

**PERSPECTIVES ON DEFICIT REDUCTION:
A REVIEW OF KEY ISSUES**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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JULY 26, 2011
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PERSPECTIVES ON DEFICIT REDUCTION: A REVIEW OF KEY ISSUES

TUESDAY, JULY 26, 2011

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

The hearing was convened, pursuant to notice, at 10:16 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Wyden, Nelson, Menendez, Cardin, Hatch, Snowe, Kyl, Coburn, Thune, and Burr.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; John Angell, Senior Advisor; Alan Cohen, Senior Budget Analyst; Claire Green, Detailee, Social Security; and Tom Klouda, Professional Staff Member, Social Security. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Chris Campbell, Staff Director.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

President Lyndon Baines Johnson once said, "Yesterday is not ours to recover, but tomorrow is ours to win or lose."

Yesterday's fiscal choices created the budget crisis we face today. To pay for yesterday's spending decisions, we now are forced to raise the Federal debt limit.

Raising the debt limit does not mean an increase in future spending. It only permits the Treasury to pay the debts we have already incurred. If we do not act, the full faith and credit of the United States will be compromised. If we do not act, we will default on our obligations in just 1 week. This would result in catastrophic consequences for our economy and cause interest rates to skyrocket.

Americans would not be able to access credit to buy a home, a car, or take out a loan to attend college. Businesses would not be able to meet payroll, much less expand.

The economy would contract, and people would lose jobs. It could lead to another recession or depression. We cannot let this happen.

But to enact legislation to raise the debt ceiling, we will need to pass a significant deficit reduction package. The deficit reduction decisions we make today will determine our economic future.

We need to solve this crisis today in a way that improves our economy tomorrow.

Any deficit reduction package must be fair. It must be balanced. And no one should be left destitute. That is particularly important when it comes to Social Security.

Social Security is not the cause of our deficit problem. It should, therefore, not be a scapegoat for the solution. One proposal that has been part of the discussion is the Ryan plan that was approved by the House of Representatives. This plan is simply unbalanced. It would hurt too many families in Montana and across the country. And, by cutting \$48 billion from programs that serve our country's farmers and ranchers, the House budget would hit rural America far too hard.

While the House budget cuts agriculture by more than 20 percent, it fails to address the escalation in defense spending. Defense spending has roughly doubled in the last decade.

The solution to our budget crisis must be equitable, and it must be lasting. To create a fair package, we have to find savings in security and non-security discretionary spending, mandatory spending, and also revenues. We have to make tough choices, but we cannot balance the budget on the backs of seniors and the middle class, while preserving tax breaks for the wealthiest Americans and special interest loopholes.

Now is not the time for a "my way or the highway" approach. We must all be willing to find common ground. Deficit reduction is just too important.

If Congress does not act, the debt held by the public as a percent of GDP will reach a remarkable 87 percent at the end of the next decade and continue growing.

If, however, we enact \$2.5 trillion of deficit reduction now, we could stabilize our debt at 75 percent of GDP. This would leave us close to our current level of debt at 69 percent of GDP.

If we want to make further progress, we will need even more spending cuts or revenue increases. Finding those dollars will not be easy. Deficit reduction never is. But we have to act before August 2, and we need to reach an agreement as soon as possible.

Over the last 3 months, this committee has held four hearings to examine major issues Congress is considering as part of a deficit reduction package. One idea our hearings explored is enacting an initial package of deficit reduction now, with a path to further deficit reduction in the future.

If legislation with further deficit reduction is not enacted in the future, then severe consequences would occur. This should provide strong incentives for both the House and the Senate to follow through with deficit reduction.

Today, we are fortunate to have an expert panel to discuss the array of proposed plans. There is already substantial agreement on both sides of the aisle regarding areas where we can achieve deficit reduction. But it is time to build on this agreement. Democrats and Republicans have to come together. We have to craft a fair and balanced package to reduce the deficit and raise the debt limit, and act now.

So let us work together now to prevent our country from defaulting, and produce a fair and balanced approach to reducing the deficit and ensure our economic progress continues and provides Americans with the opportunities they deserve.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

**OPENING STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH**

Senator HATCH. Thank you, Mr. Chairman. Thank you for holding this hearing, which continues the series of hearings that we have had on deficit reduction.

This hearing is timely given that the debt limit impasse, unfortunately, continues to grind on.

I would like to welcome all of our witnesses and thank them for their presence and their testimony and their efforts.

Mr. Chairman, I would like to briefly point out that many of these so-called plans for dealing with the debt limit seem to involve instructions to this committee to undertake “tax reform” in short order and with revenue raising as the principal objective. Part of that so-called reform usually is a direction to change tax expenditures.

Now, Mr. Chairman, I believe that, with an income tax system that is roughly 100 years old, we are in need of reform. I believe, however, that we need fundamental and comprehensive tax reform to broaden the tax base and lower tax rates.

I believe that we need tax reform to promote fairness, simplicity, growth in jobs and the economy, and, of course, efficiency.

I do not believe that revenue raising, in and of itself—accomplished by horse trading of selected tax expenditures against each other—is true reform, and I do not believe that such actions are good for jobs and the American people.

I do believe that we should thoroughly examine tax expenditures in the context of tax reform and not as one-off efforts at raising revenue to pay for the spending status quo.

But note, Mr. Chairman, that the Joint Committee on Taxation lists over 217 so-called tax expenditures. Of those, the President picked maybe three in order to get more tax revenue. He proposed hitting oil producers, including small ones; he proposed hitting users of LIFO accounting, which includes many small manufacturing companies; and he proposed hitting commercial jet producers, after having previously set up additional tax expenditures to benefit them.

What the President has proposed or leaked out to the press is hardly reform and is nowhere near comprehensive. We need to look at the forest of individual and corporate tax expenditures and not merely three trees that appeal to focus groups or along the campaign trail.

A comprehensive examination of tax expenditures will require an examination of a host of factors, including distributional effects and interactions among various features of the tax code. And a comprehensive examination will look across all tax expenditures.

Many tax expenditures are valued highly by Americans across the political and income spectrums, such as incentives for charitable giving. Other tax expenditures seem to benefit some at the expense of others, such as deductions for State and local taxes, which work as a subsidy from taxpayers in low-tax States with low

levels of government to wealthy taxpayers in high-tax States with robust levels of government spending.

We need to look across the board at tax expenditures and not simply at whatever subset happens to serve political or campaign interests. And we need to clean out our tax code. It is riddled with tax expenditures which, while often instituted with good intentions, have generated an inefficient tax code.

The code is a mess, and it has created an environment where Americans no longer trust that everyone pays their fair share due to loopholes, tax breaks, tax arbitrage, tax gimmicks, or whatever you want to call them.

We need fundamental and comprehensive tax reform, not a quick revenue fix to get us past August 2.

Mr. Chairman, I look forward to the testimony that we are about to hear, and I want to thank you for calling this meeting.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Thank you, Senator. I appreciate it very much.

I would now like to introduce our witnesses. We have a very distinguished panel, many of whom we have already met before. We deeply appreciate their returning.

The first witness is Mr. Robert Greenstein, who is president for the Center on Budget and Policy Priorities. Next, Dr. Lawrence Lindsey. Dr. Lindsey is president and chief executive officer of the Lindsey Group and former Director of the National Economic Council. Third is Michael Ettlinger, vice president for economic policy, Center for American Progress. And finally, Mr. Chris Edwards, director of tax policy studies at the Cato Institute.

Thank you all for coming. Our usual practice is for your entire statements to be included in the record automatically, and I would like each of you to summarize your statements for approximately 5 minutes. I will start with you, Mr. Greenstein.

STATEMENT OF ROBERT GREENSTEIN, PRESIDENT, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. GREENSTEIN. Thank you, Mr. Chairman and members of the committee.

As I do not have to tell you, the Nation is on an unsustainable fiscal path, and, as a number of bipartisan commissions have recommended, we need to stabilize the debt as a share of the economy, which entails reducing deficits to no more than about 3 percent of GDP.

The timing is important. Chairman Bernanke recently noted that it would be unwise to put strong austerity measures into effect right away while the economy is still weak.

In my few minutes, I would like to discuss a few principals and make a few observations about achieving deficit reduction, first and foremost of which is that deficit reduction plans really need to be inclusive, including domestic programs, defense, and revenues alike.

Now, I know the revenue point is a controversial one, but if we look, in particular, at tax expenditures, we really find that a very large amount of spending occurs in the form of tax expenditures or what Alan Greenspan has called tax entitlements.

The tax code now has over \$1 trillion a year in tax expenditures, which substantially exceeds the cost of Medicare and Medicaid combined, the cost of Social Security, and it is about double the cost of all non-security discretionary programs.

Health care, obviously, is another very big issue in the long run. It will need to be the single-largest contributor to deficit reduction, from slowing the rate of growth of health care costs throughout the U.S. health care system in the public and private sectors alike.

But, and there is a conundrum here, big savings in Medicare and Medicaid are not achievable in the next decade without seriously impeding access to care and likely starting to ration care on the basis of income. We need substantial reforms in health care delivery and payment systems, but it is going to take time to identify, test, and institute reforms on a very broad scale.

Rushing, pell mell, into untested approaches risks violating the Hippocratic oath and doing so on a mass scale. And also, a part of our conundrum is that, while measures to restore long-term Social Security solvency are essential, they will not yield significant deficit reduction savings in the decade ahead due to the bipartisan agreement that changes in Social Security benefits should not substantially affect people who are already retired or are nearing retirement.

So the difficulties of securing large savings in the next 10 years in these areas without doing very serious damage is why a number of experts—including the aforementioned Martin Feldstein, including former OMB and CBO director Peter Orszag, and, most recently, including Alan Greenspan—have called for letting all of the 2001 and 2003 tax cuts expire on schedule at the end of 2012 or paying for any parts of those that policymakers wish to extend.

That one step would reduce deficits to about 3.5 percent of GDP after the economy recovers. It would put us in striking distance of stabilizing the debt in the years ahead, and, crucially important, it would buy us time to identify and institute the major changes in the U.S. health care system that will be essential over the long run.

Let me say a word about the topic of spending caps. Caps can and have been placed on discretionary spending. I am sure they will be again. But capping mandatory spending is a very different proposition. Programs like unemployment insurance, food stamps, and Medicaid expand automatically when the economy weakens.

Economists refer to these programs as automatic stabilizers that help to limit the decline in purchasing power in a slumping economy. Without the automatic stabilizers, recessions would be more frequent, longer, and deeper, and the risk of major recessions turning into depressions would be heightened.

Caps on total Federal spending, as well as the constitutional balanced budget amendment, would keep the automatic stabilizers from working and would risk doing significant damage to the economy, businesses, and workers.

Let me close with one final point. I hope there will be a key principal in deficit reduction—and the chairman already alluded to this in his opening remarks—that we would do it in a way that does not increase poverty, hardship, and inequality.

We are a country that already has higher levels of poverty and inequality than other Western industrialized nations. The Bowles-Simpson plan erected a principle to protect the disadvantaged and to achieve deficit reduction in ways that do not increase poverty.

In April, a group of Christian leaders from the Catholic Bishops to evangelical leaders called on policymakers to honor this principal and draw what they called a circle of protection around programs for the poor. And a few weeks ago, a group of leaders of major national charities and nonprofits—the head of the United Way, Feeding America, Independent Sector, and leading civil rights organizations—issued an unusual joint letter in which they stated, and I am quoting, “Any agreement on deficit reduction should neither cut low-income assistance programs directly nor subject these programs to cuts under automatic enforcement mechanisms.”

I would simply note that virtually all major deficit reduction or fiscal responsibility laws of the past quarter century—the 1985 and 1987 Gramm-Rudman-Hollings laws; the 1990, 1993, and 1997 deficit reduction packages; and the 2002 pay-as-you-go law—did abide by these principles, and I hope the current Congress will do so again.

Thank you very much.

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

The CHAIRMAN. Thank you very much, Mr. Greenstein. That was very interesting.

Dr. Lindsey, you are next.

STATEMENT OF DR. LAWRENCE B. LINDSEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE LINDSEY GROUP, AND FORMER DIRECTOR OF THE NATIONAL ECONOMIC COUNCIL, FAIRFAX, VA

Dr. LINDSEY. Thank you, Mr. Chairman and members of the committee. I appreciate this opportunity to be here today.

In the past few weeks, your job has been extremely difficult. Unfortunately, I do not think I am going to make it any easier with some of my comments.

Media attention has been focused on the issue of the debt cap. Actually, I think the more important issue is getting long-term control of our fiscal finances.

The credit rating agencies have noticed this. Although, again, a lot of attention is focused on the debt cap, the S&P warned back on July 15 that it might downgrade U.S. debt. Their main justification was not the debt ceiling but, and I am going to quote, “if we conclude that Congress and the administration have not achieved a credible solution to the rising U.S. Government debt burden and are not likely to achieve one in the foreseeable future.”

Earlier this year, there was a lot of talk about a clean debt ceiling increase. That misses the point. I think instead we have to focus on solving the long-term debt problem.

My concern about the failure to take this opportunity to reduce long-term government spending and our debt situation is amplified by a belief that the official deficit estimates are far too optimistic. First, these deficit projections are predicated on overly optimistic expectations for economic growth.

For example, the President's budget projected growth of 3.1 percent this year, 4 percent in 2012, 4.5 percent in 2013, and 4.2 percent in 2014. We know that growth in the first half of this year was roughly 1.5 percentage points less than what the President's budget projected.

Moreover, there is an academic consensus that growth after a financial crisis tends to be at trend, not well in excess of trend. The budgetary consequences of overestimating growth, as in the President's budget, are dramatic. If you page further back through the President's budget, the budget points out that missing growth by 1 point in 1 year increases the 10-year deficit by \$750 billion.

Thus, just the 6-month shortfall that has already occurred during the first half of this year means an increase in the 10-year deficit of a bit over \$500 billion.

If the economy rebounds to a trend rate of growth of 2.5 percent starting in the current quarter, the cumulative shortfall in GDP by the end of 2014 would be 5.5-percentage points, implying a 10-year increase in the projected national debt of more than \$4 trillion.

This overwhelms anything that is now being considered as far as deficit reduction goes.

Second, Federal borrowing costs are now well below historic norms. In the past 20 years, these costs have averaged 5.7 percent. Currently, they are just 2.5 percent. This means that a mere normalization of borrowing costs would mean an extra \$700 billion per year by the end of the current decade and a gradual ramp-up to normalized rates would add \$4.9 trillion to the Treasury's interest costs over the next decade relative to maintaining current rates.

I might add that the CBO does have a more modest ramp-up in rates that accounts for about half of this in its long-term projections.

The real concern here should not be a gradual normalization of rates. The recent lessons from Europe or the many lessons of history from previous sovereign debt crises indicate that the government bond markets function smoothly for a long period of time and then suddenly crash.

This has two implications for the budgetary risks we face. One, rates might ultimately move well beyond the normalized average of the last 2 decades; and two, that move is likely to happen much sooner and much more quickly than either we or the CBO now project.

The two risks just mentioned, which I call the growth risk and the interest rate risk, place enormous constraints on the prudent conduct of fiscal policy. It is urgent that we undertake significant long-term deficit reduction, and it is equally urgent that we do so in a way that minimizes any adverse consequences for economic growth.

These constraints provide clear guideposts for what should happen. First, the focus should be primarily on long-term expenditure reductions, not short-run cuts. There is a demand-side element to growth which must be respected. This does not mean no cuts in current expenditures, but near-term spending cuts should probably be limited to perhaps 0.5 percent of GDP in the next fiscal year, with much larger spending cuts to follow.

This is precisely why long-term reform to entitlement spending that sharply reduces total spending over many decades is so crucial. It has little or no long-term impact on growth and, by freeing up resources over the long-term, probably enhances our long-term growth prospects.

Second, the focus of both budgetary and regulatory actions should be on cost-benefit analysis. There has been a lot of talk about government investment. The key is not whether one can theoretically call a spending action an investment, but whether the action produces a positive rate of return for the economy.

Consider high-speed rail. I will admit I regularly ride the Acela between New York and Washington, and, therefore, I am a tremendous beneficiary of the government subsidies to Amtrak.

So, in my personal interest, please do not take that away. But Amtrak barely makes money on the northeast corridor routes, which are the most economically promising part of the market for rail transportation in the country. Money spent on extending high-speed rail to 80 percent of the Nation's population will produce a negative rate of return, making such an investment about as effective as putting one's money in Bernie Madoff's hedge funds.

Third, this analysis can be extended to the tax side of the budget. Fiscal sustainability is much more difficult to achieve with tax increases than with long-term expenditure cuts because of the general rule that the private sector allocates resources in a manner that yields a higher return than does the public sector. If the private sector does not allocate money that produces a positive return, the firm or the individual who makes that investment decision loses their own money.

This not only concentrates the mind, it also reduces the available resources to those who make poor economic decisions.

This does not necessarily mean that higher revenues should not be part of the equation, but the key point to make is that the phrase should be revenues, not rates. Some revenue increases can actually improve economic allocation by removing subsidies to inefficient activities.

But tax rates work in the opposite direction. Higher tax rates muffle market signals and reduce economic efficiency. This fact was recognized by the President's own debt commission, which reduced rates while raising revenue.

In sum, Mr. Chairman, the need for long-term deficit reduction is urgent and has been neglected. We are taking enormous risks with the country's future as a consequence. Such reduction must focus on the long-term expenditure side of the equation, particularly entitlements. And while discretionary spending and extra revenue might be part of the solution, decisions on these issues must face a rigorous cost-benefit test.

Thank you, sir.

[The prepared statement of Dr. Lindsey appears in the appendix.]

The CHAIRMAN. Thank you, sir, very much.
Mr. Ettlenger?

**STATEMENT OF MICHAEL ETTLINGER, VICE PRESIDENT FOR
ECONOMIC POLICY, CENTER FOR AMERICAN PROGRESS,
WASHINGTON, DC**

Mr. ETTLINGER. Thank you, Chairman Baucus, Ranking Member Hatch, members of the committee, for the opportunity to be here today to discuss the Federal budget deficit.

Let me start by saying that, odd as it may seem given the tone of the debate right now, I have actually found the last several months encouraging with respect to the Nation's ability to address our long-term deficit challenges. That is because we are actually now putting the real choices on the table. We are seeing what a plan to reduce the deficit without tax increases really looks like. We are seeing what tax increases might be necessary to preserve favored spending programs. And we simply were not going to make progress until we had an open discussion of the tradeoffs involved or the real choices to be made.

So, in the big picture, I view that as important progress, even if immediately, as the deficit issue has been linked to the debt ceiling, we face a crisis.

One of the most contentious questions with respect to addressing the long-term deficit problem is whether to include taxes as part of the solution. Thanks to the House of Representatives' budget resolution, we now have some sense of what a plan that does not include taxes might look like.

It, of course, essentially ends Medicare in any sense that people are familiar with. Seniors would get vouchers that would not increase in value with rising health care costs, and would carry more and more of the costs and lose access to care. Medicare too would be slashed, hurting not just lower-income Americans, but with 70 percent of nursing home residents benefitting from Medicaid, much of the burden would fall on the middle class.

The cuts would also reach areas of public investment that are important to economic growth: a 50-percent cut in education, 37-percent cut in transportation and infrastructure, and a 20-percent cut in scientific research.

That is why we believe that taxes should be part of the answer. The U.S. is currently collecting the lowest level of taxes since 1950 as a share of GDP. Obviously, some of this is the result of the recession, but it is also the result of a tax system that is simply inadequate to our needs.

We have substantially lower taxes than other countries. Of economically advanced countries, from 2004 through 2008, only Mexico, Chile, Turkey, and South Korea had lower taxes than the United States, putting us at 26 of the 30 OECD countries.

If the U.S. were to raise taxes to the level of Canada, which would make us rank 19th, we would basically solve our deficit problem. That is not to say that we should solve our deficit problem by raising our taxes to the level of Canada and not address spending, but there is room to raise taxes without putting us at economic risk.

And, in particular, there is room to raise taxes on higher-income Americans. Tax rates on the wealthy have dropped precipitously even as their incomes have grown hugely. Adjusting for inflation,

the income of the top 1 percent has more than tripled from 1979 to 2007, and it went up 50 percent from 2001 to 2007.

Let us consider the consequences of letting the Bush tax cuts on the wealthy expire in this context. Given the rate at which the income of the wealthy rises, letting the Bush tax cuts for the wealthy expire would be the equivalent of a 1-time 10-month pay freeze on the richest 1 percent.

Given that the middle class has seen a decade-long and counting pay freeze, that does not seem like either too much to ask or likely to do grievous economic harm.

Nevertheless, there are those who argue that it would cause great harm to the economy. But the tax system we would be returning to, that of the Clinton presidency, certainly produced better results than the Bush tax system, which is, in effect, still the tax system we were operating under during the Great Recession and its aftermath.

It is telling that during the period from when taxes were increased on the well-off under President Clinton in 1993 to their cut under President Bush, the income of the top 1 percent almost doubled. It does not appear that higher taxes dampened the wealthiest 1 percent's enthusiasm for investing, hiring, doing the things they do to increase their incomes, which also benefit the economy.

Finally, just as spending cuts are not the entire answer, neither are tax increases, of course. Raised too high, taxes can, in fact, do economic harm, and there are areas of spending that should be addressed whether there was a deficit problem or not. Defense spending and improving government efficiency should top the list. And in the long run, we have to bring health care costs under control.

To conclude, the devil is obviously in the details when it comes to addressing the long-term deficit issues we face. The solution can and will, I believe, involve both spending and taxes, because the alternatives are unacceptable.

Thank you.

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

The CHAIRMAN. Thank you, sir.

Next, Mr. Edwards.

STATEMENT OF CHRIS EDWARDS, DIRECTOR, TAX POLICY STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. EDWARDS. Thank you, Chairman Baucus and Senator Hatch. Thanks for inviting me to testify today.

Federal spending has soared from 18 percent of GDP a decade ago to 24 percent of GDP today. The CBO, in its alternative fiscal scenario, expects spending to rise up to 34 percent by 2035. That would almost double the size of the U.S. Government between 2000 and 2035.

President Obama last night called for a balanced solution to the debt problem, but CBO projections show that our problem is not balanced. When the economy fully recovers, CBO shows that revenues will rise up to 18 percent of GDP, with all current tax cuts in place, which is the normal level. But it is spending that keeps rising to abnormally high levels.

The United States used to be a smaller-government country, and I believe we prospered because of it. Current OECD data shows that total Federal-State-local spending right now in the United States is 41 percent of GDP. That is just 4 percentage points less than the OECD average of 45 percent.

If you wind the clock back, we used to always have a 10 percentage point spending advantage compared to other OECD countries. We used to be 10 percentage points smaller. We have closed that gap, and we are now becoming just kind of another average OECD welfare state.

If the CBO projections are correct and we do not make any spending reforms, total American Government will consume over half of the economy by 2035. I think that would create a dismal future, especially for young Americans, with fewer opportunities and a huge burden of taxes to support the elderly, in particular.

In the last few years, Congress has deficit-spent \$5 trillion in sort of a Keynesian fashion to try to pump up the economy. But despite that \$5 trillion of deficit spending over the last 4 years, we have had the slowest economic recovery since World War II.

The biggest Keynesian stimulus since World War II, slowest economic recovery since World War II—what I conclude from that is that economists and policymakers, frankly, are lousy at trying to micromanage and stimulate the economy in the short run.

All the focus should be on the long run. Economists know more about what spurs economic growth in the long run, and we should pursue long-run spending reforms.

In the long run, higher government spending will damage economic growth. Former Council of Economic Advisors Chairman Michael Boskin explained it as kind of, the government works with a leaky bucket. When government takes tax actions, when it takes spending actions, it creates distortions on both sides of the budget. So, Boskin says, for example, if the government has a \$1 spending program, it causes \$1.50 damage on the tax side of the economy, and that \$1 of spending will only bring benefits perhaps of 50 cents on the dollar because the government is already so big.

So a new spending program for \$1 causes \$1.50 of damage to the economy and we only get 50 cents of benefit from it. The larger that government gets, the leakier the government bucket becomes, and that is why rising spending in coming years and decades, unless we make reforms, will suppress the GDP growth more and more.

The more government grows, the more GDP will be suppressed. And I would note that CBO's long-range forecasts do not take this into account. CBO long-range forecasts show the government growing as a share of the economy, but they do not take into account that suppression of GDP that will almost certainly occur if that happens.

So, what do we do about this? Well, we need to go line by line through the Federal budget to find the unneeded programs, as President Obama originally said he would. At Cato we have a website, *downsizinggovernment.org*, where we do go line-by-line through the Federal budget, finding all the programs we can cut.

I am glad now that the Senate and the House are sort of converging on a spending cut plan to attach to the debt limit increase.

I would note that even the numbers that are being thrown around, like \$3 trillion over 10 years, are, frankly, pretty small cuts.

CBO has Federal spending in 2021 at \$5.7 trillion. So Speaker Boehner has proposed a \$3-trillion spending cut plan. In rough terms, that is about \$300 billion a year. So that would reduce 2021 spending from \$5.7 trillion to about \$5.4 trillion. That is not very much. That is only a 5-percent cut.

So all the debate that is going on now really only amounts to a 5 percent cut 10 years from now. I think Congress, frankly, should easily be able to achieve that level of cuts, and I would suggest that Congress look at Senator Coburn's much larger set of cuts that he released a couple weeks ago.

His staff went through the budget line-by-line and really did a great research job, with thousands of end notes, finding the programs that do not make any sense anymore.

So to sum up, I think Congress should explore spending cuts in every area of the budget—entitlements, discretionary, defense—and I think cuts would benefit the economy both in the short run and the long run.

Thank you.

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

The CHAIRMAN. Thank you, Mr. Edwards, very much.

Gentlemen, this perhaps puts it a bit too simply, but one of the big differences between the plans outlined by the speaker and the majority leader of the Senate yesterday has to do with when the debt limit would be increased, as a length of time, as in the number of dollars that would be contributed to deficit reduction.

Essentially, under Majority Leader Reid's plan, it is about \$2.7 trillion, if I have the numbers correct, of reduction, so that the debt limit would be increased and not have to be increased again until after the election, whereas, under the speaker's plan, it is a 2-step plan, with about half that, initial spending caps, discretionary spending caps, and then there would have to be a second reduction in spending and/or increase in revenue to the deficit to allow a second debt limit increase before the end of 2012.

I would like to ask each of the four of you, on that point alone, one step bigger past 2012 or two steps smaller, two steps total past 2012, if either of those make a lot of difference, in your mind.

Mr. Greenstein?

Mr. GREENSTEIN. Huge difference.

The CHAIRMAN. And why?

Mr. GREENSTEIN. Because I think, if we pursue the speaker's plan, we really run a much greater risk of a default 6 months from now, when we will be in a much more polarized political atmosphere than we already are.

If you look at the speaker's plan, his plan—Mr. Reid's plan—will have about \$1.2 trillion in discretionary cuts. That is not going to come back on the table. The speaker's aides are saying that the Republican leaders would only appoint members to the joint committee who have agreed not to raise any taxes. That leaves only entitlements.

Under his plan, we do not raise the debt limit. Therefore, we can default in 6 months unless we pass \$1.8 trillion in cuts—\$1.5 tril-

lion in policy, \$300 billion in interest, \$1.5 trillion in essentially entitlement cuts 6 months from then.

There are only three ways you can get \$1.5 trillion in the next 10 years. You can cut Social Security and Medicare for current beneficiaries, you can repeal the coverage expansions in the health reform law while leaving the revenue increase in Medicare cuts in that law, or you can eviscerate the safety net for the poorest Americans.

The CHAIRMAN. Thank you.

Mr. GREENSTEIN. And the proof of that is, take the Gang of 6 plan. The Gang of 6 plan has net entitlement savings over 10 years of about \$455 to \$575 billion after you net out the SGR fix, \$755 to \$875 billion before that. The speaker offered \$700 billion to the President—

The CHAIRMAN. I am going to have to—

Mr. GREENSTEIN [continuing]. The President wanted \$650 billion.

The CHAIRMAN. I am going to have to let the others answer that question. We do not have a lot of time left.

Dr. Lindsey, answer my question.

Dr. LINDSEY. I do not think that worrying about the political calendar is really central. I would be more worried about the quality of the decisions being made. If it takes time to carefully sort through tax expenditures changes, entitlement changes, regular discretionary changes, I would much rather take that time.

I do not think that the proposal that Senator Reid laid out is generally considered as having a credible amount of savings in it.

Also, I would hope that, in the second step, we would go, not only to the \$2.75 trillion, but that we would go beyond it, and there is no limitation from the group doing that. I actually think a group of 12 people getting together will produce a compromise, and that seems to be a more sensible approach.

We have to do much more than 2.75, by the way.

The CHAIRMAN. Mr. Ettlenger?

Mr. ETTLINGER. I actually do think you have to pay attention to the political calendar in the sense that I do not think there is a lot to be learned about what the options are between now and 6 months from now. I do not think that the conversation is going to further mature particularly.

I think we know what we know now, and, if it is that hard now to do it, it is not going to be any easier 6 months from now. If anything, it is going to be harder. And I think that the markets will recognize it.

So there is a real risk that the deal might not have the market-calming ramifications that we hope it would have if it is only—if we have to do it again in 6 months.

The CHAIRMAN. Mr. Edwards?

Mr. EDWARDS. I would like the maximum amount of real cuts I can get, and I do not know what the best strategy to do that is. I fear, with a big package like Senator Reid's, there is more of an incentive to put in what I call smoke-and-mirror spending cuts.

I think the \$1 trillion savings he apparently has from Iraq and Afghanistan costs is not a real spending cut.

So having small packages, where we can focus on making sure that we have real cuts, makes a lot of sense. The reality is, there

is not a one-shot deal here. Congress, every year for the next decade, frankly, the rest of our lifetimes, is going to have to do spending cuts and more spending cuts, because \$2 trillion or \$3 trillion in spending cuts is not going to solve our problem.

So, even aside from the debt limit debate, we are going to be fighting over 2012 appropriations and 2013 appropriations.

We have reforms we have to do every year for many years.

The CHAIRMAN. Thank you. Thank you all very, very much.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Dr. Lindsey and Mr. Edwards, both of you suggest that we face a spending problem, and not a revenue problem, and certainly not a problem of taxing Americans too little. At least that is the way I view your testimony.

When I look at history and at the projections by the nonpartisan Congressional Budget Office and by the Office of Management and Budget, following recessions, revenues as a share of GDP seem to fall. Then as the economy recovers, revenues come back.

Now, both CBO and OMB project that revenues as a share of GDP will rise to values above the post-World War II averages as a share of GDP in the near term, and that occurs in CBO projections even when it is assumed that the current income tax rates are extended.

Those projections show me that we do not have a revenue problem or that tax rates are too low. OMB and CBO also project that spending as a percent of GDP will remain well above the post-war average.

Now, Dr. Lindsey and Mr. Edwards, you seem to agree that we do not have a revenue problem, that we do not tax Americans too little. What do you see as problems with the idea that we need to increase taxes and revenues, and what do you see as benefits from reining in spending?

Let's start with you, Dr. Lindsey, first.

Dr. LINDSEY. I think the math that you are laying out is best understood by—if you have a progressive rate structure and the economy grows, automatically, the tax share of GDP rises because the average rate on the economy will rise.

Now, we have gone from an economy with a 91-percent top tax rate to one that is roughly 35, 38 now, and, essentially, the tax rates on a cyclical basis—the tax take of GDP is the same.

That is why I think that is the math that explains it.

Senator, I honestly would prefer a focus on quality and not quantity, on both the tax and the spending side. I think you have to look at the rate of return that is actually generated for the economy from various spending programs, and, quite frankly, some taxes are more harmful than others, and some tax expenditures actually would probably be better off if we did away with them.

So, again, I am not religious about where you get the money. I just am religious in that I think we have to start to take seriously an evaluation of the cost-benefit analysis of everything we do.

Senator HATCH. Mr. Edwards?

Mr. EDWARDS. To build on what Larry said a little bit, the phenomenon of real bracket creep is very powerful when you see this in long-term economic projections.

The CBO's ultimate fiscal scenario shows revenues rising to—I think it is 18.4 percent of GDP by 2021, and then they just kind of assume that that number stays fixed after that. But the reality is that that real bracket creep will keep pushing up revenues as a share of GDP over time if we have solid economic growth.

The way I think about the proper size of the economy here is, when governments are small, they do really useful things. They provide crime control and national defense and the like. But when your government gets to 40 percent of GDP, all levels of government get to 40 percent of GDP, at the margin, that marginal investment that the government might make has a very low or perhaps negative value.

At the same time, the higher the taxes become, the more distortions are created. So the bigger the government gets, the less and less return you get from it.

Senator HATCH. Well, thank you.

Dr. Lindsey, several members of Congress have recently entertained the notion of modifying so-called “tax expenditures,” what some call “loopholes” or “tax breaks” in order to resolve the debt limit impasse or to get more revenue for the Federal Government.

Now, I believe that the principal objective of tax reform should not be simply to raise more revenue for the Federal Government. Rather, equity, efficiency, simplicity, growth in jobs and the economy, and reductions in the abilities of companies and households to arbitrage the tax system for lower taxes should all be prime considerations.

From your experience, do you think that tweaking a tax expenditure here or a so-called loophole there is a fruitful way to address our Nation's fiscal challenges?

Dr. LINDSEY. Senator, I am on record in front of Chairman Conrad's committee as being a virtual bomb-throwing radical on this issue. I do not think that—I think we have reached the limit, effectively, of income taxation.

And this is a very unpopular view, but I think, ultimately, we have to do a substitute of some kind of business receipts tax base instead of an income tax. I really do not see any way, given the political process, to get from here to there.

So I agree with you. Piecemeal moves might help. I would not object to any careful consideration of anything. But ultimately, I think we have to move away from an income-based system to an expenditure-based tax.

Senator HATCH. My time is up, Mr. Chairman,

The CHAIRMAN. Thank you, Senator.

Senator Bingaman, you are next.

Senator BINGAMAN. Thank you, Mr. Chairman.

For most of the time that I have been here in the Senate, the fight over spending and taxes was carried on through the President's proposed budget and through the appropriations process in an effort to get a budget resolution.

And this year, for the first time, we have it being carried out as part of this threat to not raise the debt ceiling. So that is sort of the new leverage that is being used here.

I guess I am concerned that, if you have two objectives, which we have—the need to raise the debt ceiling by Tuesday and, sec-

ond, the need to achieve long-term deficit reduction—we run the risk that our effort to achieve long-term deficit reduction will be substantially impeded if we refuse to raise the debt ceiling by Tuesday.

So I do not know if any of you have thoughts on that.

Mr. Greenstein?

Mr. GREENSTEIN. Well, to invoke an overused phrase that originated in extremely unfortunate circumstances, we have to make sure we do not destroy the village in order to save it. Clearly, if we default, among many untoward consequences, we are going to have increases in interest rates, and then the Federal Government will have to pay more for the interest on the debt, and the deficits and the debt actually get larger as a result.

So nothing could be more counterproductive than to default in the name of dealing with deficits and debt.

Senator BINGAMAN. Dr. Lindsey, did you have a perspective on that? When you were head of the President's council or Director of the National Economic Council for President Bush, you did not have this problem of Congress saying we will not raise the debt ceiling.

As I recall it, there were about seven different increases in the debt ceiling under President Bush. What is your thought about the tying of the two together, the tying of the long-term deficit reduction plan to giving permission to raise the debt ceiling?

Dr. LINDSEY. You are right. There was not an issue in the 2 years that I was there. But I remember—I think it was 2006, there was a debt ceiling vote. And, again, I am not pointing fingers, but I know Senator Baucus voted against it, and I know you voted against it. I am not sure Senator Nelson was in.

But President Obama, who was then a Senator, he said the fact you are voting on a debt ceiling was an indication of a lack of leadership, and the entire caucus on your side voted against raising the debt ceiling.

Again, let us be grown-up about this. This is one of the games that has been played in Washington a long time. It is part of the structure of the way things are done. It depends on which party is in the White House, which party is in the Congress. That is the way it happens.

I really think we have to move—I am sorry to be cynical about it, sir, but I have been in this town since 1981 and, you know, look, you guys are going to—I think you guys are going to get together, you are going to pass something, it is going to all work out. It may not happen by August 2, but it is going to happen, because in the end, we are all Americans and we all come together.

These are not easy issues to solve, but saying, that, oh, gee, they are playing a game and we have never played the game, I am sorry, Senator, that is just not true.

Senator BINGAMAN. Well, you do admit, do you not, that there has never been a refusal to raise the debt ceiling by the Congress? I believe since the 1950s, we have raised it 89 times under both Republican presidents and Democratic presidents. We have never threatened to—never to the point where we were saying, if you do not agree to our plan for deficit reduction or for spending and taxes, we will refuse.

Dr. LINDSEY. Again, Senator, in 2006, I was not in government. I had been—I will just remind you what happened in 2006. We were in a situation like we are right now, where the Treasury—it was Secretary Snow—was trying to figure out how to make the bills. We had exceeded the borrowing authority. We were doing all kinds of gimmicks like we are now.

The same thing happened then. I am sorry, sir—and I do not mean to be disrespectful at all—it has been part of this town on a bipartisan basis for as long as I have been here and probably long before that.

Senator BINGAMAN. Let me just say—

Dr. LINDSEY. That is not a reason for you not to act.

Senator BINGAMAN. Let me just say I do not recall the same situation—

Dr. LINDSEY. There was not an alternative deficit plan put up. At that point—

Senator BINGAMAN. I recall a very different circumstance, where it was clear that the debt ceiling would be raised, and I think the great confidence that you have that all of this is going to work out and it does not matter whether we get it done by Tuesday, is a confidence I do not share.

The CHAIRMAN. Senator Coburn?

Senator COBURN. I want to bring us back down out of the political. And, as I have studied and looked at this and as I talk to economists around the world and economists here, I would like to get your opinion—I do not care where it comes from—what is the dollar number that this country has to achieve over the next 10 years, out of the \$48 trillion that we are planning on spending right now over the next 10 years, to get us well? What do we have to eliminate in terms of dollars? I do not care where it comes from.

For the American people to have the same opportunity and prosperity potential in the future, what is the number that we have to achieve over the next 10 years in lessening the role of the Federal Government, whether it is all out of taxes or whether it is all out of cuts, what is the number that you would think is necessary to achieve that?

Mr. Greenstein?

Mr. GREENSTEIN. I do not have a specific dollar number. The key is, we have to get deficits down so that we stabilize the debt as a share of GDP. We have to get it down to 3 percent or below.

Now, if you use OMB assumptions, you get one number. If you use CBO assumptions, you get another number. If the economy recovers more slowly than either of them predict, you get a third number.

So it is hard to know the precise number.

Senator COBURN. Well, I can give you what those numbers are. If you use CBO's optimistic estimates, you have to get at least \$8 trillion. If you use the Street's average, you have to get \$10.5 trillion to \$11 trillion.

So we are not talking about the real issue. The fact is, we are Greece if we do not do that.

Mr. GREENSTEIN. Two quick thoughts. If you use mainstream CBO and OMB, the numbers are huge, but they are nowhere near

that high. And I do not want to minimize the importance of this, but I do not think we are Greece.

Senator COBURN. Dr. Lindsey?

Dr. LINDSEY. Senator, again, I think there is a quantity issue. I also think there is a quality issue. If the government could produce a magic machine that generated energy for free, I will tell you, I do not care if we had to borrow \$4 trillion to do it, it would have a great rate of return, and we would be better off, and we should borrow the money to do it.

The test always comes—always comes—not on a quantitative basis, but on a qualitative basis. The markets punish countries that take money in a way that weakens their economy and spend it in a way that does not strengthen their economy.

So I think the numbers that you mentioned, that \$8 trillion to \$10 trillion, are probably the right numbers, but I think there needs to be a lot more emphasis on the quality of spending and the quality of taxes, because that is going to get us a long way right now.

Senator COBURN. Mr. Ettlenger?

Mr. ETTLINGER. Yes. So I think what is less important than the 10-year aggregate is where you are headed and where you are ending up. And I do not have—I have not done the calculation you are asking for, but our view—my view has been that, certainly, by 2015, 2016, we ought to have stabilized the debt-to-GDP. We ought to be close to primary balance.

And in that year—we did an exercise where we came up with a plan to achieve that in 2015, and, relative to the President's budget at that time, that would take \$256 billion in 2015.

So you can kind of scale that; it would take somewhat more in the years subsequent to that. Our view has been that we do not think that there should be huge amounts of deficit reduction, consistent with what Dr. Lindsey says, in the median term.

But by 2015, we should be shooting for getting into primary balance and then sustaining it. And, if you got to there, you would be in a pretty healthy situation.

Let me just add that I would say that I do not think that that should be our ultimate goal. I think we should do better than primary balance. But in terms of getting us healthy and getting us stable, that is where we see the goal being.

Senator COBURN. But if you had primary balance, and you had 6 percent—if you went back to historical interest rates, at primary balance at \$256 billion, we are dead. So using primary balance—well, if you have a 6-percent interest rate, what you are going to have in 2015 is interest costs of about \$1.3 trillion a year.

So primary balance does not mean anything when the world says, here is our historical average interest cost.

Mr. Edwards?

Mr. EDWARDS. Three quick points. Yes, we have to stabilize our finances, and I think, as Larry pointed out, the risk is on the upside, there is no doubt about it, in terms of economic growth, in terms of interest rates, in terms of inflation.

So you have to cut enough to stabilize our finances. But, secondly, running any deficits, as I am sure you would probably agree, frankly, is immoral. We are pushing costs onto future generations

of young people, young families in the future. Every \$100 billion of deficit spending we do now is going to be a burden on them, which I think is totally unfair.

And then, third, there is a whole issue of how big should spending be. I believe with smaller spending, you increase economic growth over the long run.

So there are three different reasons why we have to cut spending.

Senator COBURN. My time is up, but I want to just make one comment.

If you, in fact, had a cogent policy to eliminate fraud in our health care programs, and you had a cogent policy to eliminate duplicate government programs, you would eliminate \$2 trillion over 10 years starting tomorrow, just that common-sense approach. That is the first \$2 trillion. And nobody is talking about doing any of that.

The CHAIRMAN. Senator Cardin, you are next.

Senator CARDIN. Thank you, Mr. Chairman.

Mr. Greenstein, I certainly agree with you that the test needs to be debt-to-GDP. I think that is the critical factor.

But I just really—when we look at our America and the international community, we have a strong economy. It has to be stronger, there is no question about it.

Our share of government as part of our economy is less than the industrial nations that we like to compare ourselves to, and we take a look at other factors.

The amount of our economy we devote to our national defense is out of line with the rest of the industrial world.

So we are looking at America from a competitive point of view. There are multiple factors. There is not one single factor, and I think we need to understand that, and we need to do a better job, because international competition is only getting more difficult, and America's economy and job growth depend upon us getting this right.

But we are faced with an August 2 deadline, and we have, at this stage, at least two competing ways in which we can get past August the 2nd, and they are, to get the debt ceiling increase, which everybody admits is one goal, and two, a glide path to deal with our deficit.

And it is interesting. They differ in one significant way, and that has been a common theme I find here in Washington that has been an issue of our economy, and that is predictability.

Now, we pay a heavy price, I believe, and I would like to get your view on it, for the failure to give predictability. Our appropriators have no idea what our budget is going to look like this year because they cannot get their allocations. We have to get that done.

The Reid proposal puts us on a predictable path for the next 2 years. It gives us confidence—if we were to pass that, we would have confidence as to what our budgets would look like for the next 2 years, what our deficit reduction would look like for the next 2 years—and establishes a joint committee for the longer-term issues.

Now, I understand the unpredictability of a joint committee, but the Boehner proposal also has a joint committee, puts much more

on it, and leaves for a future determination whether, in fact, we will go through the same ordeal again in a few months.

Now, I have heard the business community come in here and say, "Look, give us the ground rules and we will respond to whatever the ground rules are. Make decisions."

Our chairman talks frequently about how many temporary provisions we have in our tax code and how we have to deal with that to give the private sector the ground rules in order to respond.

So I would just like you to focus on this one issue of predictability and how important it is for us to give the markets some degree of confidence that we have a game plan that the Democrats and Republicans both agree to.

No, it may not have enough deficit reduction to satisfy your needs, but at least it is a game plan that gives some confidence that we in Washington could get things done.

How important is that?

Bob, you can start.

Mr. GREENSTEIN. Senator, I am really scared that, 6 months from now, we really are going to look like potentially we could look, like a banana republic, in two respects.

So I look at Senator Reid's and I look at Chairman Boehner's proposals, for example, for the discretionary spending level for 2012, and I do not know whether those levels, which are pretty close to each other, would be the agreed-upon levels to which appropriations bills would be marked or whether the House of Representatives would then ignore that and continue to mark up—

Senator CARDIN. My understanding is, Senator Reid's proposal will have the allocations to the appropriators. So we will have that, if that is agreeable.

Mr. GREENSTEIN. My point is—is there an agreement in both houses that those are the levels we mark the appropriation bills to, or do we have the risk of a government shutdown in the fall and then 6 months from now? Your point—I think, if you follow the Boehner prescription, you would likely have a deadlocked joint committee with Republican members refusing to do anything on taxes, Democratic members looking at the phenomenal impacts of \$1.5 trillion in entitlement cuts over 10 years, double or 2.5 times the Gang of 6, and we would have a deadlock, and we could have a default.

So I am very worried about both the potential for a government shutdown and a default 6 months from now.

Dr. LINDSEY. Senator Cardin, first, I would point out that the Senate did not pass a budget last year or this year. The economy still functioned, as far as uncertainty goes.

When it comes to the specific plan, you ask, if you read what the S&P report was, the proposal that the majority leader has advanced would guarantee a credit write-down, markdown of the credit standing of the United States.

What they stressed, I think, would actually increase uncertainty. Now I am not sure, to be honest, that Speaker Boehner's plan would avert that. I think it would delay it. But I would rather delay being marked down than guarantee being marked down right away.

And so I think that a 2-step approach is far sounder than one that guarantees that the credit rating agencies downgrade us.

The CHAIRMAN. Senator Menendez?

Senator CARDIN. Mr. Chairman, I would like quick responses from the other two witnesses, if we could.

The CHAIRMAN. Go ahead.

Mr. ETTLINGER. Just quickly. I think that, Senator, in fact, uncertainty is a great problem here, and I think, in fact, there may already be economic harm being done by not reaching a debt limit agreement.

We have had a couple of rough months in the economy, and that may well be the private sector reacting to the threat of a disaster happening on August 2 and their reluctance to hire people and put themselves on the line given that uncertainty.

Mr. EDWARDS. Very quickly. There has long been uncertainty in both the tax and spending side of the budget. I mean, on the tax side, there is general agreement it is crazy to keep extending the R&D tax credit, for example, by a year or two at a time. Businesses cannot plan.

On the spending side, we have issues—like the transportation funding now is totally up in the air. FAA funding is totally up in the air. Every year Amtrak comes before Congress, and they do not know how much money they are getting.

So Amtrak or the FAA, they cannot do rational capital investment unless they have long-term certainty. I mean, I proposed, for a lot of transportation, FAA and Amtrak, to privatize, to set them up as independent for-profit or nonprofit corporations. That way, they can have rational long-term planning.

Senator CARDIN. Okay.

Senator HATCH [presiding]. Senator Menendez? You are going to have to reset the clock.

Senator Menendez?

Senator MENENDEZ. Thank you. Speaker Boehner, in his rebuttal last night, derided the idea of a balanced approach to achieving long-term fiscal balancing, which in Washington means, we spend more, you pay more. And while this might be, in my mind, a nice-sounding platitude, I do not believe it is being straightforward with the American people.

The reality of the situation is, we have the largest generation of retiring Americans the country has ever seen. We have promised this generation of Americans a certain standard of living through investments in Social Security and Medicare and Medicaid in terms of the quality of their lives.

The question we are faced with is, how much of this promise are we going to keep, and how do we pay for it?

And I think while, with all due respect, the speaker hides behind the term “spending,” he avoids the reality that is a fundamental question about that quality of life for millions of Americans and the responsibility to meet it.

So, Mr. Greenstein, let me ask you: in terms of the impact on the standard of living for seniors in America, is there much of a difference between the Republican budget that was passed and the cut, cap, and balance process that the speaker presents as a viable option?

Mr. GREENSTEIN. I think the difference is very great. The cut, cap, and balance plan ultimately sought to reduce spending to about 18 percent of the gross domestic product. It averaged about 22 percent under Ronald Reagan, when there were no baby-boomers retired and health care costs per beneficiary were about one-third lower than they are today.

You really cannot get to those numbers without massive changes in Social Security and Medicare and Medicaid that, in the next 10 years, would require very deep cuts and big impacts on the standard of living.

I think we all agree that we need to significantly slow the rate of growth of health care costs systemwide, including Medicare and Medicaid, in the long run. But we do not yet know all the ways, or many of the ways, to do that—without really compromising health care quality—that get us big savings in the next 10 years.

Now, I used to think a balanced package went something like Senator Conrad's plan that was 50/50, or the Rivlin-Domenici plan. Then there was the Gang of 6 plan that was 2:1. And now we are being told the plans that are 5:1, 10:1, 20:1 spending cuts to revenue increases are unacceptable even after no less than Martin Feldstein has said tax expenditures are the single-biggest source of wasteful spending in the Federal budget.

So, yes, I think this is a serious issue for both seniors and vulnerable and low-income Americans.

Senator MENENDEZ. Mr. Edwards, I saw on page 2 of your testimony that, in your view, the Bush tax rate cuts simply brought the United States into better competitive alignment with other advanced economies. Right? That is your testimony.

Mr. EDWARDS. Right.

Senator MENENDEZ. So I looked. U.S. average GDP growth under the Clinton years from 1992–2000 was 3.85 percent. The OECD average for the same time period was 2.93 percent. The U.S. average under the Bush years was 2.08 percent. The OECD average during those same years was 2.14.

So how is it that, in terms of competitive advantage, our economy performed better by GDP growth relative to our competitors under the Clinton tax regime than the Bush tax regime? The numbers do not seem to bear out your view.

Mr. EDWARDS. Of course, many things go into determining economic growth rates in addition to taxes. During the 1990s, a lot of stuff went right. We had the NAFTA free trade agreement. President Clinton brought spending down to, I think, at least a post-1950s low of 18 percent of GDP. So there were a lot of spending cuts during the 1990s.

We had baby-boomers at their peak earning years during the 1990s. So they were highly productive and producing a lot of GDP.

President Bush did a lot of stuff wrong, in my view. The wars have been enormously expensive, and I would differ from, I think, a lot of conservatives on this point. The wars, just like other domestic spending, are very damaging to the economy. It sucks money right out of the private economy and spends it on activities which do not benefit average persons' consumption or standard of living.

So Clinton did a lot of things right, Bush made a lot of mistakes. But I do think if you look now, the average top personal income tax rate in the OECD is 42 percent this year. If you add State and local taxes onto our Federal top rate of 35, you get to about 42.

So the United States is just about the average of other OECD countries today in terms of the top rate.

Senator MENENDEZ. Yes. There are other taxes in those countries as well.

The final point: I would agree with you that President Clinton did a lot of things right. As a matter of fact, they are instructive for us at this moment. When we had the Deficit Reduction Act, it was a combination of spending cuts, some entitlement changes—not as deep as the ones we are talking about now—and revenue. And the confluence of those three actions created the first balanced budget in a generation, record surpluses, low unemployment, low interest rates, low inflation, and the greatest peacetime economy in a generation.

So it seems to me—I agree with you—he did a lot of right things that are instructive to what we need to be doing now.

Thank you, Mr. Chairman.

Senator HATCH. Thank you.

Senator Burr?

Senator BURR. Mr. Greenstein, you said that one of the plans had leverage of 20:1. Can you tell me who introduced that plan, or was that just a number you pulled out of the sky?

Mr. GREENSTEIN. Neither. I am being rhetorical here. The point that I am making is, we are being told that plans that have any revenue contribution, regardless of the ratio, are not acceptable.

Senator BURR. Right. I think you gave the impression that somebody was out there proposing something that was leveraged 20:1.

Part of what Senator Menendez just said: predictability is important—let me tell you what is predictable. I agree with Dr. Lindsey. At the end of this process, we will raise the debt ceiling, and a year and a half from now we will have a \$17.8-trillion debt limit. And in January of 2013, we will be faced with a decision of raising it again.

So, Dr. Lindsey, let me ask you this. At what point does the sovereign debt of the world become so big that the global capital available either cannot or will not finance it?

Dr. LINDSEY. Well, the “will not” always happens before the “cannot,” and that is what we have to pay attention to here, and that is what I would focus on in the credibility.

Again, I think that the deficit estimates that are now laid out are far too optimistic, the point I made in my testimony. We are living in an artificially low interest rate environment, and I think that a \$2.75-trillion deficit act this year would probably be barely enough to keep the markets happy until we have to repeat this times two or three in January 2013.

Again, I do not think that the proposal that—I have great respect for him, but I do not think the majority leader’s proposal—I think we would be downgraded in August if the majority leader’s proposal is adopted, and it will be too late.

But I think we have at least a chance of surviving until January under Speaker Boehner’s proposal. It is only a chance. It depends

on what the commission reports. But if I have a choice between being executed in the morning and being executed 6 months from now, I would at least go for the 6 months and hope something happened in between.

Senator BURR. Does the global capital that is available to finance sovereign debt make an investment decision between investment in sovereign debt or investment in gross of economy?

Dr. LINDSEY. The thing about sovereigns is, they rig the rules. And there is something out there—there is literature out there that has really caught on in the last year—called financial repression, and we are busily financially repressing the world markets into making sure they fund sovereign debt.

We are doing it through risk ratings. We are doing it through Basel III, we are doing it through money creation, we are doing it through regulation. So you can coerce the private sector into funding the government. That always happens. The Bourges did it, and the Romans did it, and we will do it, and we are doing it right now. That is really not the test.

The test is going to be what the impact of that is on the economy and the extent to which you starve private sector investment and growth as a result, and I think that is where the focus should be.

Senator BURR. Mr. Greenstein, I think you have admitted that there needed to be some cuts. Let me just ask you. Would you consider means-testing Medicare and Social Security as an option?

Mr. GREENSTEIN. History will show that I met with the chairman in 2003, he may recall. And when the prescription drug bill was being considered, I was one of the people who recommended that he support well-designed proposals to income-relate the premiums, which he did. I supported the proposals to strengthen the income-relating of the premiums in the Health Care Reform Act.

I do think we have to be careful as to how far we go. We do need to maintain these as universal social insurance programs with broad support.

I do understand that there was a further element in the deal that was discussed between the President and Speaker Boehner on that front. Given my very limited knowledge of what it is, if it is what I thought it was, that did not sound unreasonable to me either.

But there are limits as to how far we go there.

Senator BURR. Well, let me just remind all. If we spend \$3.7 trillion this year, we will collect \$2.2 trillion. We have a delta of \$1.5 trillion. If you eliminated all discretionary spending and all the money we devote to defend the country, we are still \$200 billion shy of balancing this year's annual budget.

Now, I agree with Dr. Lindsey that this is not the time to look at how we necessarily tighten the annual budget—we have to be more concerned with the long term.

But the takeaway from that, on a 1-year snapshot, is, you cannot get there without reform of our entitlement programs. That is Social Security, it is Medicare, it is Medicaid. Unfortunately, we have allowed the term “reform” to be hijacked to mean cuts.

When we talk about health care, it should be about outcome. Can you reform the Medicare system where the outcome is more positive for the participants and the cost is less for all who contribute?

I believe if we look at it from that standpoint, we can accomplish big things.

If we continue to look at it from the political sides of this debate, where any cut is a cut in quality, which is not true—as Dr. Coburn pointed out before he left—if we committed to this, we could save \$200 billion almost immediately. If we refocus how we look at the health care system and, more importantly, that means how we construct the health care system, if we insist that no changes can be made, let me assure you, the formula is there today for disaster down the road, whether that is 18 months from now when we are at \$17.8 trillion and we start this debate again, or we get to a point where the capital available in the world chooses to finance the expansion of business and job creation versus financing sovereign debt. We will not be the only game in town forever.

I thank the chair.

The CHAIRMAN. Thank you very much, Senator.

Next, Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. This is an important hearing.

And let me take this discussion for a minute or two in a different direction. In my view, one of the best ways to cut the deficit is to generate real economic growth and more jobs. And, obviously, over the last couple years, we have thrown a lot of efforts at this cause.

The Fed, of course, has dramatically slashed interest rates. We had the Economic Recovery Act. We had a whole host of housing initiatives to try to help hard-hit homeowners. But we are not generating the growth that we need.

Now, my view is the one major unused tool in the economic tool shed is tax reform, and Chairman Baucus has had very good hearings on this issue. There is a long history of it being bipartisan, Democrats and Ronald Reagan teaming up.

And it seems to me it can address all of the points that you are making here at the table. For example, Mr. Greenstein—whose work I have long admired—makes, I think, a very solid case with respect to the question of demand and what happens in an economy like this where middle-class folks and lower middle-class people are hurting and they are not going to the stores, they are not buying the washing machine, the consumer durables and the like.

Significant bipartisan tax reform could, for example, give tax relief of \$2,500 or \$3,000 into the pockets of those folks who could get back into the economy, and it would be permanent tax relief—permanent tax relief, so that the middle-class person, the lower middle-class person, could get back into the economy.

It is something that—I have listened to a lot of the hearing. It sure seems that the partisan divide is as sharp as ever. This is something with a history, where, under Chairman Baucus's leadership, Senator Hatch, members on both sides of the aisle, we could go in a direction that has a history of really doing something to generate growth, which is certainly not the only way to cut the deficit—we would never say that—but could make a meaningful difference.

What is your thought on, particularly, the idea of speeding up the timetable for tax reform, so that, because we see the history

that other steps have not worked, this is something where the timetable ought to be sped up?

Let me just go right down the row.

Mr. EDWARDS. I have long thought the single-best thing we could do for the U.S. economy is to cut our Federal corporate tax rate to get it in line with rates around the world, and there does seem to be bipartisan interest in that.

The average corporate rate in Europe now is only 23 percent. Our Federal and State rate is 40 percent. It makes no sense.

In the last couple years, because of the recession, there has been a lot of discussion, a lot of Keynesian economists who have said, well, we need more demand in the economy to get businesses investing.

But, if you look at the S&P 500 companies, half of their sales and profits are abroad these days. So the issue is not just U.S. demand. The issue is global demand, and the issue is, how do we get companies like Intel and Caterpillar and the rest, GE, to invest here in the United States rather than to expand their factories abroad?

And we all know it is an increasingly competitive world. So I think cutting the corporate rate now in a permanent way to give businesses long-term predictability, to 20 percent or so, would just be a fabulous thing to do.

China and India keep growing. We want Intel Corporation to build new plants here in California and Arizona and elsewhere to supply that growing world market.

So I have long been a fan of the corporate rate cut.

Senator WYDEN. Tax reform is a way to use growth and job creation to cut the deficit and address the topic of the hearing.

Mr. ETTLINGER. It is sort of obvious and simple, but one of the things government should do is sort of get the basics right. So there are a lot of aspects to that. One is investing in education, science, infrastructure—there is the spending side—and then there is certainly the tax side.

I do not think anyone thinks we are doing it right when it comes to taxes right now. There are all sorts of skewed incentives that have been in effect in the code over the years, pulling the economy this way and that way on the micro level.

I think we sort of lost track of what the purposes of a tax system are. So I think that, absolutely, we should launch on tax reform, and that could be a useful contribution to both getting growth going, which has, obviously, benefits for deficit reduction from that standpoint, and then simply from the revenue perspective.

I do think that an important part of that reform, as you alluded to, Senator, is the demand side of the equation. Getting U.S. domestic demand up is, in fact, a very important component to getting our economy going, probably *the* component.

It is true that companies sell—U.S. companies sell worldwide, but on the other hand, it is U.S. consumption and demand which most drives U.S. investment. So absolutely—

Senator WYDEN. Mr. Chairman, my time has expired.

The CHAIRMAN. Go ahead.

Senator WYDEN. If the other two could just address the issue. And to me, if there is some sense that you two think it would make to accelerate the timetable for tax reform, that would leave me

walking out of here to the next hearing I have to sprint to with the sense, again, that you are seeing some bipartisanship come, which, of course, is the coin of the realm right now.

Dr. LINDSEY. Senator Wyden, I remember a few months ago we had this conversation. I think it was in Mr. Conrad's committee. You had four economists, a broad spectrum up there, and they all said the same thing as to where we should go, and that is, move away from an income-based system and move toward a business receipts system.

I am a firm believer in that. I think we should scrap the current system. I know it is not very popular. I think it was you who reminded me that the Senate voted something like 93-3 or something against what I was suggesting.

All right. I am willing to be unpopular. But ultimately, the greatest reform we can make is to get rid of something where—the saying is: income is an opinion; cash is a fact. Once you go to a cash-based system, you get rid of the loopholes automatically, and I really think we have to move in that direction.

Mr. GREENSTEIN. Well, tax reform, if done well, ought to have a positive effect on economic growth. But I really worry that we overstate the effect. It is not a magic elixir, and I worry that people will think, if only we do tax reform, then we do not need to make the other hard choices on both taxes and spending.

I get nervous when I hear you talking about several thousand dollar tax cuts, which I think would be hard for us to afford. Bottom line, I am very much in favor of well-done tax reform that has the net effect of raising revenue and reducing the deficit.

I actually think it would be a mistake to do revenue-neutral tax reform, because it would take off the table the tax expenditures that are the best possibility for a revenue contribution to deficit reduction, without achieving the deficit reduction.

It would thereby put all of the burden on the spending side. I do not think members of Congress ultimately would be willing to do what you would have to do if you do 100 percent of deficit reduction on the spending side.

So we would end up at higher deficits and debt, and the negative for the economy would outweigh the positive.

Senator WYDEN. My time is up, Mr. Chairman. I only offer up that the proposition of having folks in the private sector with good-paying jobs in the United States rather than the folks on unemployment and food stamps, that ought to be part of the equation. I think you agree with that, and I look forward to working with you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. And thank you for holding this hearing. It is really an excellent panel of witnesses, and I appreciate your doing it.

Let me chime in on the theme of Senator Wyden. I, too, believe that tax reform is one part of the way out of this thicket, to broaden the base, reduce rates, help make America more competitive.

I would say, as a member of the commission, Dr. Lindsey, I actually pushed a hybrid system based on the overwhelming testimony

we had from people from very different philosophical backgrounds. The consensus was we ought to move to a hybrid system.

We ought to have an income tax, but we also ought to have a consumption-based tax as well. And I know there is a concern that, if you have two systems, that is going to lead to even more government revenue. I, frankly, do not buy that argument.

The overwhelming testimony before the Fiscal Commission was that a hybrid system would provide us benefits, and, unfortunately, the politics will not allow that at this particular time.

Look, the hard reality that we confront is, the revenue is the lowest it has been as a share of GDP in 60 years. That is fact. Spending is the highest it has been in 60 years as a share of GDP.

So to me, it is pretty self-evident you have to work both sides of the calculation.

Senator Coburn said some things with which I agree. Senator Coburn and I have been locked in a room for hundreds of hours now, and I think we were kind of surprised by how many things we agree on.

I tried to convince the commission to do a \$6-trillion package of deficit reduction, because, when I do budgets, I can balance the budget in 10 years with \$5.6 trillion of changes on the revenue and the spending side.

I also happen to agree with Dr. Lindsey. You are, to me, absolutely right when you talk about quality versus quantity. You have to have both. You have to have quantity. We have to do trillions of dollars of deficit reduction. But how we do it is also critically important.

And the fact is, not all spending is the same. There is spending that really does represent investment in education, in infrastructure. There is other spending that is pure consumption.

On the revenue side, I believe it is also true. All tax plans that raise the same amount of money are not the same in terms of their economic effects. And we have to get smart about this.

This tax code was devised when we did not have to worry about our competitive position. The United States dominated the world economy when we wrote this code.

Is there anybody who believes we would write this code today if we were starting from scratch? I mean, I cannot think of a more anti-competitive, anti-growth code that one could write than the one we have. And in addition to that, more complex.

Rocky Mountain Horror Show, that is the tax code that we have today. But I must say I am also struck by those who say, no revenue. To me, come on, revenue is the lowest it has been in 60 years, and we are not going to have a revenue component? Let's get real.

Here we are in a circumstance in which we are running deficits that are equal to 40 percent of every dollar we spend. We are borrowing 40 cents of every \$1 we spend. And we are not going to have a revenue component?

I will tell you what. If there is not a revenue component, there is not going to be an entitlement reform component, I can assure you of that, because the politics of that are very clear.

But you know what? If both sides would give some ground, if we would acknowledge there needs to be a revenue component—and

one that is carefully designed—and that there needs to be entitlement reform—which clearly there does, because the trustees tell us we are headed for insolvency. This is not imagining; it is going to happen.

I would like to ask, Mr. Ettliger—I was not here when you testified, and I apologize for that. I was in another hearing. For those who say, “Well, it is a job killer if you raise revenue,” I remember very well in 1993 we raised revenue, cut spending. We had the longest uninterrupted period of economic growth in American history, 24 million jobs created.

And when I contrast that with the Bush administration, we had massive cuts and, at the end, we were at the precipice of collapse.

So somehow this idea that there is a neat 1-for-1 relationship, you raise revenue, you kill jobs, can you—I understand you shared some information, I do not know if it was in your testimony that you delivered or in your prepared testimony, on the relationship between revenue and growth.

Mr. ETTLINGER [sarcastically]. Yes. The Clinton era was terrible. I am sure we all remember all the high unemployment and job loss in the Clinton era. That tax structure, which, of course, people are drawing a line in the sand—we cannot go back to that tax structure because it would be so damaging to the economy—in fact, it was an era when—it was not just that we saw job growth in the top-line statistics, but we saw higher business investment; we saw higher growth in productivity. The real building blocks of economic growth were, in fact, much stronger in that era than, not just the Bush era, but they were stronger than actually the Reagan era which preceded it.

So, as Mr. Edwards said earlier, there are many things that go on in an economy, not just taxes. So I would not necessarily say that, because there were higher taxes, and particularly higher taxes on the well-off, under President Clinton, that is the cause of the economic growth. But I think the truth is that there are always many other things going on and that taxes are a factor, but they are not the dispositive factor, and that well-designed taxes and that thoughtful tax policy can, in fact, be very conducive to economic growth.

So I do think that the role of taxes is sometimes overblown in terms of the level of taxes and how it affects economic growth, and, in fact, it is a balance. It is a balance between how you spend that money—if you invest it wisely and do wise things with it, in fact, the higher taxes that pay for that investment and would reduce deficits can be a very strong net-plus, and I think we saw that during the Clinton era.

Senator CONRAD. Let me just conclude, if I can, Mr. Chairman. I will never forget when I first got in this committee, Lloyd Bentsen, who was then the Secretary of the Treasury, called me down to the Treasury Department for lunch, and I assumed I was going with a group of Senators.

I got there, and I was the only one there. And he joked with me. I had just taken his seat on this committee, and he said, “You have inherited the Danish seat,” because he is Danish, and I am Danish.

And he said, “I wanted to make an impression on you.” And he had a little chart—I love charts—he had a little chart, and he had

all the debt of the country, all government debt, Federal, State, and local, all corporate debt, all individual debt, and then he had 1 percent. And you took 1 percent of all the debt of the country—and the point he was making is, interest rates and a change in interest rates make more difference in this economy than all of the tax proposals that were being discussed at the time.

And he said, “Senator, the one thing I want to leave you with is, deficits do matter, debt does matter,” and I got the message. If you would calculate all debt today, all government, all corporate, all individual, I do not know what that number would be. I have asked my staff to calculate that, and it is somewhere in the \$40 trillion range. One percent is a big, big number, and that is something that is critically important for us to remember.

If we get a 1-percent increase in interest rates because of this debt divide that we have right now, that would increase the debt \$1.3 trillion over the next 10 years. That is just the Federal Government debt.

So we have a lot at stake.

The CHAIRMAN. Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. And I want to thank our panel for their presentations today.

And I know this has already been stated, and I apologize for being late. But, Dr. Lindsey, I enjoyed your op-ed in the *Wall Street Journal* a couple of weeks ago talking about the projections for future levels of debt and how understated they may be based upon any sort of return to normalcy in interest rates and more realistic, I would say, assumption about economic growth.

In the whole sort of category of economic growth, I would be interested in your comments about tax reform, reforming the tax code, but doing it in a way that keeps revenue neutral, lowering rates, eliminating deductions, and what the dynamic effect of that might be and whether or not you would expect to see increased economic growth and increased revenue as a result of that.

Dr. LINDSEY. The more efficient we are in anything we do, whether it is in our tax design or our spending design or in our regulatory process, which has been rather bad lately, the higher growth will be.

Now, we have had growth slow on the one hand during the first half of this year. That has already taken basically three-quarters of a percent of GDP. In the long term, it will raise the debt by hundreds of billions of dollars. I think growth is actually essential to the entire proposition of the government’s health.

Senator THUNE. But your view—if you get lower rates, you broaden the base, you get the dynamic effect of the additional—

Dr. LINDSEY. Both broadening the base and lowering the rates are efficiency-increasing changes in the tax system, and both should be done. I am actually more radical. I had mentioned this before. I think you should scrap the income-based system and go toward a business receipts tax system, and you can do that in a progressive way. But I think that is really going to be the end game here.

Senator THUNE. Anybody else? Mr. Edwards, a comment on just how lowering rates impacts revenues and growth?

Mr. EDWARDS. Well, with different taxes, you get different sorts of revenue effects. I think all economists, tax economists, sort of agree with that.

There is a difference of opinion about how big those behavioral responses are, but I think most economists would agree that the biggest behavioral or dynamic responses are from taxes on capital—capital gains and corporate income taxes in particular.

There is academic research by Kevin Hassett at AEI and by Jack Mintz, who is one of Canada's tax economists. They argue that sort of the revenue-maximizing corporate rate is 25 percent. Our current Federal/State rate is 40.

So in other words, they argue—and they look at the cross-country statistics—they argue if you dropped our corporate rate over time, the additional economic growth would be enough to create enough of a dynamic response for a revenue-neutral rate cut, just from a pure rate cut.

Particularly, in a globalized economy, we have to be particularly concerned about taxes on capital. There is a reason why just about every OECD country has cut their taxes on capital more than their taxes on labor, because capital is more mobile. And so we have seen the top corporate rate drop from—a typical rate a few decades ago was 45 percent. The average rate in the OECD now is about 25 percent.

Ministries of finance and economists in every capital around the world are realizing this, that you shoot yourself in the foot by having high tax rates on capital.

Senator THUNE. Do you think that when the economy has recovered, that our tax revenues, taxation, will get back to historical averages?

Mr. EDWARDS. In my testimony, I mentioned this, but the CBO projections show that, by 2021, we get back up to 18.4 percent of GDP in revenue, with all the current tax cuts extended. That is the long-term sort of average.

And the revenues will keep rising after that because of what is called real bracket creep in the tax code.

Senator THUNE. And the argument that we do have lower revenue, which we do, than we have had in a long time, primarily gets corrected when the economy recovers.

The spending, however, which is significantly above historical averages, is going to continue, is it not, at that high level, as you look at the decade ahead of us?

Mr. EDWARDS. Right. If you look at the CBO's sort of long-run do-nothing, no-reform projections, revenues rise back up to 18 percent of GDP for the long run, sort of a flat line, but spending keeps on growing, growing, and growing.

And so it seems to be clear that this is not a balanced problem we face. It is a 1-sided kind of a spending problem.

Senator THUNE. The biggest driver of deficits in future years is health spending. And I do not know, maybe you have responded to this already, but did the health care bill increase or decrease health spending, and what is going to be the effect, positive or negative, for the Nation's fiscal situation as a result of the passage of that legislation?

Dr. LINDSEY. We have already had 1,400 waivers just to try to patch the thing together. In 2013, I guarantee you, you are going to be back here revising that bill, because it will lead to either fiscal collapse or a health system collapse, or both.

So you are probably shy. You are probably underestimating the 10-year costs by about \$1.3 trillion. That is my best back-of-the-envelope calculus from the health care reform bill.

Mr. GREENSTEIN. I would disagree. I think, as in many things, there is uncertainty, but that the best estimates we have are those from the Congressional Budget Office. CBO says modest reduction in deficits in the first 10 years, reductions in the broad range of a half a percentage point of GDP in future decades.

There is a risk that some of the savings do not hold. There is also the potential that a number of the demonstrations and pilots and research produce breakthroughs, and we get much better cost containment.

Senator THUNE. Mr. Chairman, I see my time has expired.

The CHAIRMAN. Thank you very much. And thank you, all of you, especially Dr. Greenstein, because, if you had not made that point, I would have, because the Congressional Budget Office did say compared with law, prior passage, that it does, on the margin, tend to reduce health care costs in this country.

Thanks, everybody, very much. Thanks for the hearing. I hope this helps us in our major effort these next few days in getting the debt ceiling increased and the deficits down.

The hearing is adjourned.

[Whereupon, at 11:54 a.m., the hearing was concluded.]

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

**Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Key Deficit Reduction Issues
*As prepared for delivery***

President Lyndon Baines Johnson once said, "Yesterday is not ours to recover, but tomorrow is ours to win or lose."

Yesterday's fiscal choices created the budget crisis we face today. To pay for yesterday's spending decisions, we now are forced to raise the federal debt limit.

Raising the debt limit does not mean an increase in future spending. It only permits the Treasury to pay the debts we have already incurred. If we don't act, the full faith and credit of the United States will be compromised. If we don't act, we will default on our obligations in just one week. This would result in catastrophic consequences for our economy and cause interest rates to skyrocket.

Americans wouldn't be able to access credit to buy a home, a car, or take out a loan to attend college. Businesses wouldn't be able to meet payroll, much less expand. The economy would contract and people would lose jobs. It could lead to another recession or depression. We cannot let this happen.

But to enact legislation to raise the debt ceiling, we will need to pass a significant deficit reduction package. The deficit reduction decisions we make today will determine our economic future. We need to solve this crisis today in a way that improves our economy tomorrow.

Any deficit reduction package must be fair, it must be balanced, and no one should be left destitute.

That's particularly important when it comes to Social Security. Social Security is not the cause of our deficit problem. It therefore should not be a scapegoat for the solution.

One proposal that has been part of the discussion is the Ryan plan that was approved by the House of Representatives. This plan is simply unbalanced, and it would hurt too many families in Montana and across the country.

And by cutting \$48 billion from programs that serve our country's farmers and ranchers, the House budget would hit rural America far too hard. While the House budget cuts agriculture by more than 20 percent, it fails to address the escalation in defense spending. Defense spending has roughly doubled in the last decade.

The solution to our budget crisis must be equitable and lasting. To create a fair package, we have to find savings in security and non-security discretionary spending, mandatory spending, and also revenues.

We have to make tough choices, but we can't balance the budget on the backs of seniors and the middle class while preserving tax breaks for the wealthiest Americans and special interest loopholes.

Now is not the time for a "my-way-or-the-highway" approach. We must all be willing to find common ground. Deficit reduction is just too important.

If Congress does not act, the debt held by the public as a percent of GDP will reach a remarkable 87 percent at the end of the next decade and will continue growing.

If, however, we enact \$2.5 trillion of deficit reduction now, we would stabilize our debt at 75 percent of GDP. This would leave us close to our current level of debt at 69 percent of GDP. And if we want to make further progress we would need even more spending cuts or revenue increases. Finding those dollars will not be easy. Deficit reduction never is. But we have to act before August 2 and we need to reach an agreement as soon as possible.

Over the last three months, this Committee has held four hearings to examine major issues Congress is considering as part of a deficit reduction package. One idea our hearings explored is enacting an initial package of deficit reduction now, with a path to further deficit reduction in the future. If legislation with further deficit reduction is not enacted in the future, then severe consequences would occur. This would provide strong incentives for both the House and Senate to follow through with deficit reduction legislation.

Today, we are fortunate to have an expert panel to discuss the array of proposed deficit reduction plans. There is already substantial agreement on both sides of the aisle regarding areas where we can achieve deficit reduction.

It is time to build on this agreement. Democrats and Republicans have to come together. We have to craft a fair and balanced package to reduce the deficit and raise the debt limit. And we have to act now.

So let us work together now to prevent our country from defaulting. Let us produce a fair and balanced approach to reducing the deficit. And let us ensure our economic progress continues and provides Americans with the opportunities they deserve.

Reducing Deficits by Cutting Spending

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute,

before the Senate Finance Committee

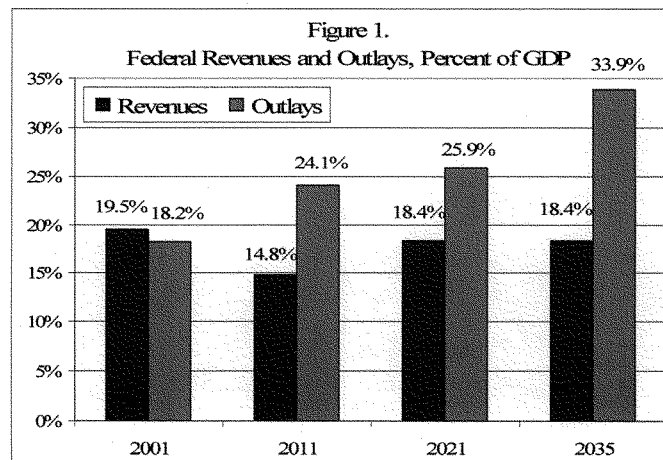
July 26, 2011

Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding federal deficit reduction. My comments will examine current budget trends and the advantages of major spending cuts.

Current Budget Trends

Federal spending has soared over the past decade. As a share of gross domestic product, spending grew from 18.2 percent in fiscal 2001 to 24.1 percent by fiscal 2011. The causes of this expansion include the costs of wars, growing entitlement programs, rising spending on discretionary programs, and the 2009 economic stimulus bill.

Recent projections from the Congressional Budget Office show that without reforms spending will keep on rising for decades to come.¹ Under the CBO's "alternative fiscal scenario," spending will be 25.9 percent of GDP by 2021 and 33.9 percent of GDP by 2035, as shown in Figure 1. Thus, the federal government is on course to consume an 86 percent greater share of the economy by 2035 than it did a decade ago (33.9 percent vs. 18.2 percent).



Some policymakers believe that our main fiscal problem is rising debt, and they are calling for a "balanced" package of spending cuts and tax increases. But CBO projections show

that the long-term debt problem is not a balanced one—it is caused by historic increases in spending, not shortages of revenues. Excessive spending is the underlying cause of the government’s long-run fiscal problems.

The last time the federal budget was balanced was under President Clinton’s last budget in fiscal 2001. Policymakers restrained spending to 18.2 percent of GDP that year, and revenues were abnormally high at 19.5 percent of GDP, mainly due to the strong economy. For example, capital gains realizations were soaring, which caused capital gains tax revenues to hit 1 percent of GDP in fiscal 2001.²

A decade later in fiscal 2011, revenues are down by 4.7 percentage points of GDP, while spending is up by 5.9 percentage points of GDP. However, revenues are down only temporarily due to the poor economy. Capital gains tax revenues, for example, are expected to be just 0.3 percent of GDP this year.³ When the economy fully recovers, revenues are expected to rise to at least the long-term normal level of about 18 percent of GDP.⁴

Some people say that the main problem is that the Bush tax cuts of 2001 and 2003 are draining the Treasury. But with the Bush tax cuts in place, federal revenues were 18.2 percent of GDP in fiscal 2006 and 18.5 percent in fiscal 2007. Certainly, the Bush tax cuts of 2001 and 2003 reduced federal revenues, but CBO scoring shows that they roughly just reversed out the federal tax increases of 1990 and 1993.⁵

Note that even with the Bush cuts, the top federal personal income tax rate of 35 percent is higher than the 28 percent rate achieved by bipartisan agreement in the late 1980s. With state-level taxes included, the top U.S. personal rate today is 42 percent, which is the same as the average among Organization of Economic Cooperation and Development countries.⁶ In my view, the Bush tax rate cuts on ordinary income, dividends, and capital gains simply brought the United States into better competitive alignment with other advanced economies.⁷

Looking ahead, the CBO projects that with current income tax cuts in place and AMT relief extended, revenues will rise to 18.4 percent of GDP by 2021, or a bit above the normal level of recent decades. For 2035, the CBO simply fixes revenues at the same 18.4 percent, but their discussion indicates that “real bracket creep” would actually keep pushing up revenues as a share of GDP beyond 2021.

America Has Become a Big-Government Nation

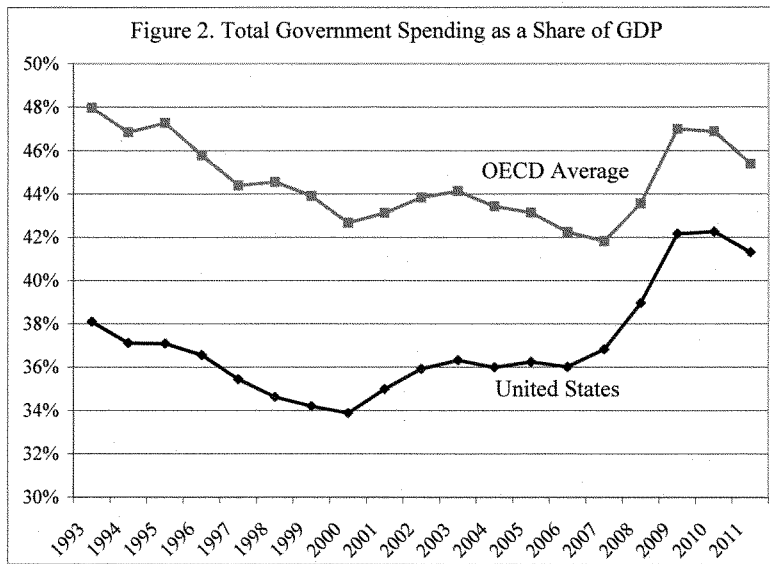
To recap, CBO projections reveal no shortage of federal revenues in coming years. Instead, they show federal spending—which is already abnormally high—rising to unprecedented peacetime levels and the government accumulating massive debt as a result.

The United States used to be a relatively small-government country, but that is no longer the case. OECD data show that total federal, state, and local government spending in the United States in 2011 is a huge 41 percent of GDP.⁸

Figure 2 shows that government in the United States used to be about 10 percentage points of GDP smaller than the average government in the OECD. But that size advantage has

now fallen to less than 5 percentage points. A number of high-income nations—such as Australia—now have smaller governments than does the United States.

Historically, America's strong growth and high living standards were built on our relatively smaller government. The ongoing surge in federal spending threatens to undo this competitive advantage that we have enjoyed in the world economy. The CBO's new projections show that federal spending will rise by about 10 percentage points of GDP by 2035. If that happens, American governments will be consuming more than half of everything produced in the nation by that year. That would doom young people to unbearable levels of taxation and a stagnant economy with fewer opportunities.



Source: OECD Economic Outlook Database, May 2011, Annex Table 25.

Government Spending Harms the Economy

There is some talk in Washington about further spending measures to try and stimulate the flagging economy. Yet now more than two years after passage of the \$821 billion stimulus package in 2009, it seems pretty clear that that effort was a very expensive Keynesian policy failure.⁹

Note that the total Keynesian stimulus of recent years has been much larger than just the 2009 stimulus bill. In Keynesian theory, the total amount of deficit spending is the amount of demand-side stimulus. We've had deficit spending of \$459 billion in fiscal 2008, \$1.4 trillion in fiscal 2009, \$1.3 trillion in fiscal 2010, and \$1.4 trillion in fiscal 2011.

Yet despite that enormous deficit-spending stimulus, U.S. unemployment remains stuck at high levels and the recovery is very sluggish compared to prior recoveries. Indeed, the

current recovery is the slowest since World War II by various measures.¹⁰ Economists Robert Gordon of Northwestern University and Robert Hall of Stanford University recently concluded that it has indeed been the worst recovery.¹¹

Obama administration economists had claimed that the Keynesian “multipliers” from government spending are large, meaning that spending would give a big boost to GDP. But other macroeconomists have found that Keynesian multipliers are actually quite small, meaning that added government spending mainly just displaces private-sector activities.¹² Stanford University Professor John Taylor took a detailed look at GDP data over recent years, and he found little evidence of any benefits from the 2009 stimulus bill.¹³ Any “sugar high” to the economy from recent increases in government spending was apparently very small and short-lived.

The reality is that Washington is very poor at trying to micromanage short-term economic performance. Its failed stimulus actions of recent years have just put the nation further into debt, which has harmed our long-term prosperity. Harvard University’s Robert Barro calculated that any short term benefit that the 2009 stimulus bill may have provided from small spending multipliers is greatly outweighed by the future damage caused by higher taxes and debt.¹⁴

Let’s take a look at how federal spending damages the economy over the long-run. Federal spending is financed by the extraction of resources from current and future taxpayers. The resources consumed by the government cannot be used to produce goods in the private marketplace. For example, the engineers needed to build a \$10 billion government high-speed rail line are taken away from building other products in the economy. The \$10 billion rail line creates government-connected jobs, but it also kills at least \$10 billion worth of private jobs.

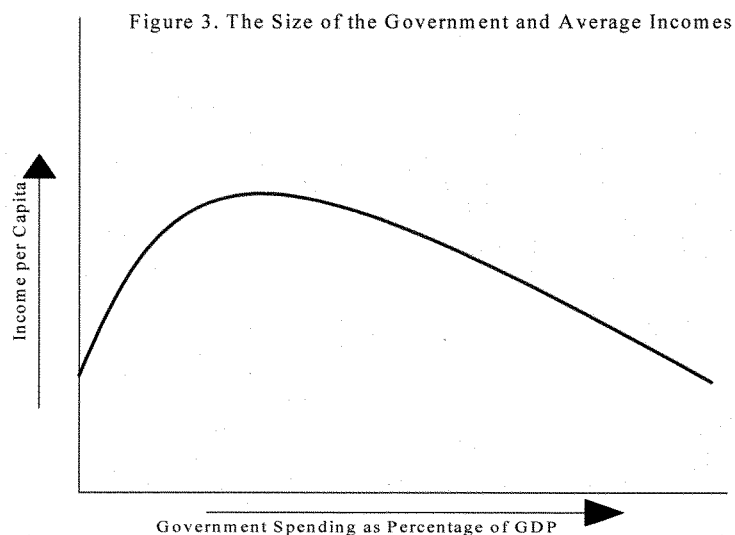
Indeed, the private sector would actually lose more than \$10 billion in this example. That is because government spending and taxing creates “deadweight losses,” which result from distortions to working, investment, and other activities. The CBO says that deadweight loss estimates “range from 20 cents to 60 cents over and above the revenue raised.”¹⁵ Harvard University’s Martin Feldstein thinks that deadweight losses “may exceed one dollar per dollar of revenue raised, making the cost of incremental governmental spending more than two dollars for each dollar of government spending.”¹⁶ Thus, a \$10 billion high-speed rail line would cost the private economy \$20 billion or more.

The government uses a “leaky bucket” when it tries to help the economy. Former Council of Economics Advisors Chairman, Michael Boskin, explains: “The cost to the economy of each additional tax dollar is about \$1.40 to \$1.50. Now that tax dollar ... is put into a bucket. Some of it leaks out in overhead, waste, and so on. In a well-managed program, the government may spend 80 or 90 cents of that dollar on achieving its goals. Inefficient programs would be much lower, \$.30 or \$.40 on the dollar.”¹⁷ Texas A&M Professor Edgar Browning comes to similar conclusions about the magnitude of the government’s leaky bucket: “It costs taxpayers \$3 to provide a benefit worth \$1 to recipients.”¹⁸

The larger the government grows, the leakier the bucket becomes. On the revenue side, tax distortions rise rapidly as marginal tax rates rise.¹⁹ On the spending side, funding is allocated to activities with ever lower returns as the government expands. Figure 3

illustrates the consequences of the leaky bucket. On the left-hand side, tax rates are low and the government initially delivers useful public goods such as crime reduction. Those activities create high returns, so per-capita incomes initially rise as the government grows.

As the government expands further, it engages in less productive activities. The marginal return from government spending falls and then turns negative. On the right-hand side of the figure, average incomes fall as the government expands. Government in the United States—at more than 40 percent of GDP—is almost certainly on the right-hand side of this figure. In a 2008 book on federal fiscal policy, Professor Browning concludes that today's welfare state reduces GDP—or average U.S. incomes—by about 25 percent.²⁰ That would place us substantially to the right in Figure 3, and it suggests that major federal spending cuts would increase U.S. incomes over time.



Cutting Federal Spending

Federal spending is soaring, and government debt is piling up at more than a trillion dollars a year. Official projections show rivers of red ink for years to come unless policymakers enact major budget reforms. Unless spending is cut, the United States is headed for economic ruin. I've proposed a detailed plan at www.DownsizingGovernment.org to cut spending on entitlements, defense, and discretionary spending over 10 years to balance the budget.²¹

The essays on this Cato website provide evidence that many federal programs produce very low or negative returns. Many programs—such as Medicare and the EITC—have

high levels of fraud and improper payments. Other programs create economic distortions, damage the environment, or restrict individual freedom.

The federal government has expanded into hundreds of areas that would be better left to state and local governments, businesses, charities, and individuals. Reviving constitutional federalism is one important way to help reduce federal spending and debt. Cutting federal spending would also enhance civil liberties and improve democratic governance by dispersing power from Washington.

Conclusions

In recent years, policymakers have put great time and effort into trying to manipulate the short-run economy. These efforts have been very unsuccessful, and the government is much further in debt as a result.

Instead, policymakers should turn their full attentions to long-run spending reforms. They should begin terminating the many unneeded and damaging federal programs that draw resources out of the private sector and sap the economy's strength. The Cato Institute has documented the reasons why we should terminate many federal programs and agencies at www.DownsizingGovernment.org.

In addition, Congress should create budget restraint mechanisms to encourage policymakers to make spending tradeoffs. In their recent testimonies to the Senate Finance Committee, former Senator Phil Gramm and former Comptroller General David Walker proposed mechanisms to target and control deficits. However, it would be better for new budget mechanisms to target spending, not deficits. A simple mechanism would be to impose a cap of three percent on the annual growth in total federal outlays. Even that modest restraint would be enough to balance the budget in a little over a decade.²²

Some policymakers worry that spending cuts would hurt the economy, but other high-income nations have cut spending with very positive economic results. In the mid-1990s, for example, Canada faced a debt crisis caused by runaway government spending—similar to our current situation. But the Canadian government changed course and slashed total spending 10 percent in just two years and then held it roughly flat for another three years.²³

Total Canadian government spending was cut by more than 10 percentage points of GDP over a decade. The Canadian economy did not sink into a recession as Keynesian economists might fear, but instead was launched on a 15-year economic boom. A recent Joint Economic Committee report summarizes other international examples of spending cuts coinciding with strong economic growth.²⁴ In sum, cutting federal spending is the right policy to strengthen U.S. growth over both the short-term and longer-term horizons.

Thank you for holding these important hearings.

- ¹ Congressional Budget Office, “CBO’s 2011 Long-Term Budget Outlook,” June 2011.
- ² Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2010 to 2020,” January 2010, p. 85.
- ³ Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011, p. 93.
- ⁴ Historical revenue data is available at www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist01z2.xls.
- ⁵ CBO scores for the first five years of the various tax changes are shown at www.cato-at-liberty.org/how-big-were-the-bush-tax-cuts.
- ⁶ OECD data is available at www.oecd.org/ctp/taxdatabase.
- ⁷ Virtually all OECD nations provide special treatment to reduce the taxation of dividends and capital gains. For example, numerous countries have tax rates of zero on long-term capital gains. See Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
- ⁸ Organization for Economic Cooperation and Development, “Economic Outlook Database,” May 2011, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls.
- ⁹ The “stimulus” bill was the American Recovery and Reinvestment Act of 2009. For an updated estimate of the bill’s cost, see Congressional Budget Office, “The Budget and Economic Outlook,” January 2011, p. 13.
- ¹⁰ Joint Economic Committee, “Uncharted Depths: Welcome to Barack Obama’s ‘Recover Bummer.’” Republican Staff, June 23, 2011.
- ¹¹ Quoted in www.cato-at-liberty.org/biggest-keynesian-stimulus-slowest-recovery.
- ¹² See, for example, Robert J. Barro, “Government Spending Is No Free Lunch,” *Wall Street Journal*, January 22, 2009; John F. Cogan and John B. Taylor, “The Obama Stimulus Impact? Zero,” *Wall Street Journal*, December 9, 2010; John H. Cochrane, “Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies,” University of Chicago Booth School of Business, February 27, 2009.
- ¹³ Dr. John Taylor, Testimony to House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, February 16, 2011.
- ¹⁴ Robert J. Barro, “The Stimulus Evidence One Year Later,” *Wall Street Journal*, February 23, 2010.
- ¹⁵ Congressional Budget Office, “Budget Options,” February 2001, p. 381.
- ¹⁶ Martin Feldstein, “How Big Should Government Be?” *National Tax Journal*, vol. 50, no. 2, June 1997, pp. 197-213.
- ¹⁷ Michael Boskin, “A Framework for the Tax Reform Debate,” in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.
- ¹⁸ Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 179.
- ¹⁹ Deadweight losses rise more than proportionally as tax rates rise.
- ²⁰ See Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 188.
- ²¹ www.DownsizingGovernment.org/balanced-budget-plan.
- ²² www.cato-at-liberty.org/federal-budget-cap-at-3.

²³ See www.cato-at-liberty.org/cutting-government-the-canadian-way and www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.

²⁴ Joint Economic Committee, “Spend Less, Owe Less, Grow the Economy,” Republican Staff, March 15, 2011.

Center for American Progress Action Fund



**Testimony before the Senate Committee on Finance on “Perspectives on Deficit Reduction:
A Review of Key Issues”**

**Michael Ettlinger,
Vice President for Economic Policy, Center for American Progress Action Fund
July 26, 2011**

Thank you Chairman Baucus and Ranking Member Hatch for the opportunity to appear today to discuss the federal budget deficit.

The risks associated with the nation’s long-term deficit challenge have been well documented by numerous independent experts, including those at the Center for American Progress, so my testimony will not focus on that today. Suffice it to say that, while our immediate deficits are necessary and appropriate given the state of the economy, the projected long-term deficits that would result from maintaining current policies are unsustainable and highly problematic.

It has been encouraging that, for the last several months, the public debate over how to solve the long-term deficit problem has entered a new, much more sincere and substantive, stage. To a significant degree, we have moved beyond the mere posturing that had characterized the previous stage of debate when most were saying how much they deplored the deficits but were staying deliberately vague about what they’d do about them. Now, finally, we are starting to see the range of possible choices put before Congress and the public. This is a critical breakthrough. The posturing stage wasn’t just a problem because it delayed finding a solution; it was a problem because it perpetuated the pernicious myth that the problem could be solved without much pain. And as long as that myth survived, it meant great political risk to anyone who proposed a serious plan.

We at CAP like to take some credit for this breakthrough. We have been diligently outlining the difficulty of the challenges and offering specific solutions since 2009, and it’s been heartening to see the debate move to the point where we have a great deal of company.

Our most recent effort was to produce a long-term budget-balancing plan called “Budgeting for Growth and Prosperity,” which was released in May. In that proposal we offer a plan to balance the budget by 2030, 10 years sooner than the House-passed budget resolution. Our plan accomplishes this while still making important investments in the economy and strengthening the social safety net, and without damaging important middle-class programs or raising middle-class taxes on average. And, while our plan would raise taxes on the wealthy, the level is well within the range of historic norms. We also cut overall spending substantially relative to the CBO

baseline. By 2035 our plan would lower spending by 4 percentage points of GDP compared to the baseline while revenue would be just half a percentage point of GDP above the baseline.

We cannot claim to have the only long-term budget plan in town. Many others have offered a wide range of plans to achieve fiscal sustainability. This just goes to show that the barriers to balancing the budget aren't economic, they're political. The United States is not like other countries that spend more than their economies can reasonably support and that face debts that they simply do not have the wealth to repay. Rather, our challenge is that we have simply decided not to pay for what we spend.

That's not to say, of course, that the answer to our fiscal woes is simply to raise taxes to cover all of our spending. Note that if we were to do so we would still be one of the lowest-taxed countries in the world. We could do it without crippling ourselves economically. Nevertheless, I know of no one who is advocating such a solution. There is much work to do on the spending side as well. It is clear we need to contain health care cost growth, although there are huge differences in opinion as to how. And many of us believe that it is not sustainable to maintain defense spending at levels above the apex of the Cold War buildup under President Ronald Reagan, with the United States spending about as much as the rest of the world combined. And certainly a dedicated effort to wring efficiencies out of the day-to-day operations of the federal government could and should yield savings. It is for these reasons that our plan does not simply raise taxes to cover projected spending.

But just as the answer should not be a tax-increase-only plan, neither can the answer be a spending-cut-only plan. There are those who subscribe to the "It's a spending problem not a tax problem" school of thought. But that's a choice not a fact.

And the House of Representatives has given us a good insight into the consequences of that choice through their budget resolution. Their plan is designed to eventually balance the budget without allowing tax revenues to exceed 19 percent of gross domestic product. In order to accomplish that goal, the House budget makes enormous cuts to some very fundamental programs, dramatically constrains public investments that are key to future economic growth, and all but shreds the social safety net.

The most well known of these massive cuts is the House plan for Medicare. Under the House budget plan, Medicare, as it is currently structured, would cease to exist. In its place, retirees would receive a voucher, the value of which would rise much slower than the cost of health care. The ultimate effect is to shift thousands of dollars of costs onto each senior citizen. That might help bring federal spending down, but it does little to control health care inflation, and it certainly doesn't help America's seniors. In fact, we've estimated, based on the Congressional Budget Office's analysis of the House budget, that the average senior will have to pay an additional \$6,000 in insurance premiums. By 2030, that added cost will rise to \$11,000.¹

But shifting health care costs from the federal books onto senior citizens is only one of the many onerous cuts proposed by the House budget. Their plan would also slash Medicaid down to the bone. Though many think of Medicaid as a program only for the very poor, in fact two-thirds of Medicaid dollars are spent on the elderly and the disabled. And fully 70 percent of nursing home

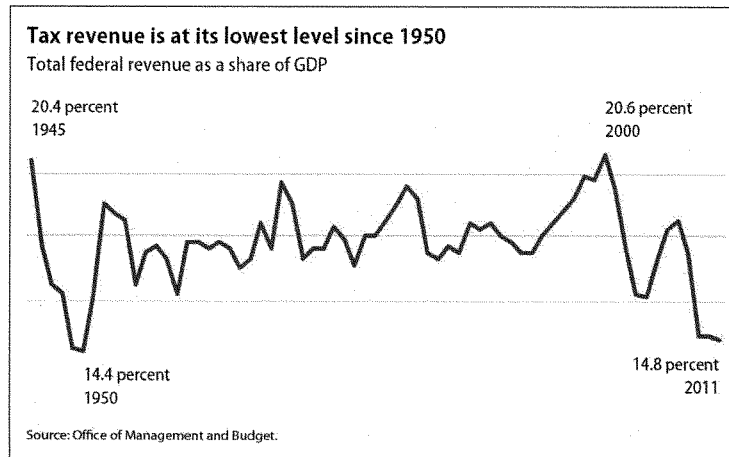
residents benefit from Medicaid. Without Medicaid, the costs of caring for them would fall to their families, many of whom are middle class.

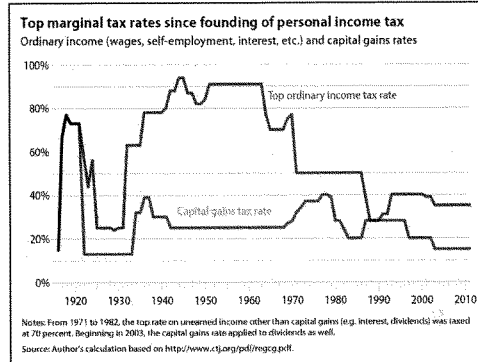
The House budget also makes draconian cuts to key areas of public investment, like education, transportation, and scientific research. In fact, the House budget would slash education funding by 53 percent, compared to current levels. Transportation and infrastructure would decline by 37 percent. And basic science and technology research and development would suffer a 28 percent cut, compared to today's levels.

Suffice it to say, the American public did not react with very much warmth to the specifics of the House budget proposal. Given the magnitude of the cuts required to keep taxes so low, it's hard to blame them.

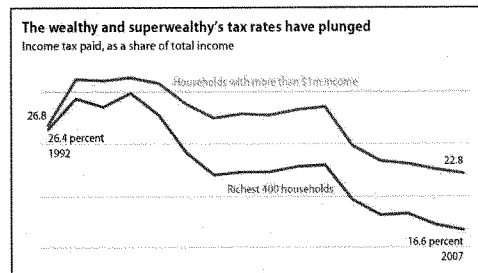
But these are the kinds of cuts that are required if you want to keep tax revenue near the average level from a time gone by. You often hear that, over the past six decades, federal revenue has averaged 18 percent of gross domestic product. And while that is true, as far as it goes, it is not at all clear why future budgets should be constrained by past levels of revenue. In fact, because of demographic changes, the rising cost of health care, and emerging economic challenges, past levels of spending and revenue are essentially irrelevant. What might have worked in 1966—the last time federal spending matched 18 percent of GDP—will simply not work now, let alone 10 or 20 years from now.

Trying to shoehorn our future needs into past levels of revenue will necessarily result in damaging cuts to popular programs, benefits, services, and investments. And our view is that such an approach is not what's best for the country. We believe that we're better off having additional revenue in the mix. For one thing, tax revenue is very low. Currently, total federal revenue is at its lowest level since 1950 as a share of GDP. Yes, the weakness of the economy has much to do with that fact. But the interaction between the economic weakness and the low rates of the Bush tax regime together produced the historically low levels of revenue we are currently experiencing.



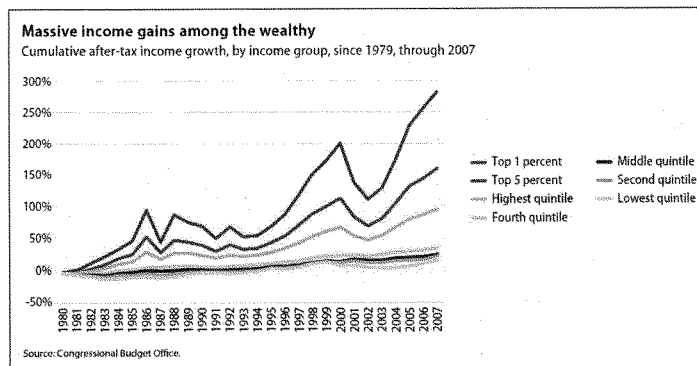


We also have low taxes relative to other economically developed countries. Only Mexico, Chile, Turkey, and South Korea had lower taxes as share of their economies from 2004 to 2008 among the 30 OECD countries. Just because our taxes are low doesn't necessarily mean that they should be higher. But consider that if instead of ranking 26th out of 30, we were 19th, which would mean we collected the same amount of revenue as Canada as a share of our economy, then we would eliminate the budget deficit problem without facing draconian spending cuts like those in the House budget resolution. As an aside, it is worth noting that Canada is also in much better economic shape than we are right now.



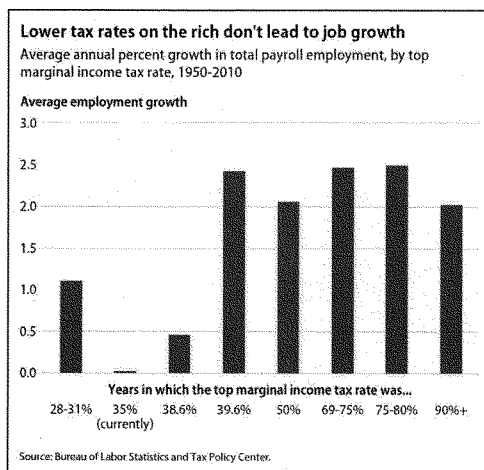
While there is clearly room to raise more revenue overall, we believe, in particular, that there is room to raise taxes on the well off. Top marginal tax rates and capital gains tax rates are at historically low levels. Effective tax rates on the well off have plunged. And

at the same time that these rates have been dropping, the incomes for the wealthy have been rising dramatically. Between 1979 and 2007 the richest 1 percent saw their before-tax incomes more than triple, adjusted for inflation. Just between 2001 and 2007 this same group's before-tax income went up by over 50 percent. With declining taxes, their after-tax income went up even more.



The issue of whether or not to extend the Bush tax cuts for the well off has obviously been a matter of hot dispute. But we should put the potential impact on the wealthy in perspective. Consider that the effect on the top 1 percent would be an after-tax income decline of just 4.4 percent.² If the income growth of the wealthy continues at the pace it has been rising over the last 25 years, averaging over 5 percent per year, then they'll make up the amount lost to higher taxes in just 10 months and continue to get further and further ahead as time goes on. In other words, for the richest 1 percent, if the Bush tax cuts were to expire in January, by October they'd still be richer than they were the previous December even though they'd be paying slightly higher taxes. It's the equivalent of a 10-month pay freeze. Given that the middle-class has suffered through a pay freeze lasting a decade and counting, it hardly seems like a great imposition to ask the wealthy to pay a bit more as part of achieving vitally needed deficit reduction.

We've actually done this before. In 1993 President Bill Clinton raised taxes on the wealthy. Nevertheless, over the next seven years, the income of the richest 1 percent almost doubled. In short, if we're worried about America's wealthy losing the will to seek profits by investing, starting businesses, and hiring people—it seems that bumping up top marginal tax rates a few points does little to dampen their quest for greater income or the attendant benefits that brings to

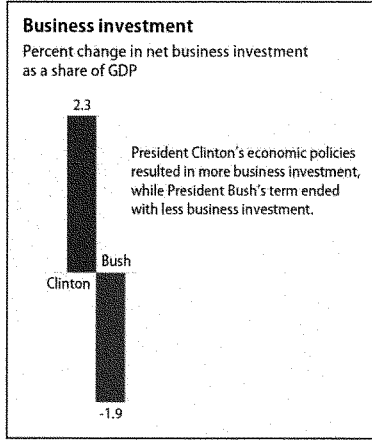


the economy. In fact, when one looks at the relationship between top marginal tax rates and job growth you find that the country has actually enjoyed higher job growth during years with higher top tax rates.

Of course, it wasn't just the wealthy who did well under the Clinton-era tax code that we are scheduled to return to when the Bush tax cuts expire. The economy during 1990s grew at an historically high rate after taxes on the well off were raised under President Clinton. In fact, economic performance under the progressive tax policies of President Clinton far outstripped economic performance during the supply-side eras of Presidents Reagan and George W.

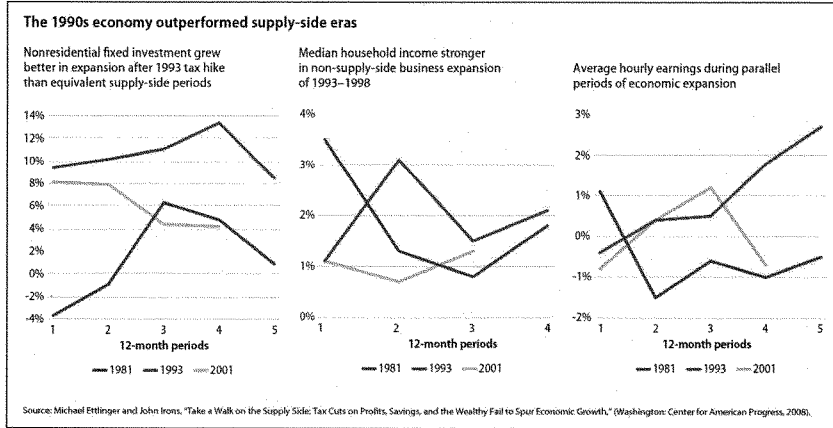
Bush. Real investment, economic growth, median income, wage levels, and employment growth were all better in the Clinton era. And, of course, the federal budget boasted a surplus during the Clinton years in stark contrast to the experience under presidents Reagan and Bush.

It is telling that not only did the broad indicators of economic performance do better under progressive tax policies, but even the actual mechanisms that were supposed to be enhanced by supply-side tax policies worked better under President Clinton's higher tax rates. Business investment and productivity in particular did better under President Clinton than under either President Reagan or President Bush.³



The economic performance under President Bush's tax regime has, of course, been particularly dismal. In the 2000s, even before the onset of the Great Recession, investment growth, job growth, and income growth were all lower than during any economic expansion in post-World War II U.S. history.⁴ The average employment growth over the period between the recessions of 2000-2001 and 2007-2009 was a mere 0.9 percent. This compares poorly to the average for postwar periods of economic expansion of 3 percent. Investment growth was 2.1 percent during the 2000s recovery compared to an average of 6.7 percent during past recoveries. And annual growth in our gross domestic product was 2.7 percent compared to an historic average of 4.8 percent.⁵

And of course, during the Great Recession and its continuing aftermath we are still operating under the Bush tax regime. In fact, we've cut taxes even further. A third of the American Recovery and Reinvestment Act was tax cuts and last December the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 also contained a substantial tax reduction. Lowering taxes as a way to boost economic growth, at least at the levels at which taxes are imposed by the United States, has proven to be disappointing as economic policy.



The reasons for the relatively weak economic performance during periods of substantial tax cuts for the well off compared to periods when taxes were higher may have nothing to do with tax policy. Other factors certainly influence the economy. To some degree, that is the point. Tax rates are not the be-all and end-all of economic growth. Other factors, including of course, what the government does with the taxes it collects, whether it makes important investments that help the economy, and myriad other private-sector trends and phenomena, are critical to economic growth. What is true, however, is that evidence that supply-side tax cuts help economic growth is weak at best and much contradicted in the economic literature.⁶

Conclusion

Deficit reduction, as with anything that involves large scale spending and tax matters, is contentious. But it's also necessary. Although at this moment it may seem like agreement is impossible, with the debt limit looming and no obvious path forward, in the end we will find a solution—because we have to. And the agreement will, in the long run, be determined by the American people. What's been good about the last six months is that we've finally started having an honest conversation about these matters. People now know what a no-tax approach looks like. And they have a sense of the alternatives. In my view, we are going to end up with a balanced approach. The public will not stand for many of the spending cuts that have been put on the table. Nor are they anxious to see themselves taxed more heavily. And though we're not there yet, there is a limit to how much the well off can be taxed without economic harm. There is a balancing to be done and what the American people want is a responsible balance. They don't want a plan that is massively skewed one way or the other. That balance will not, however, be dictated by past levels of taxation and spending. After all, the country faces different needs now with an aging population and rising health care costs. With taxes at historic lows and spending needs on the rise it is evident to me which way the balance can and should move over the coming years. Delaying that movement will only result in a longer period of high deficits. And that would hurt us all.

¹ Tony Carrk, "Ryan's Budget Attempts to End Medicare and Shift Costs to Seniors," (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2011/04/ryan_medicare.html.

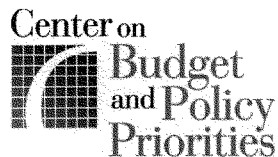
² Tax Policy Center distributional analysis of allowing the Bush tax cuts for those making more than \$250,000 to expire, compared to current policy. Tax Policy Center, Administration's FY 2012 Budget Proposals, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2964&topic2ID=40&topic3ID=93&DocTypeID=2>.

³ Michael Ettlinger and John Irons, "Take a Walk on the Supply Side: Tax Cuts on Profits, Savings, and the Wealthy Fail to Spur Economic Growth," (Washington: Center for American Progress, 2008).

⁴ Josh L. Bivens and John s. Irons, "A Feeble Recovery: the Fundamental Economic Weaknesses of the 2001-07 Expansion" (Washington: Economic Policy Institute, 2008), available at <http://www.epi.org/publications/entry/bp214/>.

⁵ Adam Hersh, Michael Ettlinger, and Kalen Pruss, "The Consequences of Conservative Economic Policy: A Tried and Failed Approach that Should Not Be Repeated" (Washington: Center for American progress, 2010), available at http://www.americanprogress.org/issues/2010/10/conservative_economics.html.

⁶ For a summary of the literature related to this subject see Peter Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be the Long-Term Effects of the Bush Tax Cut?" (Washington: Center on Budget and Policy Priorities, 2001), available at <http://www.cbpp.org/3-15-01tax.htm>. Robert D. Atkinson, *SupplySide Follies: Why Conservative Economics Fails, Liberal Economics Falters, and Innovation Economics Is the Answer* Lanham: Rowman & Littlefield, 2006.



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TESTIMONY OF ROBERT GREENSTEIN
President, Center on Budget and Policy Priorities

Before the
Senate Committee on Finance
United States Congress

Hearing on "Deficit Reduction: A Review of Key Issues"

Mr. Chairman and members of the Committee, thank you for the invitation to testify here today. As you well know, the nation is on an unsustainable fiscal course, and substantial changes in policy will be needed to right the ship. As a number of bipartisan commissions have recommended over the past year, policymakers should aim to stabilize the debt as a share of the economy (the Gross Domestic Product) so that the debt does not rise relentlessly as a share of the economy. Stabilizing the debt would put the nation on what economists define as a sustainable budget path. To stabilize the debt, budget deficits will need to be reduced to no more than about 3 percent of GDP.¹

Policymakers should meet this goal in a reasonable period of time. But it isn't necessary — or desirable — to meet it in the next few years. As Federal Reserve Chairman Bernanke noted last week, it would be unwise to put strong austerity measures into effect right away, while the economy is still growing too slowly to bring unemployment down to more normal levels. Putting substantial deficit-reduction measures into effect now would risk the loss of hundreds of thousands of jobs over the next year or two by slowing the already inadequate rate of economic growth. What policymakers really should do is to act in the weeks or months ahead to enact *both* temporary measures to strengthen the flagging recovery now *and* broader legislation that begins to take effect once the economy is stronger (probably in fiscal year 2013) and puts us on track to stabilize the debt as a share of GDP by the end of this decade. Doing so would involve tough choices, both substantively and politically, but would represent a huge accomplishment and allay fears in financial markets. As Chairman Bernanke cautioned, however, reducing the deficit more precipitously is neither necessary nor sound as policy.

¹ The size of deficits that will stabilize the debt-to-GDP ratio depends on the starting level of debt, real economic growth, and real interest rates. Under projected circumstances, total deficits of about 3 percent of GDP starting in the middle of this decade would keep the debt from increasing relative to the size of the economy. Since interest payments are expected to total about 3 percent of GDP after the economy is back to normal, the *primary* budget would be roughly in balance if the total deficit is equal to 3 percent of GDP.

In pursuing this goal, policymakers should follow a series of principles that would make deficit-reduction efforts both more equitable and more likely to be effective and sustainable over time. They also should *avoid* steps that would make deficit-reduction measures enacted now harder to sustain, and subsequent deficit-reduction legislation (which will clearly be needed) harder to enact, as explained later in this testimony. I would recommend that policymakers:

- Craft a deficit-reduction plan that is balanced and inclusive, affecting domestic programs, defense, and revenues alike. As explained below, to be effective in stabilizing the debt in the years ahead, deficit reduction likely will need to rely more heavily on revenue increases in the early years and more heavily on program savings — especially in health care programs — over the longer run. A substantial share of the new revenues should come from scaling back “tax expenditures,” the more than \$1 trillion a year in tax breaks that the tax code provides each year for particular taxpayers or groups of taxpayers.
- Enact annual caps on funding for discretionary programs, but in the context of an overall deficit-reduction plan that includes increases in revenues and savings in mandatory programs. The caps should be reasonable and attainable, with separate caps for security and non-security discretionary programs and with a goal of splitting discretionary savings roughly 50-50 between those two categories, as the Bowles-Simpson Commission plan does.
- Recognize that, while the single largest spending contribution to deficit reduction over the long run must come from slowing the growth of health care costs system-wide (in both the public and private sectors), policymakers will not be able to secure big savings from federal health care programs over the next five to ten years without causing serious damage to the ability of Americans of modest means to have access to care. The health reform law includes most (although certainly not all) of the steps we know how to take now to slow health care cost growth without reducing health care quality or access to care or pushing more people into the ranks of the uninsured; going further now by just slashing Medicare and Medicaid would be ill-advised. Similarly, although steps to restore Social Security’s long-term solvency can contribute to deficit reduction in future decades, policymakers should not expect to reap significant savings from Social Security over the coming decade; there is broad bipartisan agreement that changes in benefits should not significantly affect anyone who is now at least 55 years old and that any changes in Social Security benefits and revenues should be phased in gradually.
- Meet the goal of reducing deficits to 3 percent of GDP over the coming decade through a combination of letting all of President Bush’s tax cuts expire on schedule at the end of 2012 or paying for those parts of the tax cuts that are extended, however politically unachievable that seems at the moment, and securing reasonable savings from discretionary programs, reforms in entitlement programs, and curbing unproductive tax breaks. Over time, a growing share of the public may conclude that alternatives that do *not* include letting the tax cuts expire would produce outcomes more undesirable than returning to the tax rates of the Clinton era (when the economy performed quite well).
- Avoid proposals such as those that would place a statutory cap on total annual federal spending or write a balanced budget requirement into the U.S. Constitution — either of which would diminish the government’s ability to respond effectively to recessions (and, in fact, would make recessions worse and probably more frequent) while largely or entirely shielding taxes (including spending done through the tax code) from deficit-reduction efforts.

- Avoid making the problems of poverty and inequality, both of which are higher in the United States than in most other Western industrialized nations, worse. Policymakers should adopt and adhere to the principle espoused in the Bowles-Simpson deficit-reduction plan to protect the disadvantaged and achieve deficit reduction in ways that don't increase poverty or inequality. In late April, a group of Christian leaders — from the Catholic bishops to various evangelical leaders — called on policymakers to honor this principle and to draw a “Circle of Protection” around programs for the poor. This week a group of leaders of charities and nonprofit organization — including the heads of the United Way, Feeding America, and Independent Sector, as well as the nation's leading civil rights organizations — added their voices to this call; a letter they issued on Monday takes note of the unusually high levels of poverty and inequality in the United States and states: “Any agreement on deficit reduction should neither cut low-income assistance programs directly nor subject these programs to cuts under automatic enforcement mechanisms.” Virtually all major deficit reduction or fiscal responsibility laws of the past quarter-century — the 1985 and 1987 Gramm-Rudman-Hollings laws, the 1990, 1993, and 1997 deficit-reduction packages, and the 2010 Pay-as-you-go law — abided by these principles.

A Basic Principle for Deficit Reduction

Deficit-reduction plans should be balanced: they should cover both the expenditure and the revenue sides of the budget. A great deal of spending occurs through the tax code, in the form of tax expenditures. The Congressional Budget Act of 1974 effectively defines tax expenditures as revenue losses attributable to any provisions in federal tax law that provide special benefits to particular taxpayers or groups of taxpayers. Deductions, exemptions, exclusions, credits, and preferential tax rates on certain forms of income such as capital gains and dividends are the principal forms of tax expenditures, which Alan Greenspan once referred to as “tax entitlements.”

In 2010, the tax code included over \$1 trillion a year in tax expenditures. This substantially exceeded the cost of Medicare and Medicaid combined (\$719 billion), or Social Security (\$701 billion), or non-security discretionary programs, which stood at \$589 billion or a little over half the cost of tax expenditures. (See

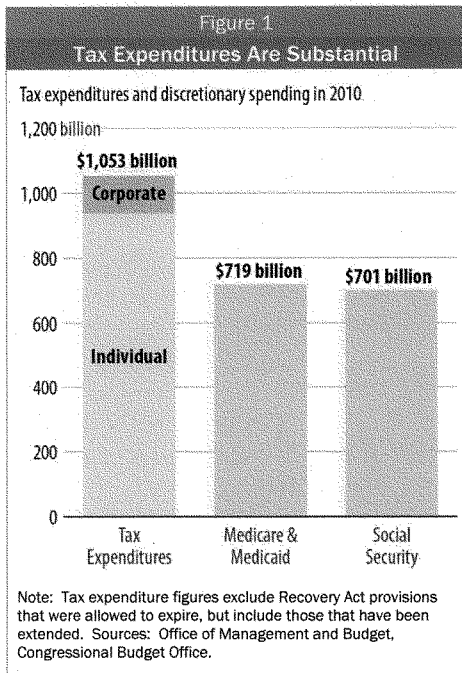


Figure 1.) Martin Feldstein, the Harvard economist who served as Chairman of President Ronald Reagan's Council of Economic Advisers, wrote last summer that tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and should be the first place that policymakers go to restrain spending.

In my view, policymakers should aim for deficit-reduction packages that, over time, are split about 50-50 between outlay reductions (i.e., reductions in programs) and revenue increases, with much of the new revenues coming from scaling back tax expenditures.² This is the approach taken in the plan produced in November by the Bipartisan Policy Center commission co-chaired by former Senator Pete Domenici and former OMB director Alice Rivlin. As noted above and explained further below (and as former OMB Director Peter Orszag has explained in various venues), the mix probably should lean more heavily on revenue-raising measures than on budget cuts in the early years (achieved in substantial part by allowing the 2001 and 2003 tax cuts to expire) and more heavily on the expenditure side of the budget (especially in the health care area) than on revenues in future decades.

Caps on Discretionary Spending

To ensure that adequate, balanced deficit reduction is achieved, policymakers also need to *avoid* certain steps. For example, multi-year caps on discretionary spending will need to be part of a deficit-reduction package; enacting such caps *on their own*, separate from a larger deficit-reduction package that also includes measures to raise revenues and secure savings in mandatory programs, would likely prove ill-advised. Enacting multi-year caps *by themselves* would undercut broader deficit reduction in the future by making subsequent deficit reduction packages harder to pass. If policymakers who oppose raising any revenues for deficit reduction can secure sizeable cuts in discretionary programs through multi-year discretionary caps *without* those caps being part of a broader package that raises revenues as well, they will have much less incentive to subsequently agree to a larger, more inclusive package.

Consider, for example, what would have happened if the discretionary caps included in the 1990 bipartisan deficit-reduction package had been enacted on their own in 1989 — the 1990 package likely never would have been passed. President George H.W. Bush and Republican congressional leaders wouldn't have agreed to the tax increases in the package if doing so hadn't gotten them the discretionary caps in return, and Democratic congressional leaders wouldn't have agreed to cuts in Medicare and other entitlements without the revenue increases. For the same reason, enacting multi-year caps now on their own would likely prove counterproductive to large-scale, long-term deficit reduction. Nor would it be likely to assure financial markets, which rightly understand that cuts in discretionary programs alone can't yield the amount of deficit reduction that will be needed. In short, discretionary caps in isolation are not a step in the right direction, as they are likely to make it harder to subsequently secure the enactment of a large-scale deficit reduction package.

² For a further discussion of how tax expenditures can be reformed in ways that increase economic efficiency and improve tax progressivity while contributing to deficit reduction, see the testimony of Robert Greenstein, President, Center on Budget and Policy Priorities, before the Senate Budget Committee, March 9, 2011, <http://www.cbpp.org/cms/index.cfm?fa=view&cid=3426>.

It also is important that multi-year discretionary caps instituted as part of a larger deficit-reduction package be set at reasonable, attainable levels. Because such caps come with *no* specifics regarding the actual cuts to be made (the specific cuts come when subsequent annual appropriation bills are enacted), it can be tempting for policymakers to set very severe caps that require overly deep cuts in discretionary programs in the years that follow. History shows that such an approach is self-defeating. In 1990 and 1993, Congress enacted multi-year discretionary caps as part of larger deficit-reduction packages and set the caps at levels that produced substantial savings but were reasonable and achievable. Those caps were adhered to, and the savings were realized. In 1997, however, policymakers gave in to the temptation to write caps into that year's deficit-reduction legislation that would require deep discretionary cuts in order to show very large discretionary savings on paper. Cuts of that magnitude proved unsustainable, and subsequent Congresses — on a bipartisan basis — chose not to adhere to the caps.³

Another critical issue in fashioning multi-year caps on discretionary programs is to make sure that sizeable savings in both non-security *and* security programs are included, as the Bowles-Simpson, Rivlin-Domenici and Gang of Six plans would do. If this is done, there should be separate caps on security and non-security discretionary programs.

Finally, any caps should continue to carve out or “fence” appropriations for program integrity activities — funding that pays for itself a number of times over by improving revenue collections and reducing fraud or inappropriate costs in Medicare and disability programs. For example, last week CBO and the Joint Committee on Taxation concluded that the Administration's plan to earmark \$13 billion for tax enforcement over the next decade would generate an additional \$42 billion in revenues over the same period. Every set of statutory caps on discretionary funding from 1990 on has included such carve-outs.⁴ History teaches that without them, the added funding needed to generate many billions of deficit reduction simply does not materialize.

The Timing of Health Care Savings

In the long run, the single largest contribution to deficit reduction will need to come from slowing the rate of growth of health care costs throughout the U.S. health care system, in the public and private sectors alike. A slower rate of health care cost growth will produce substantial budgetary savings in areas ranging from Medicare and Medicaid to the tax exclusion for employer-based health coverage.

We need to recognize, however, that major savings are not likely to be achievable here in the next five or ten years. The recently enacted health reform law includes most of the steps we know how to take now to reduce expenditures in these areas; that is how the Affordable Care Act is able to produce modest deficit reduction even as it extends coverage to 34 million uninsured Americans. There are some further steps we can take now (in areas such as Medicare and Medicaid payments for pharmaceuticals and durable medical equipment), but the savings they produce are modest

³ The achievement of a balanced budget starting in 1998 made evading the caps almost inevitable, but many observers of the 1997 agreement believed that the caps were set so low that Congress and the President were unlikely to comply with them, whether or not the budget actually reached balance.

⁴ Congressional Budget Office and Joint Committee on Taxation, “Additional Information on the Program Integrity Initiative for the Internal Revenue Service in the President's Budgetary Proposals for Fiscal Year 2012,” June 23, 2011.

compared with the savings we'll need over the long run. We will need to identify and institute ways to slow the growth of health care costs per beneficiary throughout the health care system.

For over 30 years, Medicare, Medicaid, and private-sector health care costs have generally grown at about the same rate per beneficiary, which shouldn't be surprising since they all use the same doctors, hospitals, and medical procedures. (Over the past decade, Medicare and especially Medicaid costs per beneficiary actually have grown *more slowly* than private-sector health costs.) Trying to hold Medicare and Medicaid to much lower rates of cost growth than private-sector health care on a permanent basis would ultimately lead to either or both of two undesirable outcomes: 1) our health care system becomes more of a two-tier system, in which Medicaid and Medicare beneficiaries (except for those Medicare beneficiaries who can afford to buy ample supplemental coverage) are denied some needed treatments and medical advances that other Americans get, and health care is thus increasingly rationed on the basis of income; and 2) extensive cost shifting occurs from Medicare and Medicaid to private payers, with the result that costs for employer-based coverage and other private coverage go up substantially to cross-subsidize doctors and hospitals who are underpaid by Medicare and Medicaid.

To help address the need to slow systemwide cost growth, the Affordable Care Act contains an extensive array of demonstration projects, pilots, and research to test and identify cost-saving reforms in health care delivery and payment systems that could produce substantial savings throughout the health care system. (It also includes important mechanisms, including the Independent Payment Advisory Board, to help assure implementation of cost-saving reforms.) But these reforms will take time to identify, test, and then institute on a broad scale. There is a potential for large and growing savings here in future decades, and these efforts need to be nurtured and adequately funded so they can produce the needed results. But there's not much prospect of *large* savings here in the coming decade.

Measures to restore long-term Social Security solvency also can make a contribution to deficit reduction in future decades, but here, too, significant savings will not be secured in the decade ahead. There is bipartisan agreement both that changes in Social Security benefits generally should not affect people now 55 and over and that changes in both Social Security benefits and taxes generally should be phased in gradually over a considerable period of time.

How to Address the Timing Problem

How then can sufficient savings be achieved in the coming decade to stabilize the debt as a share of the economy and thereby buy us time for the reforms — especially in health care delivery and payment systems — that are the most important component of longer-term deficit reduction? There is an answer to this question, which stands out when one examines recent analyses of the nation's fiscal problems that the Congressional Budget Office has issued.⁵

CBO reports show that if we continue on the current policy path (including extension of all of the current tax cuts, relief from the Alternative Minimum Tax, and relief from the scheduled deep cuts in Medicare physician fees), deficits will run close to 6 percent of GDP even after the economy

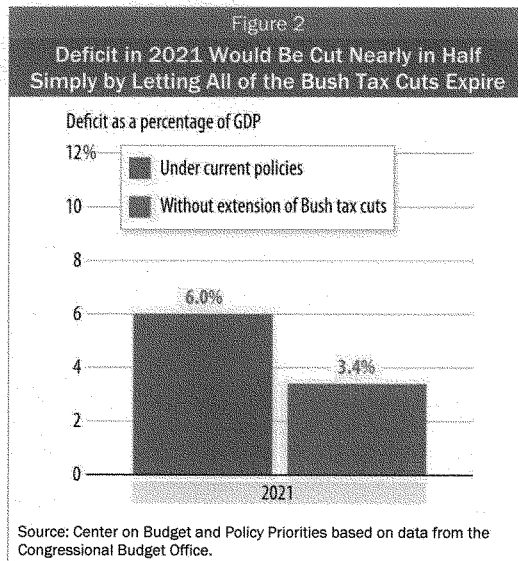
⁵ Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 2011 to 2021*, January 2011; *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012*, April 2011; *CBO's 2011 Long-Term Budget Outlook*, June 2011.

recovers, reaching 6.0 percent of GDP in 2021 — and the debt will climb by 2021 close to 95 percent of GDP.⁶

Yet CBO's data and projections report also indicate that if policymakers simply let all of the tax cuts enacted in 2001 and 2003 (not just the tax cuts for people with incomes over \$250,000) expire on schedule at the end of 2012, or if they paid for any of those tax cuts that they wish to extend with offsetting revenue increases or spending reductions — deficits would be cut nearly in half. (See Figure 2.) The deficit would stand at 3.4 percent of GDP by 2021. This is a course that former Reagan economic adviser Martin Feldstein, former OMB and CBO director Peter Orszag, and former Federal Reserve Chair Alan Greenspan all have called for, in light of the very large fiscal challenges the nation faces and the realities regarding the timing of Medicare, Medicaid, and Social Security savings.

To stabilize the debt, deficits need to be reduced to no more than about 3 percent of GDP. A combination of reasonable savings in discretionary programs, various entitlement reforms that can be put into effect in coming years (including some savings in Medicare that can be secured now), and the curbing of some unwarranted, inefficient, or low-priority tax expenditures — in conjunction with letting the Bush tax cuts expire after 2012, or paying for those elements of the tax cuts that policymakers wish to extend — would succeed in stabilizing the debt and achieving primary budget balance in the coming decade.

Federal taxes are now at historically low levels (see Figure 3). Needless to say, letting all the Bush tax cuts expire enjoys scant political support at the moment. Yet this is likely to be the only way to stabilize the debt as a share of the economy over the coming decade without draconian cuts that would cause serious damage — and that the public likely would not stand for and would eventually stop from taking full effect.



⁶ These current-policy projections adjust the CBO March 2011 baseline to assume extension of expiring tax cuts, continuation of AMT relief, phasedown of operations in Iraq and Afghanistan, and a freeze in Medicare's physician payment rates. For more explanation of the CBPP current-policy baseline, see the technical note in Kathy Ruffing and James R. Horney, *Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits*, Center on Budget and Policy Priorities, May 10, 2011.

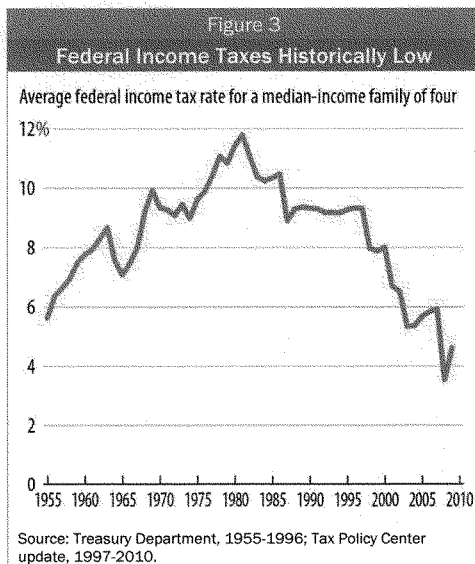
It is worth noting that revenue increases have been important ingredients of almost all of the major deficit-reduction packages enacted over the past 30 years, including those enacted in 1982, 1984, 1987, 1990, and 1993. Presidents and lawmakers of both parties have concluded that a mix of program cuts *and* revenue increases has been desirable (or acceptable) on policy grounds, and essential on political grounds to achieve major deficit-reduction success.

Unsound Measures That Should be Avoided

Some measures that have been proposed would, in my view, be ill-advised. These include proposals to place a statutory cap on total federal spending and proposals to write a balanced budget requirement into the U.S. Constitution. Many economists warn that such proposals would risk doing significant damage to the economy.

Caps can be, and have been, placed on *discretionary* spending. Capping *mandatory* spending, however, is a very different proposition. Programs like unemployment insurance, food stamps, and Medicaid automatically expand when the economy weakens. Economists refer to these program expansions as “automatic stabilizers” that help to limit the decline in purchasing power in a slumping economy. Without the automatic stabilizers, recessions would be more frequent, longer, and deeper, and the risk of major recessions turning into depressions would be heightened. Caps on total federal spending — as well as a constitutional balanced budget amendment — would prevent the automatic stabilizers from working.

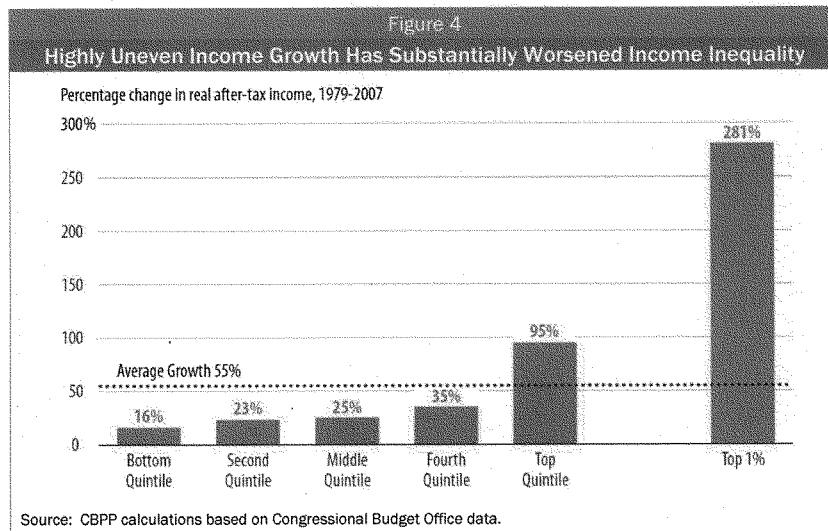
To be sure, proposals for a cap on total federal spending or a balanced budget amendment often contain mechanisms allowing the cap or the balanced budget requirement to be suspended upon the vote of a supermajority of both the House and Senate. But such supermajorities could prove impossible to obtain until long after the economy had begun to weaken; hard data on the economy come with a lag, and it could take many months after the economy has begun to weaken before sufficient data are available to convince three-fifths of both houses of Congress that economic conditions warrant waiving the balanced budget requirement, if three-fifths could be convinced to waive the requirement at all. Moreover, a determined minority in the House or Senate could demand fiscally harmful measures — potentially including new, permanent tax cuts that increase deficits and ultimately necessitate even deeper budget cuts — as the price for their votes to waive the balance-budget rule in a recession.



Measures capping total federal spending at 20 percent or 21 percent of GDP (or lower) also are designed to serve another function: such proposals would largely or entirely shield revenues — including tax expenditures — from making any significant contribution to deficit reduction by focusing solely on the expenditure side of the budget. They are inconsistent with the goal of producing a balanced, equitable deficit-reduction package.

That this is the case is shown by a report issued in early 2010 by an expert committee on the deficit convened by the National Academy of Sciences, which outlined four possible paths to stabilize the debt. As panel co-chair and former Congressional Budget Office director Rudolph Penner explained, the panel designed paths at two “extremes” — one that achieved all of its deficit reduction by cutting programs and another that got nearly all of its deficit reduction by raising taxes — and two intermediate paths (which Penner and most other NAS panel members saw as more realistic) that blended program and tax changes. The extreme low-spending path — which got all of its deficit reduction by cutting programs, while including tax changes that would *reduce* revenues over the long run — included very deep cuts in Social Security, Medicare, and Medicaid, and cuts of about 20 percent in *all* other spending including defense, veterans’ programs, education, and the like. Under this extreme path, federal spending would be 21 percent of GDP.

Indeed, federal spending under President Ronald Reagan averaged 22 percent of GDP at a time when no baby boomers were retired and health care costs were more than one-third lower as a share of the economy than they are today. As Matt Miller, the commentator and former OMB official, has written, “As a matter of math, if you run the government at a smaller level than did Ronald



Reagan while accommodating this massive increase in the number of seniors on our health and pension programs, you have to decimate the rest of the budget.”⁷

In short, measures like imposing a cap on total federal spending or trying to write fiscal policy into the Constitution are likely to do more harm than good. Such approaches also suffer from being devoid of any specific policy changes to actually achieve deficit reduction. There is no substitute for making the specific changes in discretionary and mandatory programs and the tax code that will move us to a sustainable fiscal course.

If policymakers cannot reach agreement now on enough specific policy changes to reach the goal of stabilizing the debt, they may elect to include some sort of automatic fiscal enforcement mechanism in a deficit-reduction package. If so, probably the best approach is to express any annual fiscal targets in terms of annual requirements for a *specified dollar amount of annual deficit reduction*. This is the “SAVEGO” concept that the Bipartisan Policy Center has recommended. Its advantage over annual debt or deficit targets is that it represents less dangerous economic policy. Under fixed debt or deficit targets, the amount of deficit reduction required in a given year goes up when the economy weakens and down when the economy strengthens — precisely the opposite of what sound economic policy entails. Under a SAVEGO-type approach, the amount of deficit reduction does not increase when the economy falters; neither does the amount of required deficit reduction diminish under a temporary boomlet or with rosy budget estimates.

Finally, it is essential that any automatic enforcement mechanism affect both spending and revenues. The goal of an automatic mechanism is *not* for it actually to be used to achieve deficit reduction. Just the reverse: the goal is for the deficit reduction measures that would be triggered automatically (if fiscal targets are missed) to be so unpalatable to both parties that the threat of these measures brings everyone to the table to work out deficit reduction packages, which then eliminates the need for the automatic deficit reduction measures to be used. To achieve this goal and get everyone to the table, the automatic mechanism must include *both* cuts in programs *and* increases in tax revenues (which could be realized through trims in tax expenditures, surtaxes, or other approaches).

A Key Principle: Deficit Reduction Should Not Increase Poverty or Inequality

The United States has higher degrees of poverty and inequality than most other Western industrialized nations. Deficit reduction ought not to make these problems worse. (The United States also has more modest retirement benefits and larger burdens from out-of-pocket health costs than most other Western nations.) Erskine Bowles and Alan Simpson made the need to protect the disadvantaged and to avoid increasing poverty and inequality (see Figure 4) one of the fundamental principles of their commission’s work.

History shows this principle can be honored if there is a will to do so. The three major deficit-reduction packages of the last two decades — the 1990, 1993, and 1997 packages — all adhered to this principle. (In fact, all three of these packages *reduced* poverty and inequality even as they shrank deficits, as a result of their inclusion of increases in the Earned Income Tax Credit in the 1990 and 1993 packages and in food stamps in the 1993 package, and the creation of the Children’s Health

⁷ Matt Miller, “A spending goal too small for aging America,” *Washington Post*, January 28, 2010.

Insurance Program as part of the 1997 package.) This principle was also reflected in the Gramm-Rudman-Hollings law, the Budget Enforcement Act of 1990, and last year's Pay-As-You-Go law — all of which exempted means-tested entitlement programs from the automatic across-the-board cuts triggered when deficit targets were missed or pay-as-you-go standards were violated.

**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF JULY 26, 2011
PERSPECTIVES ON DEFICIT REDUCTION: A REVIEW OF KEY ISSUES**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the current fiscal crisis and approaches to deficit reduction:

Mr. Chairman, thank you for holding this hearing, which continues a series of hearings we have had on deficit reduction. This hearing is timely, given that the debt limit impasse, unfortunately, continues to grind on.

I would like to welcome all of our witnesses and thank them for their presence and their testimony. Mr. Chairman, I'd like to briefly point out that many of the so-called plans for dealing with the debt limit seem to involve instructions to this committee to undertake "tax reform" in short order and with revenue raising as the principal objective. Part of that so-called reform usually is a direction to change tax expenditures.

Mr. Chairman, I believe that with an income tax system that is roughly 100 years old, we are in need of reform. I believe, however, that we need fundamental and comprehensive tax reform to broaden tax bases and lower tax rates.

I believe that we need tax reform to promote fairness, simplicity, growth in jobs and the economy, and efficiency. I do not believe that revenue raising in and of itself — accomplished by horse trading of selected tax expenditures against each other — is true reform, and I don't believe that such actions are good for jobs and the American people.

I do believe that we should thoroughly examine tax expenditures in the context of tax reform, and not as one-off efforts at raising revenue to pay for the spending status quo. But note, Mr. Chairman, that the Joint Committee on Taxation lists over 217 so-called tax expenditures. Of those, the President picked maybe three in order to get more tax revenue. He proposed hitting hit oil producers, including small ones; he proposed hitting users of LIFO accounting, which includes many small manufacturing companies; and he proposed hitting commercial jet producers, after having previously set up additional tax expenditures to benefit them. What the President has proposed or leaked out to the press is hardly reform, and is nowhere near comprehensive.

We need to look at the forest of individual and corporate tax expenditures, and not merely three trees that appeal to focus groups or along the campaign trail. A comprehensive examination of tax expenditures will require examination of a host of factors, including distributional effects and interactions among various features of the tax code. And a comprehensive examination will look across all tax expenditures.

Many tax expenditures are valued highly by Americans across the political and income spectrums, such as incentives for charitable giving. Others tax expenditures seem to benefit some at the expense of others, such as deductions for state and local taxes, which works as a subsidy from taxpayers in low tax states with low levels of government to wealthy taxpayers in high tax states with robust levels of government spending.

We need to look across the board at tax expenditures, and not simply at whatever subset happens to serve political or campaign interests. And we need to clean out our tax code. It is riddled with tax expenditures which, while often instituted with good intentions, have generated an inefficient tax code. The code is a mess and has created an environment where Americans no longer trust that everyone pays their fair share due to loopholes, tax breaks, tax arbitrage, tax gimmicks, or whatever you want to call them.

We need fundamental and comprehensive tax reform, not a quick revenue fix to get us past August 2. Mr. Chairman, I look forward to the testimony that we are about to hear.

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Testimony of Dr. Lawrence Lindsey
Before the Senate Finance Committee
Hearing on "Deficit Reduction: A Review of Key Issues"

The Nation's Fiscal and Economic Health

Chairman Baucus, Ranking Member Hatch, members of the Committee, thank you for inviting me to testify today on our nation's fiscal and economic health.

In the past few weeks your jobs have been consumed by the twin tasks of addressing the unsustainable long term budget position of the nation while allowing the legally allowable debt level for Federal debt to increase. While media attention has focused on the latter goal of raising the debt ceiling, in the long term getting control of the fiscal situation is actually more important. At this point, it appears to me that Congress and the Administration have not taken this latter goal as seriously as they should and I believe that the bond market will exact a price for this inaction.

In fact, while much has been made about the risks of a credit downgrade from the rating agencies for failing to raise the debt ceiling, surprisingly little attention has been paid to what the rating agencies said about the failure to cut long term spending and deficits. When S&P warned that it might downgrade U.S. debt back on July 15th, their main justification was NOT the debt ceiling but, "if we conclude that Congress and the Administration have not achieved a credible solution to the rising U.S. government debt burden and are not likely to achieve one in the foreseeable future."

Let me clear. Passing a so-called “clean” debt ceiling increase is not and never has been a means to preserve our credit rating over the long term; nor is simply passing some short term spending cuts or simply raising taxes. The American budget is burdened with long term structural problems in our entitlement programs causing them to perpetually grow faster than GDP. This is not just a political problem, it is a mathematical problem which must be addressed if we are to put America on a sound fiscal footing.

My concern about the failure to take this opportunity to significantly cut long term government spending is amplified by a belief that official deficit projections are far too optimistic. First, these deficit projections are predicated on an overly optimistic expectation for economic growth. For example, the President’s budget projected growth of 3.1 percent this year, 4 percent in 2012, 4.5 percent in 2013, and 4.2 percent in 2014. We know that growth in the first half of the year was roughly 1 ½ percentage points less than what the President’s budget projected. Moreover, there is an academic consensus that growth after a financial crisis tends to be at trend, not well in excess of trend.

The budgetary consequences of overestimating growth are dramatic. The President’s own budget estimates that missing growth by one point in one year increases the ten-year deficit by \$750 billion. Thus, just the six month shortfall that has already occurred during the first half of this year means an increase in the 10-year deficit of a bit over \$500 billion. If the economy rebounds to a trend rate of growth of 2 ½ percent starting in the current quarter, the cumulative shortfall in GDP through the end of 2014 would be 5 ½ percentage points implying a ten-year increase in the national debt that would be more than \$4 trillion higher than what is now projected. In short, even the budgetary gains that would have resulted from the so-called “Grand

Bargain” being discussed would be eliminated by having the economy growing at trend rather than what was projected.

Second, federal borrowing costs are now well below historic norms. In the last 20 years these costs have averaged 5.7 percent. Currently they are just 2.5 percent. This means that a mere normalization of borrowing costs would mean an extra \$700 billion per year by the end of the current decade, and even a gradual ramp up to normalized rates would add \$4.9 trillion to the Treasury’s interest costs over the next decade relative to maintaining current rates. I might add that the CBO does have a more modest ramp-up in rates that accounts for about half of this in its long term projections.

But the real concern here should not be a gradual normalization of rates. The recent lessons from Europe or the many lessons of history from previous sovereign debt crises indicate that government bond markets function smoothly for a long period of time and then suddenly crash. This has two implications for the budgetary risks we face: (1) rates might ultimately move well beyond the “normalized” average of the last two decades; and (2) that move is likely to happen much sooner and much more quickly than either we or the CBO now project.

The two risks just mentioned, which I would call the growth risk and the interest rate risk, place tremendous constraints on the prudent conduct of fiscal policy. It is urgent that we undertake significant long term deficit reduction and it is equally urgent that we do so in a way that minimizes any adverse consequences for economic growth. But these constraints also provide clear guideposts for what Congress should do.

First, the focus should be primarily on long term expenditure reductions not short run cuts. There is a demand-side element to growth which must be respected. This doesn’t mean no

cuts in current expenditures, but near-term spending cuts should probably be limited to perhaps half-a-percent of GDP in the next fiscal year with much larger spending cuts to follow. This is precisely why long term reform to entitlement spending that sharply reduces total spending over many decades is so crucial. It has little or no long term impact on growth, and by freeing up resources over the long term probably enhances our long term growth prospects. Gradually increasing the age of eligibility for entitlement programs, gradually adjusting benefit formulas, and increasing the flexibility states have to control costs in programs like Medicaid will all significantly improve the balance sheet of the Federal Government with little or no impact on economic growth. It is this improvement in the balance sheet that will encourage bond investors that they will be repaid the principal they invest in government securities.

Second, the focus of both budgetary and regulatory actions should be on cost-benefit analysis. There has been a lot of talk about government “investment”. The key is not whether one can rhetorically call a spending action an “investment” but whether the action taken produces a positive rate of return for the economy. Consider high-speed rail. I regularly ride the Acela between New York and Washington and therefore am a beneficiary of the government’s subsidies of Amtrak. But Amtrak barely makes money on its Northeast Corridor routes, which is the most economically promising market for rail transportation in the country. Money spent on extending high-speed rail to 80 percent of the nation’s population will produce a negative rate of return, making it as much of an investment as putting one’s money in Bernie Madoff’s hedge fund. Congress must use its oversight powers to force spending to be cost-effective and to force the various regulatory agencies to enact only those regulations that support economic growth and provide a positive rate of return for the economy.

Third, this analysis can be extended to the tax side of the budget. Fiscal sustainability is much more difficult to achieve with tax increases than with long term expenditure cuts because, as a general rule, the private sector allocates resources in a manner that yields a higher return than does the public sector. If the private sector does not allocate money that produces a positive return the firm or individual who makes that investment loses their own money. This not only tends to concentrate the mind, it also reduces the resources available to those firms that make poor economic decisions. By contrast, the political process does not have economic maximization as its objective, but getting a majority of votes.

This does not necessarily mean that higher revenues should not be part of the equation. But the key point to make is that the phrase should be “revenues” not “rates”. Some revenue increases can actually improve economic allocation by removing subsidies to inefficient activities. But tax rates work in the opposite direction; higher rates muffle market signals and reduce economic efficiency. This fact was recognized by the President’s Debt Commission which *reduced* rates while still increasing revenue.

In sum, Mr. Chairman, the need for long term deficit reduction is urgent and has been neglected. We are taking enormous risks with our country’s future as a consequence. Such reduction must focus on the long term expenditure side of the equation, particularly entitlements. And while both discretionary spending and extra revenue might be part of the solution, decisions on these issues must face a rigorous cost benefit test. Thank you, and I would be happy to answer your questions.

COMMUNICATIONS



**STATEMENT FOR THE RECORD
SUBMITTED TO THE
SENATE FINANCE COMMITTEE
ON
Perspectives on Deficit Reduction: A Review of Key Issues**

July 26, 2011

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On behalf of our members and all Americans age 50 and older, AARP appreciates the opportunity to submit comments as the Committee reviews some of the key issues discussed as part of the Committee's deficit reduction hearings. AARP agrees with the need to tackle our nation's long-term fiscal challenges. However, we do not believe that Congress should use a debt ceiling debate to institute harmful cuts to benefits under the Social Security, Medicare, and Medicaid programs.

Through surveys, town hall meetings, correspondence, and other forms of communication, we have heard older Americans' views on the nation's debt and its impact on programs that particularly impact older Americans. Older Americans overwhelmingly believe that Medicare and Social Security benefits should be "off the table" for deficit reduction. These views are shared by older Americans (age 50+) regardless of whether they are currently enrolled in the Medicare program. In a recent survey of registered voters over age 50, when asked what Congress' priorities should be, a vast majority responded that protecting Medicare and Social Security trumped reducing the deficit. In addition, according to the latest monthly tracking poll by the Kaiser Family Foundation, most Americans oppose the idea of converting Medicaid to a block grant to reduce the federal deficit. A Washington Post-ABC news poll found that 69 percent of Americans oppose cutting Medicaid.

Social Security

Social Security benefits are financed through payroll contributions from employees and their employers, each and every year, throughout an individual's working life. The payroll contributions and benefits paid, including any administrative costs, are accounted for separately from the rest of the federal budget. Importantly, Social Security has not contributed to our large deficits.

To the contrary, Social Security has had cash surpluses each year for most of the past 30 years, taking in more in revenue than it has needed to pay benefits. These surpluses, generated by the payroll contributions made by the American people, have been borrowed to meet other expenses of the federal government. In exchange for use of these surpluses, the federal government has issued Social Security U.S. Treasury bonds of equal value. That is, Social Security has reduced the past need for additional government borrowing from the public and resulted in a public debt that is less today than what it otherwise would have been.

Social Security reserves are invested in the safest investment in the world, U.S. Treasury bonds, which are backed by the full faith and credit of the United States government and have never been defaulted on in our history. The debt held by the Social Security Trust Funds is a real obligation of the United States to its own people, and the American people, like any other creditor, expect that the money borrowed from them by the government will be paid back. If Congress chooses to not pay back the Trust Funds obligations and defaults on the U.S. Treasury

bonds, then this will be a true "raid" on Social Security. However, honoring the full faith and credit of the United States is a core value of our country and fundamental to the economic security of all Americans, not just retirees.

According to the Social Security Trustees, the program has sufficient income from payroll contributions and assets in Treasury notes to pay 100 percent of promised benefits for a quarter century, and even with no changes, can continue to pay approximately 75 percent of promised benefits thereafter. While Social Security faces this long-term shortfall, targeting it now for any cuts, including arbitrary, across-the-board cuts, is unfair and unnecessary, and would most assuredly mean significant reductions in benefits for current beneficiaries, as well as for their children and grandchildren.

Older Americans truly understand that budgets matter and that we all need to live within our means. But they also understand that budgets impact real people – federal programs can make meaningful differences in peoples' lives and help ensure that older and disabled Americans can live independently and with dignity as they grow older. They also understand the difference between programs that have been contributed to and earned over the course of a lifetime of work and those that are not. For example, AARP generally opposes proposals that result in arbitrary, across-the-board, spending cuts that fail to distinguish between different types of spending and would take a meat ax approach to governing.

In this regard, we are opposed to subjecting Social Security to sequestration procedures that serve to enforce spending caps. Social Security is currently exempt from sequestration in statutory PAYGO, and was exempt from sequestration or other generalized budget cuts in Gramm-Rudman-Hollings. Social Security is also not subject to reconciliation instructions, which would otherwise permit changes to the Social Security program on a fast track and for the purpose of reducing deficits. These exemptions are consistent with the recommendations of the National Commission on Fiscal Responsibility and Reform, which explicitly noted that Social Security should be reformed "for its own sake, and not for deficit reduction." The Commission's view echoes that of the National Commission on Social Security Reform (also known as the Greenspan Commission), which stated in its report in 1983: "The National Commission believes that changes in the Social Security program should be made only for programmatic reasons, and not for purposes of balancing the budget." The policy of exempting Social Security from cuts to meet deficit reduction has stood for over a quarter century and we urge that this prudent and justifiable policy continue.

Social Security is currently the principal source of income for nearly two-thirds of older American households receiving benefits, and roughly one third of those households depend on Social Security benefits for nearly all (90 percent or more) of their income. Despite its critical importance, Social Security's earned benefits are modest, averaging only about \$1,200 per month for all retired workers in March 2011. Nonetheless, Social Security keeps countless millions of older

Americans out of poverty and allows tens of millions of Americans to live their retirement years independently, without fear of outliving their retirement income. Social Security also provides critical income protection for workers and their families who become disabled or deceased. Moreover, while personal savings should always play an important role in retirement planning, with the growing prevalence of 401(k) and other individual account plans and the decline in defined benefit pension plans, the guaranteed benefit of Social Security will become increasingly important to future generations as workers live longer and bear more of the market risk associated with investing for their own retirement.

Given the already modest benefits current Social Security beneficiaries receive, the program's continued critical importance to future generations' income and retirement security, the system's dedicated financing, and the lack of a contributory impact on our current large deficits, AARP firmly believes that Social Security should not be targeted for cuts for deficit reduction or as part of a budget exercise to satisfy arbitrary spending thresholds. AARP therefore will not accept any cuts of any kind to Social Security as part of a deal to pay the nation's bills; this includes back door proposals to cut benefits -- such as the proposed chained CPI -- which AARP also believes should not be considered as part of the debt ceiling or deficit reduction negotiations.

In the face of declining pensions, shrinking savings, falling home values, rising health costs, and longer life expectancies, Social Security deserves to have its own national conversation that focuses on preserving and strengthening the retirement security of Americans and their families for generations to come. AARP welcomes that conversation, and we have already begun a renewed effort to engage our members and other Americans on ways to strengthen Social Security now and in the future.

Medicare

Over 47 million older Americans and Americans with disabilities depend on Medicare today. Medicare is the bedrock of health security for these families. As Congress develops legislation to address our nation's deficit, AARP strongly urges you to reject any proposals that would impose arbitrary, harmful cuts to the Medicare program or shift additional costs onto Medicare beneficiaries. Half of all beneficiaries live on incomes of less than \$22,000, and many already struggle to pay for their ever-rising health and prescription drug costs.

Some have proposed requiring Medicare beneficiaries to pay even more for their Medicare benefits, either through higher co-payments or higher premiums. AARP strongly urges you to reject higher costs for people in Medicare. Before we shift additional cost burdens onto beneficiaries, Congress should address the real problem of increasing health care costs throughout the entire system. Singling out the Medicare program – either for arbitrary cuts or for increased costs to beneficiaries – will not rein in overall health care costs. It will simply shift costs on to other payers of health care services, particularly beneficiaries and their families, and undermine current and future beneficiaries' access to quality care.

Significant savings related to the Medicare program have recently been enacted into law. Included with these targeted savings are important delivery system reforms – such as Accountable Care Organizations (ACOs), patient-centered medical homes, value-based purchasing, quality-based payments, and patient safety initiatives – which we believe hold great promise to hold down systemic health costs, including costs in Medicare. We believe it is important that such reforms are implemented in a manner that achieves higher quality and a more efficient Medicare program, including the improvement of primary and coordinated care, and payment incentives that reward improved outcomes rather than volume.

Simply shifting higher costs to seniors does nothing to improve health care quality or combat the real underlying problem of rising costs throughout the health care system. Similarly, AARP opposes raising the age of eligibility for Medicare because it would reduce coverage and increase costs for younger retirees.

Finally, AARP is concerned with some proposals – like that from the so-called “Gang of Six” -- that calls for more than \$500 billion in additional health savings with very little indication of where these additional health savings would come from. According to reports, this proposal would direct this committee to permanently reform or replace the SGR (\$298 billion) and fully offset that with health care savings. While we recognize the need to avert the 30% cut in reimbursements physicians who treat Medicare beneficiaries, it is unclear how the Finance Committee would be able to fix the SGR and find savings of more

than \$500 billion without imposing additional cost sharing on seniors or impacting quality and access to care.

In addition, the Gang of Six proposal calls for the elimination of certain Medicare supplemental plans that cover all copayments and cost-sharing. Just like all Americans, people on Medicare value choice. AARP believes Congress should not prohibit older Americans from purchasing the insurance coverage they feel they need, nor should Congress simply shift additional costs onto beneficiaries. People choose supplemental policies because they provide financial and health security – the peace of mind that even if they have a health crisis or frequent, ongoing health care needs that they will be able to manage.

Medicaid and CLASS

Medicaid helps millions of people of all ages, including the elderly, who have disabilities and need long-term services and supports, such as help with eating, bathing and dressing. Financing options for long-term services and supports (LTSS) are limited, and most people are unable to save the thousands of dollars necessary for LTSS. Many mistakenly believe Medicare covers long-term care (LTC) – it does not.

Medicaid is the nation's largest payer for long-term care. Nearly a third of those turning age 65 will have long-term care costs that exceed their ability to pay and will need Medicaid assistance to help with LTC. Medicaid is a last resort for these individuals, especially when faced with depleted savings and high care costs. Medicaid covers nearly two-thirds of nursing home residents as the primary payer. The cost of nursing home care is significant for individuals – the national median annual cost of a private room in a nursing home is over \$75,000.

As Congress considers proposals to reduce spending in Medicaid, we want to ensure that Congress understands the importance of the program to older Americans and their families. AARP is again concerned that putting arbitrary caps or limits on federal Medicaid spending could reduce access to and quality of care, such as reducing staffing in nursing homes, which could put the health and safety of seniors and people with disabilities at risk. Proposals that would arbitrarily limit or cut federal matching Medicaid spending don't simply make Medicaid costs disappear; these costs would be shifted to individuals, providers, and state governments.

We also want to note our opposition to proposals to eliminate the "maintenance of effort" (MOE) requirement included as part of the Patient Protection and Affordable Care Act (ACA). We are concerned that states will make cuts to Medicaid that could leave many older Americans, persons with disabilities, and children without health care coverage. Medicaid provides critical long-term care coverage to older adults and persons with disabilities. Starting in 2014, the ACA expands Medicaid coverage for persons with incomes up to 133% of the federal poverty level, to ensure that people who cannot afford care on the private market still have access to core services without the inefficiencies and expense of

uncompensated care. The ACA provided the MOE provisions to serve as a bridge to 2014, making certain that important health coverage remains in place until the new law is fully implemented. According to the Congressional Budget Office's scoring of legislation to repeal the MOE requirement, MOE elimination would lead to hundreds of thousands of vulnerable Americans losing coverage each year.

Medicaid cuts could also reduce access to much needed, preferred, and cost effective home and community-based services. An AARP study found that 9 out of 10 Americans age 50+ want to stay in their current residence for as long as possible. And, on average, Medicaid can provide home and community-based services to three people for the cost of serving one person in a nursing home. When states cut Medicaid LTC spending, they often target home and community services (HCBS), since these are defined as "optional services" under Medicaid law (even though they are critical services for many people). Cutting HCBS could result in more people having to go to nursing homes – generally more costly than HCBS – and their care being paid for by Medicaid.

Arbitrary limits on Medicaid spending could also mean deep cuts that would devastate support for family caregivers who provide needed support for their loved ones to help keep them living in their homes and communities. Last week, AARP's Public Policy Institute released a new report, "Valuing the Invaluable: 2011 Update, The Growing Contributions and Costs of Family Caregiving," which found that the estimated economic value of family caregivers' unpaid contributions was approximately \$450 billion in 2009. This amount is more than total Medicaid spending in 2009, including both federal and state contributions for both health care and long-term services and supports (LTSS). Family members often undertake caregiving willingly, and many find it a source of deep satisfaction and meaning. However, those who take on this unpaid role risk the stress, physical strain, competing demands, and financial hardship of caregiving, and thus are vulnerable themselves. Potential cuts could include services – such as respite care – that allow unpaid caregivers a short reprieve from their caregiving duties, and likely save the Medicaid program millions each year across the states.

Significant cuts to Medicaid cannot be made without harming individuals and families who rely on Medicaid for health or long-term services and supports, and these individuals include formerly middle income people who have had their life savings wiped out by the high costs of LTSS. In addition, Medicaid cuts often translate into job losses for medical and health centers and nursing homes (which are major employers in many communities), and the health workforce more broadly. This employment effect can reduce access to care for many older persons – even those whose care is not paid for by Medicaid.

In addition to opposing harmful cuts in Medicaid, AARP strongly opposes proposals that would repeal the Community Living Assistance Services and Supports (CLASS) program – an important priority for AARP members. Receiving CLASS benefits may help delay or prevent potential spend down to

Medicaid eligibility because CLASS will help cover long-term services and supports (LTSS) costs in the home instead of often more costly institutional settings. Moreover, repealing CLASS would add to the federal deficit over the next ten years. The Congressional Budget Office (CBO) has estimated that CLASS would reduce federal deficits by \$83 billion in the next ten years, including about \$2 billion in federal Medicaid savings due to CLASS, just in the few years that CLASS pays benefits. We urge the rejection of proposals to repeal this important program that would give people a new option to help plan and pay for services that help them live in their homes and communities.

Finally, we also want to note that about 9 million individuals – sometimes referred to as “dual eligibles” -- are eligible for and receiving services through both Medicare and Medicaid. These individuals include both low-income individuals and formerly middle class individuals described earlier who have exhausted their retirement savings on health and long-term care and now rely on Medicaid to help pay for their care at home or in a nursing home. Seniors in these two programs present some of the greatest opportunities—and challenges—to improve the quality of health and long-term care while achieving efficiencies in the programs. By better coordinating their care and ensuring the delivery of high quality care, we can keep our most vulnerable seniors healthier and out of the hospital. We are working with Congress, the Centers for Medicare & Medicaid Services, states, and other stakeholders to improve care for the dual eligibles and ensure that they and their advocates have a place at the table as those improvements are discussed and implemented.

Suggested Health Savings

Rather than harmful cuts, Congress should instead focus on proposals that would save money and improve the Medicare and Medicaid programs without harming beneficiaries. The following provides only a few examples, particularly for high cost prescription drugs, of cost-saving proposals Congress should consider instead of simply asking older Americans to pay more for their care:

- *Prescription Drug Rebates for Duals* (S. 1206): AARP supports such rebates, which are expected to save the Medicare program over \$100 billion over the next ten years without negatively impacting Medicare Part D benefits.
- *Biologic Exclusivity*: AARP supports reducing the exclusivity period for biologic drugs, which will speed lower cost generics to market.
- *Prohibit Pay-For-Delay Agreements*: AARP supports legislation that will help to bring lower cost generic drugs to market sooner by preventing abuses in patent settlements between generic and brand prescription drug companies.

- *Medicare Secretarial Negotiating Authority:* AARP supports legislation that would enable the Secretary of HHS to use the bargaining power of Medicare's 47 million beneficiaries to negotiate for lower prescription drug prices.
- *Prescription Drug Reimportation:* AARP supports the Pharmaceutical Market Access and Drug Safety Act, sponsored by Senators Stabenow and Snowe, which would establish a framework for the safe, legal importation of lower-priced prescription drugs from abroad.
- *Encouraging Generic Utilization in the Medicaid Program:* AARP supports the Affordable Medicines Utilization Act of 2011, introduced by Senators Scott Brown, McCain, and Wyden. This legislation would encourage states to improve the use of generics in their Medicaid programs by allowing them to keep a portion of the savings they generate by using lower-cost, FDA approved generic medications instead of more costly brand equivalents.
- *Home and Community-Based Services (HCBS):* AARP supports expanded access to home and community-based services -- Medicaid can provide HCBS to three people for the cost of serving one person in a nursing home.
- *Medicare and Medicaid FAST Act:* AARP supports legislation, introduced by Senators Carper and Coburn, as well as other efforts, to curb waste and fraud from the Medicare and Medicaid programs.

CONCLUSION

On behalf of our millions of members and all older Americans, we thank you for the opportunity to share with you our views on the importance of the Social Security, Medicare and Medicaid programs. As Congress continues its work to rein in federal spending, we strongly urge you to enact legislation that will strengthen these vital programs without harmful cuts or added costs to beneficiaries, and without arbitrary, across the board cuts that may harm the programs older Americans rely on.

Comments for the Record

Perspectives on Deficit Reduction: A Review of Key Issues

United States Senate Committee on Finance
Thursday, June 30, 2011, 10:00 AM
215 Dirksen Senate Office Building

Submitted by:

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Chairman Baucus and Ranking Member Hatch, thank you for this opportunity to provide comments to the Committee. At the Center we are a bit puzzled as to why what is obviously a summary review of the series is being held at this point, when the hearing on Perspectives on Revenue has been postponed, but we will let that pass for now.

In our view, there is only one key issue to consider for deficit reduction – solvency.

At the end of the day, the General Fund, the Social Security Trust Fund and the Medicare Trust Fund must all be left solvent in the long term without major cost shifting unless this leaves both the Treasury and the beneficiaries better off while at the same time simplifying the tax system.

In order to judge whether this occurs, we must first identify the appropriate baseline.

Baseline Issues for Revenue

The most important fact in determining which baseline to use for deficit reduction, especially when focusing on revenues, is the automatic expiration of the 2001, 2003 and 2010 tax cuts on January 1, 2013. As the Center for Budget and Policy Priorities reports, allowing the Bush/Obama tax cuts to expire on schedule will rather automatically cut the deficit to net interest costs - essentially stopping the need for any cuts at all. This solution will only happen, however, if the President and Congress refuse to compromise on the issue of high income tax cuts. Given that most donors are within that income strata, we do not believe it is wise to count on such a refusal – although it would certainly eliminate the need for hearings on deficit reduction.

That fact must still guide the deliberations of Congress on the issue of deficit reduction. Any solution must be as productive in these terms as letting the tax cuts expire automatically.

The complicating factor in simply letting the tax cuts expire is recent poor economic news, which indicates that the events of 2008 were not simply a recession, but a full blown depression. Low tax rates enacted on capital gains, income and dividends during the Clinton and Bush administrations have created two asset based recessions, the first in the technology sector and the second in housing. The recent recession is more accurately described as a Depression, since the financing of the real estate bubble has still not been resolved, even while economic growth numbers have begun to rebound. Until the underwater mortgage problem is dealt with, recovery will be elusive and efforts to stimulate it with tax cuts will be a grand waste of money. Giving a general tax cut to most households will inadequately assist those families who are burdened with underwater mortgages while providing unneeded benefits to the remainder.

The problem of uncertainty is general, but the solution to this uncertainty is to correct the housing market by providing direct assistance to underwater borrowers, either through bankruptcy reforms allowing "cram-downs" on primary residences or through the Federal Reserve buying mortgage backed securities from Freddie Mac, Fannie Mae and other government entities such as the VA and FHA at the value of the underlying assets and then directing servicers to adjust principal balances. Barring such actions, the only real way out is asset inflation as part of general inflation, which would harm the investing community more than reform.

If tax cuts were really the way to stimulate the economy to produce jobs, recent tax cuts would have led to job growth at an all time high rather than faltering. This is obviously not the case. Those high income individuals and businesses who have benefited from these cuts are still not hiring and have no incentive to do so, as their return on current production and savings is adequate at current tax rates to fund their needs. If their taxes were increased, they would have an incentive to expand operations in order to maintain the same level of income. This phenomenon explains why the 1993 tax legislation resulted in the most sustained economic growth in American history, while the tax cuts in subsequent years have ignited three boom-bust cycles (with the recent oil boom being the third) but very little economic growth.

In order to keep the general fund solvent, housing must be dealt with and some agreement must be reached that the baseline by which we measure sovereignty is not current tax rates, but the rates contained in permanent law. If any cuts are made to those rates, they must be balanced with spending cuts.

Of course, we face an even more urgent problem, the solvency of the United States as a whole due to the imminent breaching of the debt limit. This threatens all trust funds, from debt held by the public, to Social Security.

At the very least, the constraints on borrowing to fund the conversion of Social Security trust fund assets to debt held by the public must be dealt with by enacting a clean debt limit extension, or at the very least, automatically allowing the debt limit to increase to facilitate this conversion. The only alternative to this is immediately increasing income taxes before they go up automatically in 2013. While Social Security may not be a legal obligation to retirees, the funds which back it are such an obligation under the 14th Amendment, so it would be unconstitutional to not give their repayment first priority.

Let us be clear that August 4th is not the real deadline which is of concern, but December 31, 2012. The only leverage against automatic tax increases is a deal in advance of their expiration and the only leverage for such a deal is the debt limit extension.

Tax Reform

Tax reform, if undertaken at all, should have the goal of simplifying the collection of revenue while maintaining or improving its basic progressive structure (which in current law is more honored in its breach, given low taxes on capital gains and dividends). The use of the tax code to provide subsidies to working families must be maintained, but this should occur without requiring that every household file a tax return to receive them, often by paying others to do so and paying a premium for refund anticipation loans which are heavily marketed to those least able to afford the finance costs.

On the other hand, the number of people paying no tax as a result of these benefits has justly drawn criticism that a sense of shared sacrifice has been abandoned. This has led many to demand some form of consumption tax so that all are conscious of some sacrifice. Some form of visible consumption tax will also provide an incentive to save to those who otherwise would not because their incomes are too low to do so. The wealthy, however, need no such incentive – having the ability to satisfy all of their current economic needs with additional income to spare.

The Center for Fiscal Equity again offers a four point plan for reaching a long term deal on revenues.

Part One is a Value Added Tax (VAT), which is suggested because of its difficulty to evade, because it can be as visible to the ultimate consumer as a retail sales tax and because it can be zero rated at the border for exports and collected fully for imports. As this feature has been well explained by others, I will not go into detail on this point. What is more important is to exercise care in delineating what is funded by such a tax.

We believe that VAT funding should be confined to funding domestic discretionary military and civilian spending. Zero rating a tax supporting such spending is totally appropriate, as foreign consumers gain no benefit from these expenditures. Likewise, making imports fully taxable for this spending correctly burdens the consumers who fully benefit from these services. As importantly, making such a tax visible provides an incentive to taxpayers to demand less of such spending.

An extreme example of such spending incentives would be the creation of a regional VAT funding regional appropriations, with varying rates depending upon spending levels. While creation of regional appropriations panels and government agencies can be accomplished under the Constitution as currently written, creation of any regional excise would require a constitutional amendment, as the Constitution requires all excises to be uniform.

In order to fully fund current domestic obligations, the Center calculates that the tax rate should be 13.3%. In order for this to be affordable, during the transition, income tax withholding tables should be adjusted to increase net income by the same percentage, with Social Security beneficiaries receiving a similar bump in payments. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Two is a VAT-like Net Business Receipts Tax (NBRT). Its base is similar to a VAT, but not identical. Unlike a VAT, and NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The key difference between the two taxes is that the NBRT should be the vehicle for distributing tax benefits for families, particularly the Child Tax Credit, the Dependent Care Credit and the Health Insurance Exclusion, as well as any recently enacted credits or subsidies under the Patient Protection and Affordable Care Act (ACA). In the event the ACA is reformed, any additional subsidies or taxes should be taken against this tax (to pay for a public option or provide for catastrophic care and Health Savings Accounts and/or Flexible Spending Accounts).

The Child Tax Credit should be made fully refundable and should be expanded to include revenue now collected under the dependent exemption, the home mortgage interest deduction and the property tax deduction. Transitioning these deductions will allow a \$500 per month per child distribution with payroll. It will likely increase incentives to expand affordable housing and may not decrease housing for the wealthy, who are less likely to forgo vacation housing or purchase of luxury housing for want of a tax cut, as the richest families likely pay the alternative minimum tax anyway, so that they do not fully use this tax benefit now.

This tax should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

An extreme example of this proposal is to have a differential regional rate and differential benefit levels for this tax, which may or may not require an amendment – as this tax may be far enough removed from the transaction level to be considered an income tax rather than an excise.

Again, in the extreme, this tax could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions.

Employers receive a tax credit if their retirees opt out of Medicare and Medicaid for seniors by fully employer funding of retiree health care, either by hiring doctors or purchasing comparable coverage, including catastrophic coverage in return for some kind of tax credit.

This proposal is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

It is not appropriate for this tax to be zero rated, as doing so would decrease the incentive to pass these tax benefits to employees. As importantly, the tax benefits and government services provided under this tax go to workers and their families. As such, overseas purchasers accrue benefits from these services and should therefore participate in their funding.

If the NBRT is enacted in this way, the United States should seek modification to our trade agreements to require that similar expenditures not be funded with taxes that are zero rated at the border. As foreign consumers benefit from subsidies for American families, American consumers benefit from services provided to overseas workers and their families.

This benefit should be recognized in international tax and trade policy and American workers should not be penalized when other nations refuse to distribute the cost of benefits to foreign workers to the American consumers who receive the benefit of these services. If our trading partners do not match this initiative, some items of spending could be shifted from NBRT funding to VAT funding, so that we are not making unilateral concessions in this area.

The VAT would replace income taxes collected at the lowest rate, while the NBRT would replace disability insurance, hospital insurance, the corporate income tax, business income taxation through the personal income tax and the mid range of personal income tax collection, effectively lowering personal income taxes by 25% in most brackets. Note that collection of this tax would lead to a reduction of gross wages, but not necessarily net wages – although larger families would receive a large wage bump, while wealthier families and childless families would likely receive a somewhat lower net wage due to loss of some tax subsidies and because reductions in income to make up for an increased tax benefit for families will likely be skewed to higher incomes. For this reason, a higher minimum wage is necessary so that lower wage workers are compensated with more than just their child tax benefits.

The NBRT rate is projected to be 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Three is the continuation of a payroll tax for Old Age and Survivors Insurance (although insurance for survivors under age 60 may be shifted to the NBRT). Given the across the board decrease in gross income, the tax rate would have to be increased to 6.5% for employees and employers (provided younger survivors are excluded). To improve program progressivity, the employer contribution could be credited on an equal basis, moving redistributive effects from benefit distribution to revenue collection. Additionally, the amount subject to tax should be increased or the income cap eliminated, which would help both program income and support for lower income retirees. I have addressed this issue more fully in prior comments dated May 17, 2011, which I will not repeat here.

Part Four is surtax on high income earners and heirs. It would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay a surtax on that income.

We considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

This surtax could have few rates or many rates, although I suspect as rates go up, taxpayers of more modest means would prefer a more graduated rate structure. The need for some form of surtax at all is necessary both to preserve the progressivity of the system overall, especially if permanent tax law enacted before 2001 is considered the baseline (which it should be) and to take into account the fact that at the higher levels, income is less likely to be spent so that higher tax rates are necessary to ensure progressivity.

This tax would fund net interest on the debt, repayment of the Social Security Trust fund, any other debt reduction and overseas civilian, military, naval and marine activities, most especially international conflicts, which would otherwise require borrowing to fund. It would also fund transfers to discretionary and entitlement spending funds when tax revenue loss is due to economic recession or depression, as is currently the case. Unlike the other parts of the system, this fund would allow the running of deficits.

Explicitly identifying this tax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards. The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit.

Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1961 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall. Additionally, as foreign labor markets mature, foreign workers will demand more of their own productive product as consumers, so depending on globalization for funding the deficit is not wise in the long term.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

Again, thank you for the opportunity to submit these comments for the record.

