal to increase taxes. Many states, including both Iowa and Montana, may consider increases in cigarette and other so-called "sin" taxes. Montana is considering a wide variety of tax increases, including taxes on rental cars, hotel accommodations and energy. Sales and income taxes are also on the table. Ten states report that an increase in sales or personal income taxes is possible during the state legislative session this year. California is considering an increase in both the personal income tax and the sales tax. The New York legislature is considering eliminating the sales tax exemption for clothing. New Jersey is considering increases in income tax rates and hotel room occupancy taxes.

Before I move on to discussing proposals to spur the economic growth that we so badly need, I would like to answer a criticism that I have frequently heard in recent months. There are some who say that states' fiscal problems are the result of poor decisions that states made during the 1990s, either because we spent too much or enacted excessive tax cuts. I believe that an examination of the facts will show that states acted responsibly. During the 1990s, states saved an unprecedented amount of money in rainy day funds. Every year from 1992 to 2000, states ended their fiscal years with higher balances than they started. States ended fiscal year 2000 with an aggregate balance of more than $47 billion, or more than 10 percent of their general fund budgets.

States also increased spending in such areas as education, transportation and public safety and expanded Medicaid to serve an increasing number of low-income parents and children. During the late 1990s, some of the factors driving our current expenditure growth began to emerge, such as the spiraling costs of health care, out-of-control increases in special education expenditures, the costs for our on-going commitment to standards-based education reforms and court-ordered improvements to our systems of financing public education. But for the most part, we avoided the temptation to use one-time revenues to expand long-term spending and targeted those increases to meet critical needs and one-time expenses. We boosted spending in some areas, such as higher education, that typically receive new revenue during boom times and experience cuts in a downturn.

We also felt that it was appropriate to give surplus revenues back to the taxpayers who paid them. However, as a percentage of personal income, state taxes have remained largely constant throughout the 1990s. From 1995 to 2000, states enacted roughly $35 billion in tax reductions. Even if these tax cuts had never been enacted, the states still would be facing huge budget gaps. As I noted earlier, the cumulative three-year gap is more than $180 billion.

STATE-FEDERAL PARTNERSHIP TO SPUR ECONOMIC RECOVERY

NCSL supports a federal economic stimulus package to spur consumer spending and capital investment and to encourage job growth. Only a long-term, sustained economic recovery will ease the fiscal pressures facing the states. From here, there are two paths that we can follow. The first is to forget the states and

ignore our fiscal crisis. While you extend federal unemployment benefits, we will be cutting job training, health insurance and child care funding. While you cut taxes, we will be raising taxes and fees. The economy will be caught in the middle of a tug or war that states do not want, but do not have the resources to avoid. The second path is to move forward in concert with each other.

Last month, NCSL's executive committee adopted a resolution calling for a state-federal partnership to spur economic recovery. Such a partnership would:

- Recognize the critical link between states and the national economy;
- Ensure that the state-federal partnership avoids unfunded mandates and underfunded national expectations;
- Include tax strategies to spur, not constrain, state investment;
- Invest in capital projects that leverage state and private investment; and
- Provide immediate, temporary relief for states.

PROVIDE IMMEDIATE, TEMPORARY RELIEF FOR STATES

I would like to focus on the last of these points first. Temporary fiscal relief to the states through countercyclical revenue sharing, as proposed by Senator Baucus, or through one-time revenue grants, as proposed by Senator Snowe, would certainly go far in easing the states' fiscal crisis to avert counterproductive cuts in the safety net and tax increases that sap consumer spending. We support their efforts and look forward to working with you, Mr. Chairman, and with the rest of the committee to incorporate their proposals into economic stimulus legislation.

In addition, our executive committee resolution identified several more targeted approaches to ease the states' fiscal burden.
These include:

- Preventing unspent funds for the State Children's Health Insurance Program from reverting to the federal treasury.
- Preventing the scheduled reduction in disproportionate share hospital (DSH) payments, extending the inflationary increase adjuster to FY 2003-FY2005 and increasing the DSH cap by 3 percent for "low" DSH states.
- Assisting unemployed workers who are seeking employment and encouraging job retention through an increase in mandatory funds for the Child Care and Development Block Grant, with a temporary match waiver.
- Delaying implementation dates, providing temporary waivers or reductions of state matching rates and/or suspension of program sanctions or permitting states to pursue corrective compliance plans.
- Supplementing existing block grants, such as the SSBG or NEGs, for FY 2003 and/or FY 2004.
- Holding harmless states confronted with Medicaid matching rate reductions for FY 2003 and FY 2004 with a temporary, unconditional boost in matching rates for FY 2003 and FY 2004.
- Infusing $3.6 billion in general revenues into the existing Temporary Extension of Unemployment Compensation system.

We commend Senator Rockefeller for introducing legislation to extend the availability of unspent funds for the State Children's Health Insurance Program and Senators Grassley, Baucus, Hatch, Snowe, Bingaman, and Lincoln for cosponsoring this important legislation.

INVEST IN CAPITAL PROJECTS THAT LEVERAGE STATE AND PRIVATE INVESTMENT

A second part of our resolution calls upon the federal government to invest in capital projects that leverage state and private investment. I understand that your hearing tomorrow will focus on investment incentives, so I will keep my remarks on this point brief and point out that we cannot build the economy without maintaining our commitment to infrastructure development. Unfortunately, states find ourselves with no choice but to draw back from that commitment and achieve cost savings by delaying capital projects. On this point, we would also like to commend Senator Baucus for his proposal to enhance highway spending through the issuance of new highway bonds. Expanded federal investments in highways, mass transit and

passenger rail, and in water and wastewater infrastructure projects, especially if it is paired with a temporary waiver of requirements for states to match funding, would make it possible for states to continue with planned capital projects that have been cancelled and to build the necessary infrastructure to accommodate both current and future economic growth.

ADOPT TAX STRATEGIES TO SPUR, NOT CONSTRAIN, STATE INVESTMENT

The difference between states working with, or working against, federal government actions to spur the economy is perhaps most striking in considering changes in the federal tax code. Federal lawmakers from both sides of the aisle have proposed tax changes that are supported by NCSL. For example, NCSL called upon the federal government more than a year ago to accelerate the scheduled increase in the child tax credit. We support a payroll tax holiday that would lift both the employee and the employer share of payroll taxes. We support the use of tax rebates to provide cash that is linked to scheduled reductions in federal marginal income tax rates. We would also support an investment tax credit to spur business investment.

I would like to cite an example of the kind of federal tax change that you should avoid. A major component of last year's economic stimulus legislation was an acceleration of the depreciation schedule for certain investments in equipment. At first glance, it appeared to be a very good way to provide economic stimulus. It provides a high up-front benefit to the taxpayer and encourages near-term investment. In the long run, it avoids exacerbating the federal deficit because depreciation that is claimed now cannot be claimed later. Although the first-year costs to the federal government are high, the ten-year cost was substantially lower.

For the states, however, it was a worst case scenario. Before last year's economic stimulus legislation was enacted, 46 states used the same depreciation schedule as the federal government. If every state had continued to do so, it could have cost states up to $14 billion over a three-year period. Because states must balance their budgets over a one-year or two-year horizon, we were unable to assume cost savings later in the decade to offset the immediate cost. States were faced with a no-win situation. If we conformed to the depreciation bonus, we would have to either raise other taxes or identify additional spending cuts by that amount, putting a damper on the economic growth it was designed to encourage. If we decoupled from the depreciation bonus, we would reduce the effect of the stimulus - and increase complexity for taxpayers, who would be required to maintain two sets of basis calculation for qualifying investments. Most states chose the latter. Sixteen states, as well as the District of Columbia and New York City, passed legislation to explicitly decouple from the bonus depreciation allowance. Only three states passed legislation to conform - and one of those, Maine, has since reversed its course. Currently, taxpayers in all but 17 states cannot claim the full intended benefit, and must keep two sets of books to comply with both federal and state tax laws. Those 16 states have had to make offsetting changes in their budgets to accommodate the costs of the depreciation acceleration. Some state legislatures have not met since last year's federal legislation and have not yet determined whether to conform or decouple, further adding to the confusion for taxpayers.

For this reason, NCSL had supported a credit against federal tax liability for investments in qualifying equipment. An easy rule of thumb to avoid this kind of situation is to provide tax relief and incentives for economic growth through tax credits and other means of changing federal tax liability - rather than definitions of adjusted gross or taxable income - whenever possible.

As you consider tax incentives to spur economic growth, we ask that you keep one goal in mind: to first do no harm. Should you pursue dividend tax relief as proposed by the president, we would like to work with you to avoid substantive changes in IRS reporting requirements upon which states rely, and to maintain a level playing field for tax-exempt bonds. We are also eager to work with you to adopt legislation, such as that proposed by Senator Smith, to lift administrative burdens that inflate the cost of public financing.

We stand ready to work with you, as you consider tax reform measures, to ensure that these are accomplished in a manner that will improve, rather than exacerbate, state fiscal conditions.

ENSURE THAT THE STATE-FEDERAL PARTNERSHIP AVOIDS UNFUNDED MANDATES AND UNDERFUNDED NATIONAL EXPECTATIONS

Also in the category of "first do no harm" is avoiding the imposition of unfunded mandates on the states. Since 1995, NCSL has praised the Unfunded Mandates Reform Act for curbing the practice of shifting the cost of federal laws onto the states. But in the recent past, Congress has exploited loopholes in that law to move away from its spirit and intent. We have entered into a new era of unfunded mandates and underfunded national expectations.

The Help America Vote Act, a vital piece of legislation that will ensure that every one of our citizens has full access to the polls and that every vote is counted, was signed into law just four short months ago. States have less than 11 months to meet the first deadlines for implementing many of the required election reforms. It is imperative that full funding of $2.2 billion be appropriated for fiscal year 2003. In addition, states will need the full authorized funding for fiscal year 2004. Sadly, both the omnibus appropriations bill now being considered in conference and the president's request for 2004 fall far short of providing full funding. Now is not the time to be imposing a new unfunded mandate on the states.

Another new burden that the federal government has recently imposed on states is in the area of homeland security. State and local governments have spent billions of dollars with the expectation of reimbursement from the federal government. The Public Health Security and Bioterrorism Preparedness and Response Act of 2002 required every community water system that serves a population of greater than 3,300 persons to perform vulnerability assessments, but provided funds only for the largest. These assessments will cost hundreds of millions of dollars. Inoculating our first responders and public health officials from smallpox will carry a substantial cost and states may be legally liable for complications that arise. But the only funds that we have seen so far have been insufficient to cover the need and recent proposals to increase funding have come at the expense of other critical law enforcement and public safety needs.

The burdens that unfunded mandates place on the states are extraordinary. Every year, states must appropriate funds to cover tens of billion dollars that the federal government has promised, but failed, to send our way. There is no more vivid example than the Individuals With Disabilities Education Act. More than a quarter century ago, the federal government promised to pay the additional cost for states to provide a free and appropriate public education for special education students. At the time, the Congress authorized payments to the states to cover 40% of average per pupil expenditures, the estimated additional amount needed to educate a special education student. Congress has never lived up to this commitment, and it would require $11 billion in immediate, one-time spending to cover that commitment for the current fiscal year. The Center for Special Education Finance, which is funded by the U.S. Department of Education, has estimated that the actual cost for states exceeds $25 billion per year. That is equal to the entire aggregate state budget gap for fiscal year 2003.

And that is only the beginning. Funding to implement the No Child Left Behind Act is $5 billion short of the authorized amount. Some state estimates of the cost to conform are much higher. New Hampshire has estimated that for every new federal dollar, state and local jurisdictions will need to spend $7 of their own. If these numbers hold true across the country, the one-year cost to implement the No Child Left Behind Act could be as high as $35 billion.

NCSL has done a preliminary analysis of the costs to states for these four mandates and underfunded national expectations - special education, No Child Left Behind, election reform and homeland security. The costs range from a minimum of $26 billion to almost $100 billion. There are some who have suggested that federal assistance to the states would be a handout. That kind of logic not only ignores the reality of state balanced budget requirements, the reasons for our current imbalance, and the need to avoid budget-balancing decisions that put a brake on economic stimulus, but it also ignores the fact that every year, the states appropriate tens of billions of dollars in handouts to the federal government to pay for programs that the federal government has promised but failed to fund.

There is no time like the present to rectify this current imbalance by providing fiscal relief for the states. We stand prepared to work with you to do so as part of an economic stimulus package. NCSL looks forward to working with this committee to enact legislation that will spur economic growth. We can best achieve a rapid economic recovery is if we work together, rather than at cross purposes.

I thank you for this opportunity to discuss these important issues with you today and would be happy to answer any questions.

Testimony on Proposals for Economic Growth and Job Creation

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow in Economic Studies
Co-Director, Tax Policy Center
The Brookings Institution

Testimony before the Committee on Finance
United States Senate
February 11, 2003

Mr. Chairman, Senator Baucus, and Members of the Committee, it is an honor to appear before you to discuss proposals for economic growth and job creation. In evaluating such proposals, it is important to distinguish between the short run and the long run.

- In the short run, a key economic difficulty is that the nation is not fully using the capacity it has available to produce goods and services. As one indication of unused capacity, the capacity utilization rate for December 2002 computed by the Federal Reserve Board of Governors was 75.4 percent, significantly below its average of 81.5 percent for the past three decades.[2] Given unused capacity, the crucial step to higher economic growth in the short run is expanded aggregate demand for the goods and services that firms could produce today. In other words, higher spending would encourage firms to more fully use available resources.

- In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. The challenge is therefore much different: rather than ensuring that we are using all the capacity we have, which is a short-run issue, the long-run challenge is to boost the growth rate of that capacity over time. A primary determinant of how quickly that capacity increases is our nation's saving rate. Higher national saving is reflected in either increased domestic investment or reduced borrowing from abroad, or both. Which of these two effects predominates, in the end, is not very important; either way, Americans end up owning a larger capital stock in the future. The returns to that higher capital stock increase national income in the future. The single most important step that policy-makers could take to raise national saving is to restore long-term fiscal discipline to the Federal budget.

The different needs for the short run and the long run complicate the challenges facing policy-makers, since the appropriate policies for the short run may be exactly the opposite of the appropriate policies for the long run. For example, spurring consumption would arguably be beneficial in the short run, since it would expand the demand for goods and services. But spurring national saving would be beneficial in the long run, since it would finance expansions

[1] Peter R. Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution and a Co-Director of the Tax Policy Center. Much of this testimony draws upon joint work with William Gale. I thank Henry Aaron, Robert Cumby, Robert Greenstein, and Jonathan Orszag for helpful discussions and comments, and David Gunter and Matt Hall for excellent research assistance. The views in this testimony are those of the author alone, and should not be attributed to the staff, officers, or trustees of the Brookings Institution or the Tax Policy Center.
[2] See http://www.federalreserve.gov/releases/G17/Current/default.htm.

in capacity and the capital stock owned by Americans. The expanded capital stock in turn would raise future national income.

My testimony argues that:

- The Administration's tax proposals are not well-designed for boosting growth in either the short run or the long run, since they would have only modest effects on demand in 2003 and would expand budget deficits in the long run. All else being equal, the expanded budget deficits would reduce national saving in the long run, exactly the opposite of what would be needed to boost growth.

- A more auspicious set of policies, given current conditions and the different imperatives for the short run and the long run, would combine a targeted short-term stimulus package with long-term fiscal discipline. In particular, a well-designed and timely short-term stimulus package could significantly bolster aggregate demand in 2003. Such a package should be limited to 2003 only, should amount to about one percent of GDP, and should include:

    - Temporary fiscal relief to the states to mitigate the reductions in expenditures and increases in taxes that states are undertaking;
    - Temporary increased Federal government purchases of goods and services, especially in homeland security;
    - Temporary incentives for businesses to accelerate investments into 2003; and
    - Temporary, progressive tax cuts aimed at those households most likely to spend the funds.

  This short-term package should be coupled with policies to narrow the long-term budget gap, which would provide some additional short-term benefit by putting further downward pressure on long-term interest rates. More importantly, the combination of short-term stimulus and long-term fiscal discipline would best address the economic challenges facing the nation: It would boost demand in the short run and national saving in the long run.

Before examining these points in more detail, it is worth noting that both monetary policy and fiscal policy have already provided a significant amount of short-term stimulus, and many economists do not believe that any further fiscal stimulus is warranted – especially since the history of efforts to stimulate the economy using fiscal policy is not particularly encouraging.

In my opinion, the case for further short-term fiscal stimulus is a close call but remains persuasive. The downside risks to economic performance loom larger than the downside risks of a well-designed stimulus package, in part because the extraordinarily low level of inflation presents asymmetrical risks (given current conditions, further potential reductions in price inflation from its already low level entail larger perils, including the admittedly remote possibility of deflation, than potential increases of the same magnitude). Nonetheless, the debate about whether further fiscal stimulus is even warranted underscores three points. First,

any short-term stimulus package should be enacted as soon as possible, to maximize the likelihood that it takes effect while the economy is still weak and thus that it is in place in time to accelerate the recovery. Second, the stimulus package should be limited in size to about one percent of GDP and well-targeted to boosting demand in the short run. Third, the stimulus package should not significantly exacerbate the long-term budget outlook. As I indicated previously, one reason that it is important not to exacerbate the long-term budget outlook is that budget deficits reduce national saving, which in turn reduces economic growth (all else being equal).

Administration's tax proposals

The Administration has proposed two sets of tax cuts: those included in its growth package and other tax cuts included in the budget. The growth package would, along with other smaller changes, make the 2001 tax cut permanent and exclude dividends and some capital gains from taxation at the individual level. The additional tax cuts in the budget include, most prominently, expanded tax-free savings accounts with no income limits. These proposals do not seem well-designed for either the short run or the long run, since they would fail to do much to boost demand in 2003 and would expand budget deficits in the long run.[3]

A letter released yesterday that was signed by 10 Nobel Prize winners in economics, along with more than 400 other economists (including myself), emphasized:[4]

> "Economic growth, though positive, has not been sufficient to generate jobs and prevent unemployment from rising. In fact, there are now more than two million fewer private sector jobs than at the start of the current recession. Overcapacity, corporate scandals, and uncertainty have and will continue to weigh down the economy.
>
> The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus. As tax reform, the dividend tax cut is misdirected in that it targets individuals rather than corporations, is overly complex, and could be, but is not, part of a revenue-neutral tax reform effort.
>
> Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income.

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[3] For a quantitative analysis of the Administration's growth package, see Macroeconomic Advisers, LLC, "A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003. The report does find a significant increase in demand in the short run, but also finds that the proposals would reduce potential GDP in the long term: "Initially the plan would stimulate aggregate demand significantly by raising disposable income, boosting equity values, and reducing the cost of capital. However, the tax cut also reduces national saving directly while offering little new, permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in federal outlays, the plan will raise equilibrium real interest rates, crowd out private-sector investment, and eventually undermine potential GDP."

[4] See http://www.epinet.org/stmt/2003/statement_signed.pdf.

> To be effective, a stimulus plan should rely on immediate but temporary spending and tax measures to expand demand, and it should also rely on immediate but temporary incentives for investment. Such a stimulus plan would spur growth and jobs in the short term without exacerbating the long-term budget outlook."

That letter was written primarily in response to the Administration's growth package, which was announced on January 7th.[5] More recently, the Administration's budget included a proposal to create new tax-advantaged savings accounts, in the form of Retirement Savings Accounts (RSAs) and Lifetime Savings Accounts (LSAs). Such accounts would significantly reduce revenue when the baby boomers are retired, both because they would shelter substantial (and growing) amounts of assets from taxation and because the encouragement of rollovers from existing tax-deferred saving into the back-loaded RSA saving plans would generate a shift of revenues from outside the 5-year budget window to inside that window. The result would be the loss of tens of billions of dollars per year when the budget is already projected to be under pressure from the retirement of the baby boomers.

Furthermore, the proposed accounts are unlikely to produce a significant increase in private saving: The contributions to the tax-preferred accounts will disproportionately reflect shifts of assets from taxable accounts into tax-sheltered accounts by high-income households, rather than new saving.[6] The vast majority of households – roughly 95 percent – do not maximize their *existing* tax-preferred savings, so expanding the opportunities for such saving is unlikely to generate a significant increase in saving for them.[7] Higher-income households already saving substantial amounts outside of tax-advantaged accounts, however, will likely shift their assets into the tax-sheltered account. The result is little, if any, net increase in private saving. The combined effect of the reduction in government revenue and the modest increase in private saving is unlikely to be a significant increase in national saving, and may well be a decline.

Economic effects of deficit-financed tax cuts

An important aspect of all the Administration's tax proposals -- including making the 2001 tax cuts permanent, the new dividend proposal, and the new savings proposal -- is that they are all deficit financed. The implied revenue losses are substantial: The tax cuts would amount to approximately 1.7 percent of GDP in FY 2013, for example.[8] That 1.7 percent of

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[5] For further analysis of the dividend proposal, see William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," The Brookings Institution, January 13, 2003; and William G. Gale and Peter R. Orszag, "The President's Tax Proposals: Second Thoughts," *Tax Notes*, January 27, 2003.

[6] Even academics who believe that 401(k) plans and IRAs raise private saving have questioned whether private saving will increase significantly if the new proposals were enacted. See Daniel Altman, "Accounts Chock-Full or a Plan Half Empty," *The New York Times*, February 1, 2003.

[7] Carroll (2000) reports that only 4 percent of eligible taxpayers made the maximum $2,000 contribution to a traditional IRA in 1995. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. Estimates in Copeland (2002) suggest that about 3 percent of individuals made the maximum contribution to a traditional IRA in recent waves of the Survey of Income and Program Participation (covering 1997, 1998, and 1999). Craig Copeland, "IRA Assets and Characteristics of IRA Owners," EBRI Notes, December 2002. The 2001 tax legislation, furthermore, included scheduled increases in IRA limits, which are $3,000 this year and are scheduled to rise to $5,000 by 2008. The likely result is that even fewer taxpayers will be constrained in the amount of their IRA contributions than the historical data suggest.

[8] According to the Treasury "Blue Book," the revenue loss in FY 2013 is $299 billion. The Administration did not provide GDP projections for FY 2013, but the CBO estimate of GDP for FY 2013 is $17.851 trillion. The Treasury revenue loss is 1.7 percent of the CBO GDP projection in FY 2003. In addition, the Administration's estimate of nominal GDP in calendar year

GDP figure may understate the permanent cost of the Administration's tax proposals, since it is artificially restrained by failing to address the looming alternative minimum tax problem and since it does not fully reflect the long-term cost of the proposed savings accounts. To put the 1.7 percent of GDP figure in context, the projected 75-year deficit in Social Security is 0.7 percent of GDP.[9] The proposed tax cuts are thus more than twice the size of the Social Security deficit over the next 75 years.

It is important to emphasize that deficit-financed tax cuts are unlikely to have significant positive effects on economic growth in the long term, and may well reduce it. A full analysis of tax cuts that result in larger budget deficits needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit; and (2) the decline in national saving caused by the expanded budget deficit.

The most recent prominent example of the tradeoffs involved is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its (possibly positive) effect from changes in incentives and its (negative) effect through increases in the budget deficit. Given the structure of the 2001 tax cut, researchers have generally found that the negative effects of the tax cuts via expanded budget deficits (and reduced national) saving offset and potentially outweigh any positive effects on future output from the impact of reduced marginal tax rates.[10] Similarly, an analysis of the new tax cuts proposed by the Administration needs to account for any positive incentive effects from reduced taxes *and* negative effects from expansions of the deficit and reduced national saving.

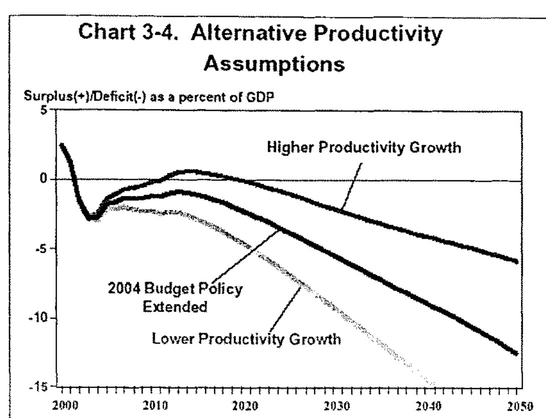
Long-term budget outlook under the Administration's budget

Two other points are worth noting briefly about the Administration's budget. First, Table 2-5 of the *Analytical Perspectives* (a part of the Administration's published budget) shows a structural budget deficit in 2008 of $189.6 billion, or slightly more than one percent of GDP. That deficit cannot be attributed to the business cycle, since a structural deficit by definition is one that has already adjusted for the state of the business cycle. Nor can it be blamed on any other irregular factors, since there is no reason to believe that 2008 will be an atypical year. It instead reflects an underlying imbalance between revenue and expenditure (which is actually wider than shown in the budget, because of unrealistic assumptions regarding the alternative minimum tax and other factors).

2008 is $13.919 trillion, relative to CBO's projection of $14.154 trillion. If the ratio of the Administration's projection to CBO's projection in calendar year 2008 applied in FY 2013, the implied Administration forecast would be $17.555 trillion. The Treasury projection of the revenue loss is 1.7 percent of this constructed GDP forecast.

[9] Social Security Administration, 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Table VI.E5, page 164.

[10] See Alan J. Auerbach, "The Bush Tax Cut and National Saving," Prepared for the 2002 Spring Symposium of the National Tax Association, May 2002; Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2001; Douglas W. Elmendorf, and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," Prepared for the National Tax Association's 2002 Spring Symposium; and William G. Gale, and Samara R. Potter. 2002. "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal* Vol. LV, No. 1 (March): 133-186. One reason for the tepid estimated response to the 2001 tax cut is that 64 percent of filers, accounting for 38 percent of taxable income, would receive no reduction in marginal tax rates, according to Treasury estimates (Kiefer et al 2002).



Source: FY 2004 Budget, *Analytical Perspectives*, Chart 3-4

Second, the budget shows substantial out-year deficits, as depicted in Chart 3-4 (also taken from the *Analytical Perspectives*), even if productivity growth turns out to be higher than currently expected. In the face of these substantial deficits, enacting large, permanent tax cuts must mean some combination of: (1) shifting tax burdens to future generations, which will already be facing higher taxes based on current projections; (2) reneging on government promises in some form; or (3) running substantial budget deficits that would likely become unsustainable.

Proposals to boost growth in the short term and long term

If the Administration's proposals do not seem appropriate in either the short run or the long run, what should be done instead? The most promising set of policies, given current conditions and the different imperatives for the short run and the long run, would combine a targeted short-term stimulus package with long-term fiscal discipline. In particular, a well-designed and timely short-term stimulus package could bolster aggregate demand in 2003. Such a short-term package should include temporary fiscal relief to the states to mitigate the reductions in expenditures and increases in taxes that states are undertaking; temporary increases in Federal government purchases of goods and services, especially in homeland security; temporary incentives for businesses to accelerate investments into 2003; and temporary progressive tax cuts aimed at those households most likely to spend the funds.

Fiscal relief to the states

The projected deficit in state budgets for Fiscal Year 2004, which begins in most states on July 1, totals at least $65 billion, with some estimates ranging as high as $85 billion.[11] All

[11] See National Conference on State Legislatures, "State Budget Gaps Growing at Alarming Rate," February 4, 2003, and Iris J. Lav and Nicholas Johnson, "State Budget Deficits for Fiscal Year 2004 are Huge and Growing," Center on Budget and Policy Priorities, January 23, 2003.

states except Vermont have some form of balanced budget requirement.[12] In response to the projected and current budget deficits, states are therefore raising taxes and cutting spending -- steps that are counterproductive from a macroeconomic perspective. Fiscal relief from the Federal government would mitigate the need for the states to undertake these problematic tax increases and spending reductions.[13] In designing the fiscal relief package, Federal policy-makers should take into account both the immediate benefit of assisting the states and the potential moral hazard created (i.e., that assisting the states now may discourage them from acting responsibly during the next business cycle).

Increased Federal government purchases of goods and services, especially in homeland security

Expansions in government spending are often more stimulative in the short run than tax cuts, because part of the tax cut is likely to be saved rather than spent.[14] Elmendorf and Reifschneider (2002) use a large-scale econometric model developed at the Federal Reserve and find that an expansion in government spending generates a larger increase in GDP in the short run than does an equal-dollar-magnitude reduction in personal income taxes.[15] As they note, "Changes in government spending have a larger stimulative effect than changes in taxes because a sizable share of each dollar of lower taxes goes to private saving, whereas each dollar of additional government spending boosts aggregate spending by the full dollar."[16]

A particularly promising area for temporary increases in government spending is homeland security. The Administration has proposed $41 billion in homeland security spending for FY 2004. A Brookings team, of which I was part, concluded that roughly $5 billion in additional spending on homeland security would be warranted.[17] In addition to improving homeland security, such funds would expand short-term demand for the goods and services produced by private firms.

Investment incentives

Since the Committee will be holding a separate hearing on investment incentives, I will merely note two recent documents in which co-authors and I have discussed incentives to

[12] The form of the balanced budget rule varies from state to state, with the requirements being easier to meet in some states than others.
[13] See Alice Rivlin, "Another State Fiscal Crisis: Is There a Better Way?" Brookings Institution Policy Brief #23, January 2003.
[14] See, for example, Peter Orszag and Joseph Stiglitz, "Tax Cuts Are Not Automatically the Best Stimulus: A Response to Glenn Hubbard," Center on Budget and Policy Priorities, November 27, 2001 and CBSMarketwatch, November 30, 2001.
[15] Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal*, Volume LV, No. 3, September 2002.
[16] Elmendorf and Reifschneider, page 382.
[17] Ivo Daalder, Mac Destler, David Gunter, James Lindsay, Michael O'Hanlon, Peter Orszag, and James Steinberg, "Protecting the American Homeland: One Year On," The Brookings Institution, January 2003; and Michael O'Hanlon, Peter Orszag, Ivo Daalder, Mac Destler, David Gunter, Robert Litan, and James Steinberg, *Protecting the American Homeland: A Preliminary Analysis* (Brookings Institution Press: 2002).

boost investment in the short term.[18] My colleague William Gale will discuss investment incentives in his testimony on the appropriate panel.

Progressive, temporary tax cuts

Finally, a stimulus package could include progressive, temporary tax cuts. It is worth noting that research suggests that in the past, households have spent in the short term between 20 percent and 70 percent of any temporary income tax cuts they receive.[19] One recent paper suggests that the 2001 tax rebates generated particularly modest increases in spending.[20] One reason for somewhat modest effects from many temporary tax cuts is that most households base their spending decisions on longer-term income averages, rather than just this year's after-tax income.[21] However, a significant share of income – somewhere between 15 percent and 50 percent – accrues to households that seem to behave as if they base their consumption decisions on current income alone.[22] Focusing temporary tax cuts on such households, who are disproportionately lower-income households living paycheck to paycheck, would magnify the effect on current consumer spending.[23] The rebate from the 2001 tax cut either excluded, or

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[18] William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes,* October 8, 2001, and Peter Orszag, "Evaluating Economic Stimulus Proposals," Testimony before the Senate Budget Committee, October 25, 2001.

[19] For example, see Alan S. Blinder, "Temporary Income Taxes and Consumer Spending," *Journal of Political Economy,* February 1981, pages 26-53; James M. Poterba, "Are Consumers Forward Looking? Evidence from Fiscal Experiments," *American Economic Review,* May 1988, pages 413-8; Matthew D. Shapiro and Joel Slemrod, "Consumer Response to the Timing of Income: Evidence from a Change in Tax Withholding," *American Economic Review,* March 1995, pages 274-83; Nicholas Souleles, "The Response of Household Consumption to Income Tax Refunds," *American Economic Review,* September 1999, pages 947-58; and Chris Carroll, "A Theory of the Consumption Function, With and Without Liquidity Constraints (Expanded Version)," NBER Working Paper 8387, National Bureau of Economic Research, July 2001.

[20] Matthew D. Shapiro and Joel Slemrod, "Did the 2001 Tax Rebate Stimulate Spending? Evidence from Taxpayer Surveys," NBER Working Paper 9308, November 2002.

[21] Some observers have concluded that permanent tax cuts are therefore likely to be more effective at stimulating the economy than temporary ones. Three observations are worth noting about this argument. First, the theory behind this statement suggests that spending will be proportionate to the permanent size of the tax cut; the larger increase in consumption that results from a permanent tax cut therefore merely reflects the larger permanent revenue loss involved. Second, the argument ignores the effect of permanent revenue losses on long-term interest rates and therefore on current economic activity. Third, the argument ignores the significant minority of households who base their spending decisions on current income rather than some measure of long-term average income.

[22] See Robert J. Gordon, *Macroeconomics* (Addison Wesley: 2000), pages 506-506. Campbell and Mankiw (1990) estimate that 40 to 50 percent of income accrues to individuals who consume based on current income rather than permanent income. See John Y. Campbell and N. Gregory Mankiw, "Permanent Income, Current Income, and Consumption," *Journal of Business and Economic Statistics*, Vol. 8, No. 3, July 1990. Other articles suggest a somewhat lower share.

[23] Dynan, Skinner and Zeldes (2000) show that, in several different data sets, propensities to consume out of current and permanent income fall as those income measures rise. Parker (1999) uses data from the Consumer Expenditure Survey and finds that the marginal propensity to consume (MPC) out of transitory income at low levels of resources (which for most low-income households is effectively current income) is much higher than the MPC out of transitory income for very high-income households. McCarthy (1995) uses data from the Panel Survey of Income Dynamics and shows that the marginal propensity to consume out of idiosyncratic income shocks is larger for low-wealth households than for high-wealth households. See Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save More?" NBER Working paper 7906, National Bureau of Economic Research, September 2000; Jonathan Parker, "The Consumption Function Re-estimated," August 1999; and Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Households," *Journal of Monetary Economics,* November 1995, pages 301-27.

provided only a partial rebate to, 51 million people.[24] Those excluded from the 2001 rebate were disproportionately workers who would be particularly likely to spend immediately any temporary tax cut.

Long-term fiscal discipline

Such a short-term package should be coupled with policies to narrow the long-term budget gap, which would provide some additional short-term economic benefit by putting further downward pressure on long-term interest rates.[25] More importantly, the combination of short-term stimulus and long-term fiscal discipline would best address the economic challenges facing the nation: It would boost demand in the short run and national saving in the long run.

Conclusion

The economic challenges facing the nation differ significantly depending on the time horizon. In the short run, a key challenge is to boost spending (to expand demand for the capacity we have available to produce goods and services). In the long run, a key challenge is to boost saving (to finance expansions in capacity over time). Unfortunately, the Administration's proposals seem poorly designed to meet either challenge. A better package would combine targeted short-term stimulus (limited to 2003 alone) with long-term fiscal discipline (to boost national saving).

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[24] Citizens for Tax Justice, "51 Million Taxpayers Won't Get Full Rebates from 2001 Tax Bill," June 1, 2001, available at http://www.ctj.org/html/rebate01.htm.
[25] For a review of the literature on deficits and interest rates, see William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center, December 2002.

tax break

by William G. Gale and Peter R. Orszag

Perspectives on the Budget Outlook

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I. Introduction

The release of the Congressional Budget Office's new baseline budget projections on January 29 offers the opportunity to reassess the fiscal status of the federal government as Congress and the administration consider a new set of budget proposals. This article examines the current budget outlook, the magnitude and sources of changes in the outlook since January 2001, and adjustments to the official data that more accurately reflect the continuation of current policy and the government's underlying financial status. Based on this analysis, we also provide a very preliminary and brief assessment of the administration's new budget proposals. We reach the following conclusions:

- CBO now projects a 10-year baseline unified surplus of $1.3 trillion for fiscal years 2004 to 2013. But the budget outside of Social Security faces a baseline deficit of $1.2 trillion, and outside of the Medicare and Social Security Trust Funds, the baseline deficit is $1.6 trillion. (None of the figures in this article include recent tax proposals, a Medicare prescription drug benefit, or the cost of a war with Iraq. Incorporating these items would make the budget outlook look less promising.)
- These figures represent staggering declines from the baseline forecasts made two years ago. The projected unified budget outcome for 2002 to 2011 deteriorated from a projected surplus of $5.6 trillion (4 percent of GDP) in January 2001 to essentially zero ($20 billion) in January 2003. The budget outcome for 2002 alone declined by $471 billion (4.6 percent of GDP).
- The short-term changes are due primarily to worsening economic conditions, which account for about two-thirds of the decline in 2002 and about half of the projected change for 2003. The longer-term changes are due as much to the 2001 tax cut — which accounts for 40 percent of the deterioration in the budget outlook for 2010 — as to economic and technical changes, which account for 37 percent.
- The official projections significantly misrepresent the government's underlying fiscal position because of unrealistic assumptions regarding the continuation of current policy and because retirement programs are merged with other programs in the budget.
- Making realistic assumptions about how current policies will be maintained — in particular, that expiring tax provisions are extended, a moderate AMT fix is provided, and real per capita discretionary spending is held constant — we estimate that the adjusted unified budget is in deficit for each of the next 10 years and will cumulate deficits of $1.1 trillion over the decade. These deficits emerge just from efforts to maintain the policy status quo. The differences between the official and our adjusted projections for the unified budget grow over time. In 2013 alone, the difference exceeds $600 billion (3.6 percent of GDP).
- The unified budget figures above include large cash-flow surpluses accruing in trust funds for Social Security, Medicare, and government pensions over the next 10 years. But in the longer term, Social Security and Medicare face significant deficits. The adjusted budget outside of these trust funds faces a deficit of $4.5 trillion over the next decade, including an adjusted deficit of 4 percent of GDP in 2003 and an average deficit of just over 3 percent of GDP during the rest of the decade.
- Policymakers face three sets of budget challenges: near-term deficits (over the next two years), medium-term deficits (over the next three to 10 years), and long-term deficits (beyond the 10-year horizon). The near-term deficits are not a major problem in and of themselves — the economy could use a boost right now and unusual events like a war should be at least partially funded via deficits.
- The implied medium- and long-term deficits, however, are troubling. First, our adjusted unified budget shows a deficit in each of the next 10 years, even though the economy is predicted to have reached full employment

within the next few years. This indicates a persistent and fundamental imbalance between projected tax and spending policies even before the bulk of the baby boomers will have retired. Second, the medium-term deficits will be followed by a period in which projected deficits rise substantially. The time profile of projected deficits implies that if fiscal responsibility is not established in the remainder of this decade, it will prove much more difficult to do so after the baby boomers start retiring.

- Ignoring the medium- and long-term fiscal gaps would represent a significant policy mistake. Making the fiscal gap worse would be an even bigger mistake. Policymakers should be particularly wary of proposals that would raise medium- and long-term deficits; that reduce medium-term deficits by shifting revenues from the future to within the 10-year budget window; or that detract attention from these issues.
- The administration's new budget is replete with such problematic proposals. These include making the 2001 tax cut permanent, massively expanding Roth IRA treatment of saving, encouraging rollovers of existing IRAs to back-loaded saving plans, and focusing on a five-year budget horizon. The administration's policies would produce unified "deficits as far as the eye can see" even though the economy is projected to return to full employment in a few years. The deficits would be much larger if the retirement trust funds were not included. The administration's proposals would exacerbate the nation's fiscal problems in the medium and long term.

The administration's new budget is replete with problematic proposals.

Section II summarizes CBO's recent budget projections and discusses the level and sources of changes in the projections over time. Section III explores adjustments to the official budget baseline. Section IV offers a set of concluding remarks.

II. The Changing Budget Outlook

Table 1 reports selected baseline projections made by the Congressional Budget Office (CBO) since January 2001. Appendix Table 1 contains the projections for each year, and Figures 1a-1c plot the data on an annual basis.

Before turning to the specific figures, it is helpful to note the two dominant general trends. First, projected budget outcomes have deteriorated dramatically since January 2001. The unified budget shows a cumulative decline of $5.6 trillion over the 2002 to 2011 horizon. This change is substantial; it represents more than 4 percent of projected GDP and more than 20 percent of projected federal revenue or projected federal spending over this period. Moreover, the change is not a temporary shock. The time path of projected revenue has fallen substantially over the entire decade since the January 2001 forecast.

Second, all of the official projections show significantly worse outcomes in the next few years than toward the end of the decade. The time pattern of the deficits may at first glance be heartening, since the official baseline appears to imply that the budget will right itself over time. However, as we show in section III, realistic adjustments for current policy will imply continual deficits rather than the re-emergence of surpluses over time.

The specific figures show that the unified budget deficit was $158 billion in 2002. The baseline projects a unified deficit of $199 billion in 2003, with the deficit then falling and eventually turning to a surplus by 2007. The official projected surplus then rises to more than $500 billion by 2013. (As shown below, the entire baseline surplus in 2013 reflects assumptions that expiring tax provisions — like the 2001 tax cut — are allowed to expire, and that no fix for the AMT is provided.) As a result, the budget for 2004 through 2009 runs a cumulative deficit, and more than 90 percent of the cumulative $1.3 trillion 10-year surplus for 2004 to 2013 is accounted for by surpluses projected for 2011 to 2013.

Outside of Social Security, the 10-year budget now faces a deficit of $1.2 trillion, with deficits in every year through 2010. In contrast, in January 2001, the non-Social Security budget was projected to run surpluses of $3.1 trillion through 2011, with annual surpluses rising steadily over time from $141 billion to $558 billion.

Outside of the Social Security and Medicare Trust Funds, the budget is projected to stay in deficit until 2012, and has a cumulative deficit of $1.6 trillion over the next 10 years. Again, these projections represent stark changes from January 2001. At that point, the budget outside of the Medicare and Social Security Trust Funds had a projected surplus of $2.7 trillion through 2011.

Table 2 examines the sources of the decline since January 2001 in projected unified budget outcomes over the 2002-2011 time period (with the annual figures presented in Appendix Table 2 and plotted in Figure 2). Of the $5.6 trillion decline in the cumulative 2002-11 projected surplus, about $1.6 trillion is due to the 2001 tax cut, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), including the additional interest on induced increases in federal debt.[1] About $2.6 trillion arises from the combination of economic and technical changes, while $1.4 trillion is attributable to increased spending — primarily defense ($736 billion) and homeland security outlays in the aftermath of the terrorist attacks — and other revenue changes, namely the 2002 tax cut stimulus package.

(Text continued on p. 1010.)

[1]This figure includes only the revenue losses, outlay increases, and debt services costs that occur within the 2002 to 2011 time period. It omits the direct revenue losses due to the tax cuts that occurred in 2001, but includes the interest costs on those tax cuts in subsequent years.

Table 1: Changing Budget Projections (Surplus or Deficit in Billions of Current Dollars)

Projection Date	Projection Horizon	Unified Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
10-Year Baseline				
January 2001[1]	2002-11	5,610	3,119	2727
January 2002[2]	2002-11	1,601	-745	-1127
January 2003[3]	2002-11	20	-2,219	-2551
January 2002[2]	2003-12	2,263	-242	-632
January 2003[3]	2003-12	629	-1,768	-2107
January 2003[3]	2004-13	1,336	-1,231	-1580
5-Year Baseline				
January 2001[1]	2002-06	2,007	986	786
January 2002[2]	2002-06	250	-725	-912
January 2003[3]	2002-06	-592	-1,492	-1,641

[1]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2002-2011" January 2001. Tables 1-1 and 1- 7.
[2]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." January 2002. Summary Table 1, Tables 1-1 and 1-6.
[3]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2004-2013." January 2003. Tables 1-2 and 1-5.

Table 2: Sources of Change in the Unified Budget Baseline, 2002-2011
January 2001-January 2003

	January 2001-January 2003[1,2]	
	($ billions)	(percent of change)
Legislative Changes		
EGTRRA		
Revenue Provisions	1,186	21.2
Outlays	88	1.6
Debt Service	372	6.7
Subtotal	1,647	29.5
Other Revenue Changes		
Revenue	55	1.0
Debt Service	54	1.0
Subtotal	110	2.0
Other Outlays		
Outlays	960	17.2
Debt Service	296	5.3
Subtotal	1,256	22.5
Economic and Technical Changes		
Revenue	2,101	37.6
Outlay	476	8.5
Subtotal	2,577	46.1
Total Change in Surplus	5,590	100.0

[1]Columns may not sum to total due to rounding.
[2]Source and notes: see Appendix Table 2.

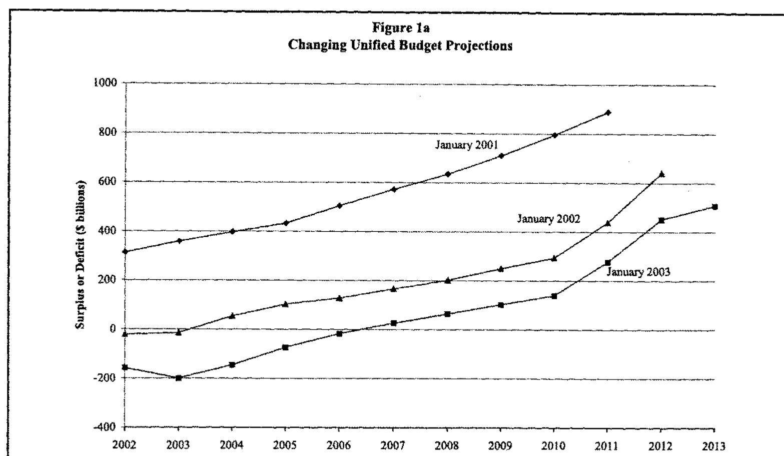

Figure 1a
Changing Unified Budget Projections

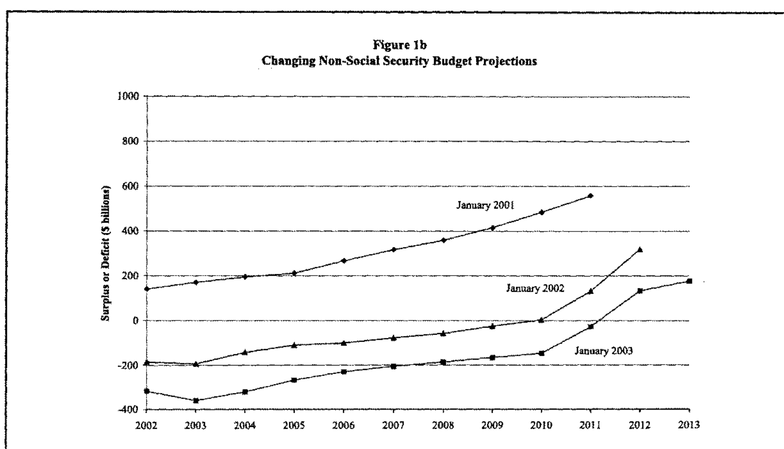

Figure 1b
Changing Non-Social Security Budget Projections

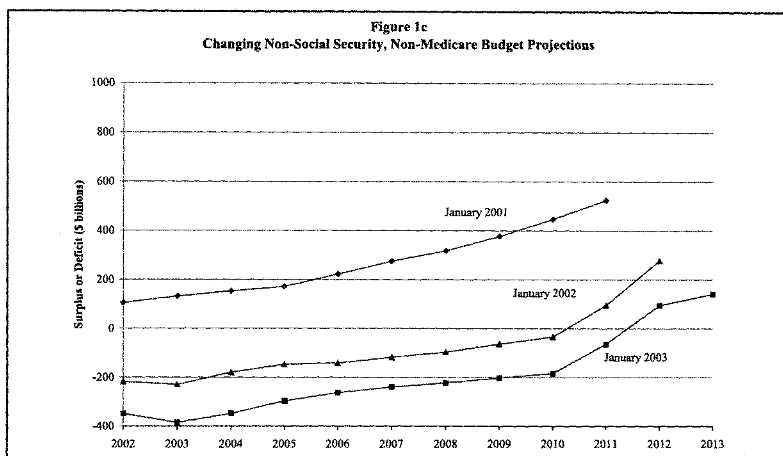

Figure 1c
Changing Non-Social Security, Non-Medicare Budget Projections

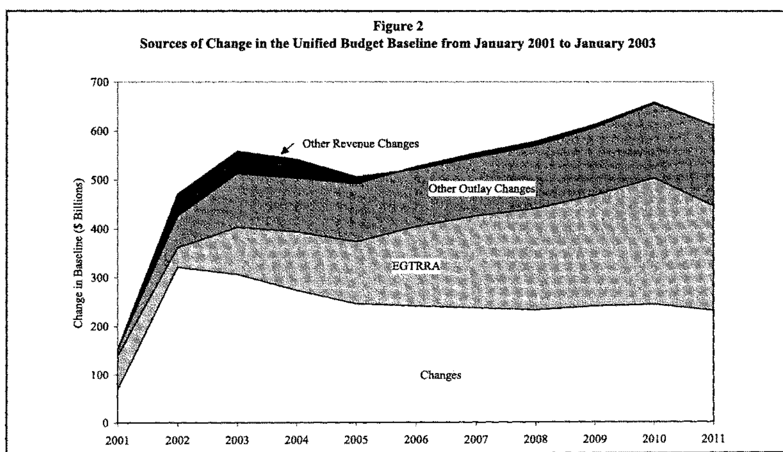

Figure 2
Sources of Change in the Unified Budget Baseline from January 2001 to January 2003

The decline in the budget surplus over the next few years is due predominantly to economic and technical changes, which in turn are due largely to the economic slowdown. In later years, however, these changes decline in importance as EGTRRA phases in more completely. In 2010, just before it sunsets, the tax cut accounts for 40 percent of the decline in the projected surplus since January 2001, slightly more than the economic and technical changes.

III. Adjusting the 10-Year Budget Outlook

The CBO publishes baselines at least twice a year. CBO (2002) describes the budget baseline as a mechanical forecast of current policy and that is intended to serve only as a "neutral benchmark . . . according to rules [that are] set forth in law and long-standing practices . . . ." The budget baseline is useful — indeed, it is necessary — because Congress needs a benchmark against which to measure the costs of proposals that change the tax law, spending rules, or spending amounts.

> ***The budget baseline is useful — indeed, it is necessary — because Congress needs a benchmark against which to measure the costs of proposals that change the tax law, spending rules, or spending amounts.***

The CBO baseline budget projections dominate public discussions of the fiscal status of the government, but as CBO itself emphasizes, the baseline is not intended to serve as a prediction of likely budget outcomes, for at least three reasons. First, the baseline by design does not reflect major new initiatives that may be enacted. Prominent examples currently include a Medicare prescription drug benefit and new tax cuts or spending increases to stimulate the economy. Second, even in the absence of major new initiatives, the set of default assumptions about current spending and tax policies used to develop the baseline are often unrealistic. Third, the economy — and with it revenue and spending totals — may evolve differently than the baseline projections assume.

A. Current Policy

To obtain a better understanding of whether the government is living within its means under current policies, we adjust the baseline budget figures. To do this, we maintain the assumption that no major new initiatives are enacted and that the economy evolves according to CBO's projections. But we make what we believe are more realistic assumptions than the baseline does about what constitutes current policy for spending and taxes. This clearly involves a set of judgment calls, so we explain the adjustments and their justifications below.

The first area where CBO's baseline assumptions do not appear to be a good reflection of current policy involves discretionary spending, which represents slightly more than a third of total outlays. Discretionary spending typically requires new appropriations by Congress every year. That is, current laws generally do not determine what discretionary spending will be in future years, raising the issue of what levels should be assumed in the budget projections for such spending. CBO routinely assumes that real discretionary spending (that is, spending adjusted for inflation) will remain constant at the level prevailing in the first year of the 10-year budget period. Because population and income grow over time, this assumption implies that by 2012 discretionary spending will fall by more than 20 percent relative to gross domestic product (GDP) and by about 8 percent in real per capita terms.

Although judgments may reasonably differ about future spending choices, CBO's assumption is unrealistic — either as a measure that holds current policy constant or as a prediction of likely spending outcomes.[2] To maintain current policy, we believe that a baseline computed on the assumption that real discretionary spending grows at the same rate as the population would be appropriate.[3] This is the same criterion endorsed by George W. Bush as a presidential candidate.[4]

The second area where the baseline makes unrealistic assumptions involves expiring tax provisions. CBO assumes that Congress will extend expiring spending programs, but that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled, even if Congress has repeatedly renewed them. The assumption regarding spending is reasonable, since spending programs with expiration dates are normally renewed. But the assumption regarding taxes is not reasonable in most cases. The Internal Revenue Code currently contains several sorts of expiring tax provisions. The first includes provisions

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[2]As a measure of likely budget outcomes, we believe that holding discretionary spending constant as a share of GDP would be appropriate. As CBO (2003) notes, nondefense discretionary spending has been roughly constant as a share of GDP since the early 1980s. Defense and homeland security spending will likely rise as a share of GDP over the next decade. For convenience, we also report budget measures below with discretionary spending held constant as a share of GDP.

[3]In recent years, CBO has presented sensitivity analysis with a variety of alternative discretionary spending paths. Theoretically, one would prefer the measure that best reflects the cost of maintaining a given level of government services. The problem arises because some types of discretionary spending (like FBI staffing) likely require real increases that at least keep pace with population growth to maintain a given level of services, whereas others (like administrative expenses for government departments) may be largely fixed in real terms and therefore not need to keep pace with population growth. Still other types of spending (like the costs of inspecting imports, which may be proportionate to the volume of imports) may require a constant or rising share of output to maintain a constant level of services. In any case, both casual inspection of the fixed cost component of various categories of spending and historical analysis of spending trends suggest that real discretionary spending is unlikely to decline sharply on a per capita basis.

[4]Bush argued that an "honest comparison" of spending growth should take inflation and population growth into account (Slater 1999, Calmes 1999).

Table 3: Baseline and Adjusted Budget Outcomes for 2004-2013 (Surplus or Deficit in $ Billions)[1]

Projection Date	January 2003[2]		
Projection Horizon	2004-08	2009-13	2004-13
CBO Unified Adjusted Budget Baseline	-144	1,480	1,336
-Adjustment for expiring tax provisions			
Repeal sunset provisions	5	605	610
Extend AMT provisions	57	134	191
Extend JCWA	145	117	262
Extend other expiring provisions	30	129	159
Interest	24	179	203
Subtotal	261	1,164	1,425
=Unified Budget adjusted for expiring tax provisions	-404	316	-88
-Adjustment for AMT			
Index AMT	40	320	360
Allow Dependent Exemption	27	59	87
Interest	6	65	71
Subtotal	73	445	517
=Unified Budget adjusted for expiring tax provisions and AMT	-477	-128	-605
-Adjustment for holding real DS/person constant			
Hold real DS/person constant	109	327	437
Interest	11	78	89
Subtotal	120	405	525
=Unified Budget adjusted for expiring tax provisions and AMT with real DS/person constant	-597	-533	-1,131
-Adjustment for Retirement Funds			
Social Security	1,062	1,505	2,567
Medicare	162	187	349
Government Pensions	226	258	484
Subtotal	1,451	1,950	3,400
=Non-retirement fund budget adjusted for expiring tax provisions and AMT with real DS/person constant	-2,048	-2,483	-4,531
-Further adjustment if discretionary spending/GDP constant			
Outlays	175	624	799
Interest	16	136	152
Subtotal	190	760	951
=Non-retirement fund budget adjusted for expiring tax provisions and AMT with DS/GDP constant	-2,238	-3,243	-5,481

[1]Due to rounding, columns may not sum to total.
[2]Source and notes: see Appendix Table 3.

of the 2001 tax cut, EGTRRA. All of these provisions "sunset," or end automatically in 2010, and some end sooner than that. The second category includes the elements of the 2002 economic stimulus package. The third involves the alternative minimum tax, which we discuss further below. The fourth includes a variety of other tax provisions that have statutory expiration dates but that are routinely extended for a few years at a time as their expiration date approaches. We believe that the most accurate assumption of current policy, on balance, would be that all of these various provisions will be extended. This is not a statement of desired or optimal policy, simply a statement of what we see as the current stance of policy.

The third issue involves the alternative minimum tax (AMT), which offers a dramatic example of how the baseline projections generate unlikely outcomes. The AMT was designed in the late 1960s, and then strengthened in 1986, to curb excessive use of tax shelters and other tax avoidance (see Burman, *et al.*, 2002). The AMT runs parallel to the regular income tax system. It uses a somewhat different measure of income, permits fewer deductions, and applies flatter rates than does the regular income tax. In theory, each taxpayer must compute tax liability under both the conventional income tax and the AMT and pay the larger liability. In practice, the AMT currently generates larger liability for so few taxpayers — about 3 million — that few

filers, other than the tiny minority who might be affected, bother with it.

Because the AMT is not adjusted for inflation, while the ordinary income tax is, the AMT applies to ever more taxpayers as prices rise. In addition, EGTRRA, which cut the ordinary income tax but not the AMT, will greatly increase the number of people subject to the AMT. All told, by 2010 an estimated 36 million filers will become subject to the AMT under current law. This result is troubling in large part because the AMT is significantly more complex than the regular tax. Policymakers will therefore be under powerful pressure to modify the AMT.

Our budget estimates reflect current policy toward the AMT in two ways. First, we assume that provisions of the AMT that are slated to expire before the end of the budget window are granted a continuance. Under current law, the AMT exemption is increased for 2001 to 2004, but after 2004 it reverts to its 2000 level. We assume that the temporary increase in the exemption is made permanent. Also, under current law, the use of nonrefundable personal credits against the AMT is allowed through 2003. We assume that this provision is made permanent as well. Our second adjustment is to index the AMT exemption, brackets, and phaseouts for inflation starting in 2004 and to allow dependent exemptions in the AMT.[5]

Table 3 splits these costs into two components. The cost of extending the exemption and use of nonrefundable credits is shown as an "adjustment for expiring tax provisions" and based on CBO estimates. The additional costs of indexing and adding a dependent exemption are shown separately and are based on estimates using the Tax Policy Center microsimulation model. Taken together, the adjustments would reduce revenues by $638 billion and add $114 billion to debt service costs, for a total budgetary cost of $752 billion. Even so, it would leave 8.5 million taxpayers on the AMT in 2013 assuming that EGTRRA is extended — well above current numbers but well below the 43.5 million slated to face the AMT without these changes.

B. Retirement Funds

Another reason the unified budget projections over the next 10 years do not provide an accurate indicator of the underlying stance of government policy — including its sustainability and its effects on the economy — is that some currently legislated policies have budgetary implications in years more than a decade into the future. Those implications are not captured in medium-term budget projections. In particular, projecting the unified budget over a decade or less provides a misleading picture of the long-term budget position of the federal government when current or past policies result in a spending-revenue imbalance after the end of the budget projection period. Under current laws, the primary source of such imbalances is long-term commitments to pay pension and health care benefits to the elderly through Social Security, Medicare, Medicaid, and the Federal Employees Retirement program. Currently, taxes earmarked to pay for Social Security and Medicare Hospital Insurance exceed outlays on those programs. But in the long run, the programs face significant deficits.

There are several potential ways to address this problem, each with different strengths and weaknesses. The approach we take here is to separate some of these programs from the official budget. In various pieces of legislation between 1983 and 1990, Congress took a step in this direction by classifying Social Security as "off-budget."[6] The Congressional Budget Office and the Office of Management and Budget now report revenues and expenditures not only for the unified budget, but also for "off-budget" programs and "on-budget programs." The exclusion from the "on-budget" accounts of current cash flow surpluses in Social Security partially offsets the omission of sizeable deficits in that program that are expected to occur in years beyond the 10-year budget window.[7] We extend this approach by also considering the budget picture, excluding the trust funds for Social Security, Medicare, and government pensions.

C. Implications of the Adjustments

Table 3 shows the sizable effects of adjusting the surplus for current policy assumptions and retirement trust funds over the 10-year period. (Appendix Table 3 provides the figures on an annual basis, and Figure 3 plots different measures of the adjusted baseline on an annual basis.)

As noted above, the CBO unified budget baseline projects a 10-year surplus of $1.3 trillion, with surpluses rising sharply over time. Adjusting the CBO baseline for our assumptions regarding current policy implies that the unified budget will be in *deficit* to the tune of $1.1 billion over the next decade if real discretionary spending per capita is held constant. Notably, the adjusted unified baseline shows a deficit in every year through 2013.[8]

The unified budget, however, includes retirement trust fund surpluses that exceed $3 trillion. Adjusting

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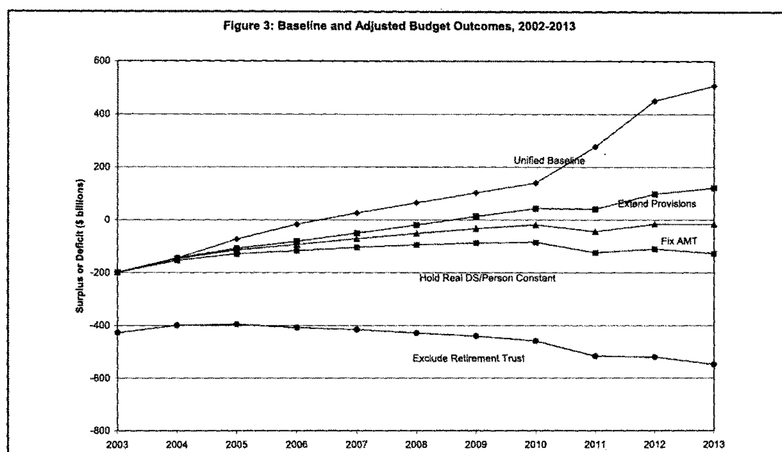
[5]This is "plan 2" in Burman, *et al.* (2002) and is designed to reduce the chances that households with income below $100,000 end up on the AMT.

[6]At the same time, Congress also designated the U.S. Postal Service as an off-budget entity. The Postal Service's budgetary impact, though, is a tiny fraction of Social Security's.

[7]This economic logic may help explain the significant, bipartisan political support a few years ago for the notion that retirement trust funds ought to be kept separate from the rest of the budget. Both Houses of Congress voted overwhelmingly in 2000 to support measures that protected the Medicare Hospital Insurance Trust Fund from being used to finance other programs or tax cuts (Mohr 2001). A recent legislative proposal would provide similar protection to military pensions (U.S. House of Representatives 2001). Almost all states already separate pension reserves from their operating budgets.

[8]If discretionary spending grows with GDP — instead of growing with inflation and population — the adjusted unified deficit would be $2.1 trillion.

Figure 3: Baseline and Adjusted Budget Outcomes, 2002-2013



further by taking the retirement funds off-budget generates a 10-year deficit, other than retirement funds, of $4.5 trillion.

Although the precise figures should not be taken literally due to uncertainty and other factors, the basic trends in the data are clear. First, the CBO baseline suggests that the budgetary future features rising surpluses within the 10-year window, while our adjusted unified budget baseline implies continual deficits through 2013. Second, the differences grow over time. By 2013, the annual difference between the official projected unified budget and our alternative unified deficit is more than $600 billion. Third, acknowledging that the retirement trust funds are running current surpluses but will run deficits in the future makes the budget outlook far worse. The adjusted budget outside of the retirement trust funds is projected to run deficits of $4.5 trillion over the next decade, and the difference between the official unified projection and our adjusted non-retirement-trust-fund budget exceeds $1 trillion in 2013 alone.

D. Longer-Term Estimates

The adjusted budget figures above give a more accurate assessment of the government's fiscal status than the unified budget does, but both the adjusted and official figures focus only on the next 10 years. The adjusted budget thus represents a somewhat awkward half-step to examining long-term budget issues directly. An alternative solution — one that we do not follow here, but that is worth mentioning — is to extend the budget horizon beyond 10 years. The Social Security and Medicare actuaries, for example, annually publish 75-year projections of the financial balance under these programs. Extending this approach to the entire budget suggests significant long-term budget challenges. Auerbach, et al. (2003), using estimates from the August 2002 CBO baseline, estimate that federal revenues are likely to fall short of federal spending by 4 to 8 percent of GDP in the long run. That is, it would require an increase in federal revenues of about 20 percent-38 percent, a comparable decline in spending, or some combination of the two, to bring the long-term budget into balance.

Substantial uncertainty surrounds both the short-term and long-term projections. Much of the problem stems from the fact that the surplus or deficit is the difference between two large quantities, taxes and spending. Small percentage changes in either direction can result in large percentage changes in the difference between them. CBO (2003) publishes a very useful "fan" graph that shows that the range of possible baseline budget outcomes is large. The source of this variation, though, is that the economy (and associated technical factors affecting the budget) may evolve differently than anticipated by CBO. This source of uncertainty does not significantly affect our adjustments: The difference between the official projection and our adjusted outcome would remain largely intact even in very different underlying economic conditions. In addition, although there is significant uncertainty in the longer-term forecasts beyond 10 years, most studies have concluded that even adjusting for the contingencies, the likelihood of a significant fiscal gap is high (see Auerbach, et al., 2003).

IV. Discussion

The budget outlook presents policymakers with a complex and difficult set of problems. A short-term

deficit is certain over the next year or two; a medium-term deficit is highly likely over the next 5 to 10 years; and a significantly larger long-term fiscal gap appears probable.

In the near term, as long as economic growth is sluggish and capacity is underused, current budget deficits can help stimulate aggregate demand and return the nation to its full-employment growth path. In addition, financing a significant part of any war with deficits is appropriate.

Nevertheless, policymakers should not consider themselves free to run up short-term or medium-term deficits without constraint. Specifically, the danger is that policies that raise short-term deficits end up putting the economy on a path where large structural deficits persist, even after the economy returns to full employment and war efforts have subsided. Indeed, our estimates suggest the economy is already on such a path, especially when the retirement trust funds are excluded from the totals.

In light of these concerns, policymakers should be especially wary of three kinds of policies: those that raise long-term deficits; those that artificially reduce deficits in the short or medium term by shifting revenue streams from the future; and those that shift attention away from medium- and long-term fiscal challenges.

Unfortunately, a first glance suggests the administration's new budget proposals are replete with such problematic policies. Making the 2001 tax cut permanent would raise the long-term fiscal gap by between 1.5 and 1.9 percent of GDP, depending on the AMT fix involved (Auerbach, et al., 2003). The expansion of Roth IRA treatment for saving would also dramatically reduce long-term revenues. The encouragement of rollovers from existing tax-deferred saving into backloaded saving plans would generate a shift of revenues from outside the budget window to inside the window. Choosing to focus on a five-year budget horizon is an effort to downplay problems over the remainder of the decade and the longer term, and is especially hypocritical for an administration that is proposing tax cuts that *begin* to take effect well after the five-year window expires. The president claims that these policies will allow the economy to grow its way out of the budget problem, but the administration's own estimates belie that claim. The administration's forecast shows the economy returning to full employment in the next few years, but it also shows — in the words of budget director Mitch Daniels — deficits for "the foreseeable future" (Rosenbaum, 2003). These deficits would be much larger if the retirement trust funds were not included.

In short, the administration's new budget proposals would increase fiscal problems in the medium and long term. Whatever their other effects, these proposals will create a fiscal drag that reduces future income growth and imposes new burdens on future generations (Gale and Orszag, 2002, 2003). Indeed, the implied increase in the public debt and in burdens placed on future generations due to the president's policies to date and the new proposals runs in the trillions of dollars. In contrast, policies that increase the deficit now but reduce it in future years would help in the short term by fueling aggregate demand and returning the economy to full employment, and help in the long term by providing the fiscal discipline that would raise national saving and capital formation.

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Appendix Table 1: Changing Annual Budget Projections (Surplus or Deficit in Billions of Current Dollars)[1]

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Unified Budget												
January 2001[2]	313	359	397	433	505	573	635	710	796	889		
January 2002[3]	-21	-14	54	103	128	166	202	250	294	439	641	
January 2003[4]	-158	-199	-145	-73	-16	26	65	103	140	277	451	508
Non-Social Security Budget												
January 2001[2]	141	171	195	212	267	316	359	416	484	558		
January 2002[3]	-184	-193	-141	-108	-99	-76	-56	-24	4	132	319	
January 2003[4]	-317	-360	-320	-267	-229	-205	-185	-165	-145	-26	134	177
Non-Social Security, Non-Medicare Budget												
January 2001[2]	105	132	154	172	223	275	318	377	447	524		
January 2002[3]	-217	-229	-179	-146	-141	-117	-96	-63	-34	95	278	
January 2003[4]	-349	-386	-348	-296	-263	-239	-222	-202	-183	-63	95	142

[1]Due to rounding, annual data from Appendix Table 1 may not sum to the CBO totals listed in Table 1.
[2]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2002-2011." Tables 1-1 and 1-7.
[3]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." Tables 1-1 and 1-6.
[4]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2004-2013." Tables 1-2 and 1-5.

Appendix Table 2: Sources of Change in the Unified Budget Baseline, Year-by-Year January 2001 to January 2003

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Legislative Changes												
EGTRRA												
Revenue Provisions	70	31	84	101	100	126	142	151	158	176	117	1,186
Outlays	0	6	7	7	7	10	10	9	10	11	12	88
Debt Service[1]	0	3	7	13	20	28	37	48	60	72	85	372
Subtotal	71	40	97	121	127	163	189	208	227	259	215	1,647
Other Revenue Changes												
Revenue	1	43	42	32	7	-13	-15	-15	-12	-9	-6	55
Debt Service	0	1	3	5	7	7	7	6	6	6	6	54
Subtotal	1	44	45	38	14	-5	-8	-8	-6	-3	0	110
Other Outlays												
Outlays	13	64	104	98	101	98	97	98	98	100	102	960
Debt Service	0	2	5	12	18	25	32	39	46	54	63	296
Subtotal	13	66	110	110	119	122	128	137	145	154	165	1,256
Economic and Technical Changes												
Revenue	72	308	295	266	237	206	184	171	163	155	115	2,101
Outlay	-3	13	11	8	8	36	53	62	78	90	116	476
Subtotal	69	321	306	274	246	241	238	233	241	245	232	2,577
Total Change in Surplus	154	471	558	542	506	521	547	570	607	656	612	5,590

Appendix Table 2 *(continued)*												
As Percent of Change in Surplus[2]												
EGTRRA	46	9	17	22	25	31	35	36	37	40	35	29
Other Revenue Changes	1	9	8	7	3	-1	-2	-1	-1	0	0	2
Other Outlays	8	14	20	20	24	23	23	24	24	24	27	22
Economic/ Technical Changes	45	68	55	50	49	46	43	41	40	37	38	46
Total	100	100	100	100	100	100	100	100	100	100	100	100

[1]Debt Service is apportioned to each of the categories based on CBPP imputations of the interest rate.
[2]Percents may not sum to 100 due to rounding.

Appendix Table 3: Baseline and Adjusted Budget Outcomes for 2003-2013 January 2003 Projections (Surplus or Deficit in $ billions)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
CBO Unified Adjusted Budget Baseline[1]	-199	-145	-73	-16	26	65	103	140	277	451	508
-Adjustment for expiring tax provisions											
Repeal sunset provisions[2]	0	1	1	1	1	2	2	2	131	230	240
Extend AMT provisions[2]	0	0	4	13	18	22	27	31	28	23	26
Extend JCWA[3]	0	0	28	42	40	35	30	26	22	20	19
Extend other expiring provisions[4]	0	-1	1	6	10	14	15	17	26	35	36
Interest[5]	0	0	1	4	7	12	16	21	30	46	65
Subtotal	0	0	35	65	77	85	90	97	236	353	386
=Unified Budget adjusted for expiring tax provisions	-199	-145	-108	-81	-50	-20	13	43	41	98	121
Adjustment for AMT[6]											
Index AMT	0	0	2	6	12	20	31	42	61	84	101
Allow Dependent Exemptions	0	1	4	6	7	9	10	11	12	13	14
Interest	0	0	0	1	2	3	5	8	12	17	24
Subtotal	0	2	6	12	21	32	46	61	85	114	138
=Unified Budget adjusted for expiring tax provisions and AMT	-199	-147	-114	-94	-71	-51	-33	-18	-44	-16	-17
Adjustment for holding real DS/person constant[7]											
Hold real DS/person constant	0	7	14	22	29	38	46	55	65	75	86
Interest	0	0	1	2	3	5	8	11	15	19	25
Subtotal	0	7	15	23	32	43	54	66	80	94	111
=Unified Budget adjusted for expiring tax provisions and AMT with real DS/person constant	-199	-154	-129	-117	-104	-94	-87	-85	-124	-110	-127
Adjustment for Retirement Funds[8]											
Social Security	160	175	194	212	231	250	268	286	303	317	330
Medicare	26	28	29	34	34	36	37	38	37	39	36
Government Pensions	42	43	44	45	46	48	48	50	52	53	55
Subtotal	228	246	267	291	312	335	353	374	392	409	421
=Non-retirement fund budget adjusted for expiring tax provisions and AMT with real DS/person constant	-428	-400	-396	-408	-415	-429	-440	-458	-516	-520	-548
Nominal GDP[9]	10,756	11,309	11,934	12,582	13,263	13,972	14,712	15,480	16,250	17,013	17,851
=Adjusted budget, given as percent of nominal GDP	-4.0	-3.5	-3.3	-3.2	-3.1	-3.1	-3.0	-3.0	-3.2	-3.1	-3.1
Further Adjustment for holding DS/GDP constant[10]											

Appendix Table 3 *(Continued)*

Outlays	0	6	18	33	50	68	86	105	124	144	165
Interest	0	0	1	2	5	8	13	19	26	34	45
Subtotal	0	6	19	35	54	76	99	124	149	179	210
=Non-retirement fund budget adjusted for expiring tax provisions and AMT with DS/GDP constant	-428	-406	-415	-443	-469	-504	-539	-582	-666	-698	-758
=Adjusted budget, given as percent of nominal GDP	-4.0	-3.6	-3.5	-3.5	-3.5	-3.6	-3.7	-3.8	-4.1	-4.1	-4.2

[1]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 1-2.
[2]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 3-11.
[3]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Box 1-2.
[4]Author's calculations. Numbers are calculated so that the subtotal sums to Table 3-11, excluding interest costs.
[5]CBO debt service matrix, January 2003.
[6]Author's calculations using microsimulation of Tax Policy Center.
[7]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 4-1. U.S. Bureau of the Census. Annual Projections of the Total Resident Population as of July 1: Middle, Lowest, Highest, and Zero International Migration Series, 1999 to 2100. February 14, 2000.
[8]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 1-5.
[9]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table E-2.
[10]Author's calculations using The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 4-4.

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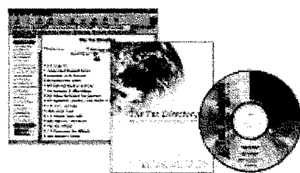

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PREPARED STATEMENT OF HON. LEON E. PANETTA

FEBRUARY 12, 2003

Mr. Chairman and Distinguished Members of the Finance Committee:

I am honored to have this opportunity to appear before you to share my thoughts on the subject of Economic Growth and Job Creation: Incentives for Investment. There are two fundamental principles that must support whatever incentives for investment the Congress decides are necessary. These principles are drawn from my experience in the Congress as Chairman of the House Budget Committee and in the executive branch as Director of the Office of Management and Budget. But they are also influenced by my present experiences as a member of the Board of the New York Stock Exchange and Co-Chair of its Corporate Accountability and Listing Standards Committee.

The first principle is that there is no effective federal incentive for investment that can produce sustained economic growth and jobs unless it is at the same time accompanied by strong fiscal discipline.

The second principle is that at a time of great uncertainty over the consequences of a number of foreign and domestic crises, the key guideline for federal policy should be to "do no harm." In other words, do nothing that will add only greater uncertainty to an already nervous investment environment.

The danger you must avoid is that in the rush to judgment to find a temporary or permanent solution to kick starting a weak economy, you are willing to excuse exploding future deficits on the basis that somehow they are insignificant or can take care of themselves.

The lesson of the last 25 years is that deficits do matter and they will not be reduced without strong and unified action by the President and the Congress. In the 1980s, the nation was looking at what OMB Director David Stockman predicted would be "deficits as far as the eye could see." As a result of the Reagan tax cut, dramatic defense-spending increases, growing entitlement and discretionary spending and a slowing economy, deficits were projected to reach $200 billion by the end of the 1980s and escalate to $300 billion by the early 1990s, reaching $600 billion by the beginning of the new century.

The national debt was well on the way to quadrupling from less than $1 trillion to more than $4 trillion by 1992. The economy was being affected by high long-term interest rates, increased government borrowing, reduced capital for investment and everlarger interest payments on the debt.

In a word, the deficit was out of control but neither political party had the political will or courage to directly confront the problem. Rather than making the tough budget decisions that had to be made, Congress passed budgets based on a combination of "smoke and mirrors" accounting, "rosy scenario" economic projections, funding shifts from one fiscal year to another to hide spending, and exaggerated savings from program reductions that few believed would be realized.

In the midst of the frustration over exploding deficits, Congress passed the Gramm-Rudman-Hollings bill that required an automatic "across the board" cut if certain deficit-reduction targets were not met. Congress, however, kept changing the targets for fear of what such arbitrary cuts would do.

None of these steps nor any of the hoped for economic benefits of the tax cut reversed the continuing growth in deficits.

In the end, it was finally recognized that the key to reducing the deficit was not procedural gimmickry or artificial legislative or constitutional mandates of one kind or another. Nor could one resolve conflicting priorities by putting the budget process on automatic pilot. Political leaders are elected to make hard choices, to set priorities and to discipline the budget.

In 1990, former President George Bush did exactly that in an historic budget agreement that achieved significant debt reduction, established caps on discretionary spending, and implemented a "pay-as-you-go" discipline that required any new proposal for tax cuts or entitlement spending to be fully paid for. Without those vital budget disciplines, this nation would never have achieved a balanced budget.

In 1993, former President Bill Clinton pushed through his economic plan for $500 billion in deficit reduction over five years, continuing the budget disciplines put in place by the 1990 agreement.

Combined with the Balanced Budget Agreement of 1997, these efforts by former Presidents and Congresses sent a vital signal to the financial markets that strong fiscal discipline would be enforced. These credible efforts to reduce the deficit along with the actions of the Federal Reserve, corporate and business leaders helped produce the strongest economic growth and job creation in the history of the country.

Those are the facts. Those lessons should not now be ignored in favor of unproven and speculative theories that promote painless remedies for controlling the deficit. Many of you played important roles in the difficult decisions that had to be made. There is not a member among you that has not at one time or another criticized the dangers of uncontrolled deficits. You were right to do so. Nothing has changed that reality.

Deficits do matter. Increased government borrowing places a drag on the economy by reducing national savings, increasing long-term interest rates, crowding out capital spending, reducing investment in capital stock to improve productivity, increasing the debt owed to foreign investors, jeopardizing the social safety net for retirees, reducing the future income and living standards of American households, and putting a tax burden on our children who ultimately will have to pay the interest on the debt. We have a responsibility to future generations to make sure that any incentive for investment is accompanied by strong fiscal discipline.

The second principle of "do no harm" makes clear that we must not add further instability to the economic outlook of the nation. As Chairman Greenspan pointed out yesterday, the business community is concerned about the consequences of a series of uncertainties that currently plague the nation. That is not to say that they are pessimistic about the long-term future of the country as it confronts these crises. But it is to say that they are increasingly worried about the growing number of problems that the nation must deal with in order to provide a more stable environment for investment and growth. Consider the list of challenges: The potential for war in Iraq, the resulting turmoil in the Middle East, the impact on oil prices, the growing conflict with North Korea, the terrorism alerts that impact on business and consumer fears, the continuing concern over corporate scandals, the confused enforcement and regulatory environment affecting CEOs and boards of directors, the serious losses on future retirement income, the escalating foreign trade deficit, and the budget crisis looming over state governments that will reach $60 billion to $80 billion collectively. All of this combined with a volatile stock market and high unemployment makes clear that we live in a more dangerous and unpredictable world.

To add to this the prospect of cumulative deficits over $2.1 trillion for 2002 through 2011, an $8 trillion fiscal reversal from the $5.6 trillion surplus projected in January of 2001, a national debt on course to exceed $10 trillion by the end of the decade, an extra $1.1 trillion in spending for interest on the debt, an unfunded liability for Social Security, Medicare and other retirement programs that OMB projects to be $24.8 trillion, and a tax cut agenda that could cost $.2.526 trillion over ten years and reduce state revenues by about $64 billion is all tantamount to creating even greater anxiety about our economic future.

Recognizing these realities and the principles that should guide any investment decisions, the following points should be considered in your deliberations:

1. Don't dig the deficit hole deeper. Any costs for an incentive package should follow the "pay-as-you- go" rules with budget offsets or, in the least, should provide a firm fiscal plan to fully pay for these additional costs.

2. Temporary is better than permanent. All economic stimulus measures, including tax cut and spending proposals, should be temporary and

stimulative without harming the long-term budget outlook.

3. Tax cuts should be targeted. Less than nine percent of the ten year $670 billion tax cut proposed by the Administration would have an impact on this year. To be effective and fair, tax cuts should be targeted to consumers and working families likely to spend and businesses likely to invest and hire new workers now.

4. States should be helped through their fiscal difficulties. Any federal effort to promote growth and jobs could be undermined by states having to raise taxes, cut spending and layoff employees in order to balance their budgets. Support to the states for homeland security and sufficient funding for vital programs that serve the most in need could help the states through this difficult period so that federal and state governments are working together and not in opposition to one another.

In his State of the Union address, President Bush said: "This country has many challenges we will not pass along our problems to other Congresses, other Presidents, and other generations." He was right. Unfortunately, his proposals fail to live up to that promise.

To enact permanent new tax cuts in the face of large new spending pressures such as the prospect of a costly war in Iraq, increased homeland security needs and a major prescription drug benefit is to live beyond our means and pass the IOUs to our children and grandchildren.

If incentives are to be provided that support economic growth and job creation, hard choices must be made that implement strong budget discipline and restore a sense of confidence in the economic stability and future of a very uncertain world.
That will require both leadership and sacrifice. That is the clear lesson of the past. It is the clear lesson of the present if we are to secure a strong economy and a strong democracy for the future.

Economic Growth and Job Creation
Senator Gordon H. Smith
2/11/03

- I want to thank the Chairman for holding this hearing on examination of the various proposals for recovery and sustainable growth pertaining to consumption. I want to thank the various witnesses for taking the time to appear here today.

- As I have said before, I strongly believe that we cannot and must not try to tax and spend our way out of the current economic downturn.

- I believe that good stimulus legislation is a combination of short-term and long-term proposals that will give a quick boost to the economy and then sustain that boost into a long period of growth and job creation in the economy.

- Today we are looking at various forms of "consumption" proposals. Both the President's proposals and several of the proposals being discussed in Congress.

- I believe that several of these proposals have great merit - in many instances they perform two functions, one as a safety net for the least wealthy in our society and two they do have some economic impact.

- I don't believe that they have the long-term growth potential of many of the President's proposals - such as acceleration of the previously enacted individual tax marginal rate cuts. But they are stimulative to a degree and, more importantly, I believe, will in some way shape or form will make up part of the stimulus package that will be reported out of the Senate.

- I am a strong supporter of some of these proposals - FMAP legislation – that would allow states to continue providing health care to our society's most vulnerable members in this economic downturn by providing a temporary increase in the federal medical assistance program funds states receive to pay their poriton of the Medicaid bill.

- I believe that FMAP legislation will prevent the erosion of health insurance coverage and maintain a strong health care safety net for the most vulnerable during an economic downturn.

- Further, as states close shortfalls in their budgets they are turning to health care to the poor for budget cuts.

- I also have worked for the last two years on varying forms of Unemployment Insurance, most recently with Senator Kennedy in an effort to help those unemployed in Oregon who have exhausted their benefits and are still seeking employment.

- I strongly supported the President's extension of unemployment benefits...but I think we ought to do more. I believe we need a stronger benefit package that will cover those workers still looking for employment. And there are a lot of those workers in my home state of Oregon.

- I look forward to hearing from our witnesses today.