S. HRG. 109–695

STATE OF THE ECONOMY AND BUDGET

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

September 28, 2006—THE STATE OF THE ECONOMY AND BUDGET

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HEARING ON STATE OF THE ECONOMY AND BUDGET

THURSDAY, SEPTEMBER 28, 2006

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The Committee met, pursuant to notice, at 9:58 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg (Chairman of the Committee) presiding.

Present: Senators Gregg, Alexander, Grassley, Allard, Conrad, Sarbanes, and Murray.

OPENING STATEMENT OF CHAIRMAN GREGG

Senator GREGG. I believe we are going to get started even though it is a few minutes early, if that is agreeable to Senator Conrad.

We appreciate Dr. Lazear coming today and we appreciate the other witnesses who are on our second panel joining us. I would at the opening make the point that, unfortunately, we did not receive Dr. Lazear's statement until just a few minutes ago. That is unfortunate, because the Democratic membership has a right to the statement 24 hours before the hearing, and the Administration really doesn't do itself any good by not getting those statements up here in a timely manner. It is really unfair to the minority not to get them.

So I would hope that this would not be a recurring event, and on behalf of at least the majority of the Senate, we apologize to the minority for not having the statement.

Senator CONRAD. Mr. Chairman, might I inquire? What is the rule of the Committee with respect to testimony before the Committee?

Senator GREGG. I believe it has to be filed 24 hours before the testimony is presented. Is that correct? You probably know more than I do.

Senator CONRAD. I think that is the rule, and what is the consequence for a failure to adhere to the rule?

Senator GREGG. I have no idea.

Dr. LAZEAR. The consequence is the dissolution of the hearing, if I am not mistaken.

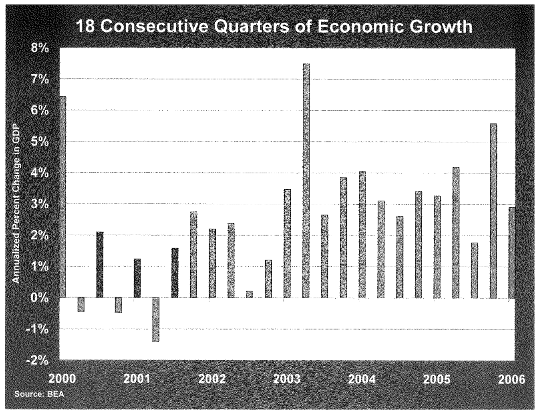
Senator GREGG. The problem would be then we would never get anybody to testify. They would never send in their testimony.

Senator CONRAD. It may be a valuable lesson to send if we are going to have these hearings and they are going to be meaningful. I have not had a chance to read three paragraphs of the testimony before we hear it here, which makes it difficult to prepare questions, makes it difficult to prepare a response. I am not going to insist on imposing the rule here, but I would send a message that I may not always be so tolerant.

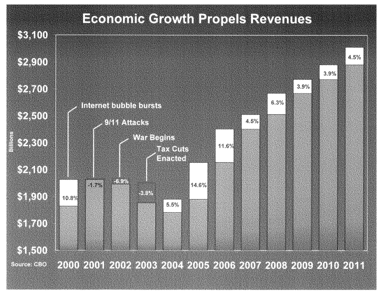
I think we have the rule for a reason and it is a good reason. So we will go forward. I thank the chairman for his explanation of the situation as well.

Senator GREGG. I appreciate it and I appreciate the Senator allowing us to go forward, because I think it would be within his rights to state that the hearing shouldn't go, and that would mean we wouldn't be able to give opening statements, which would mean we would miss potentially thousands of charts. We do appreciate the minority's allowing us to move forward and waiving that right.

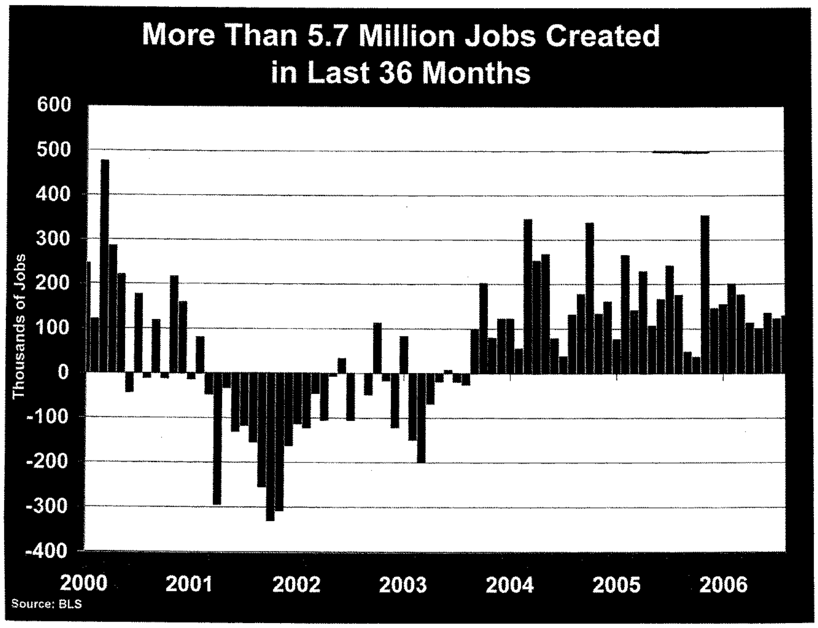
I want to start my opening statement and talk a little bit about what this hearing is about, which is the state of the economy, specifically the effect on the economy of the tax cuts which were put in place by this Administration. There has obviously been a lot of representations of what these tax cuts have and have not done, and I am sure the Senator from North Dakota will have a differing view than I do, but if we look at the facts on the ground, and maybe we can put the first chart up, the economic growth, we have seen now 18 consecutive quarters of economic growth, significant economic growth. This came in light of a period when this Administration came into power, came into office, that was extremely disruptive for our economy. We have had the internet bubble, which burst which was a dramatic event economically in and of itself and should have led to a severe recession. We had the attack of 9–11, which was a hugely disruptive event to our culture and to our economy. And those two things coupled together, basically in a regular economic cycle would have led, I believe, to a very dramatic and significant decline in the economy and recessionary event of significant proportions.



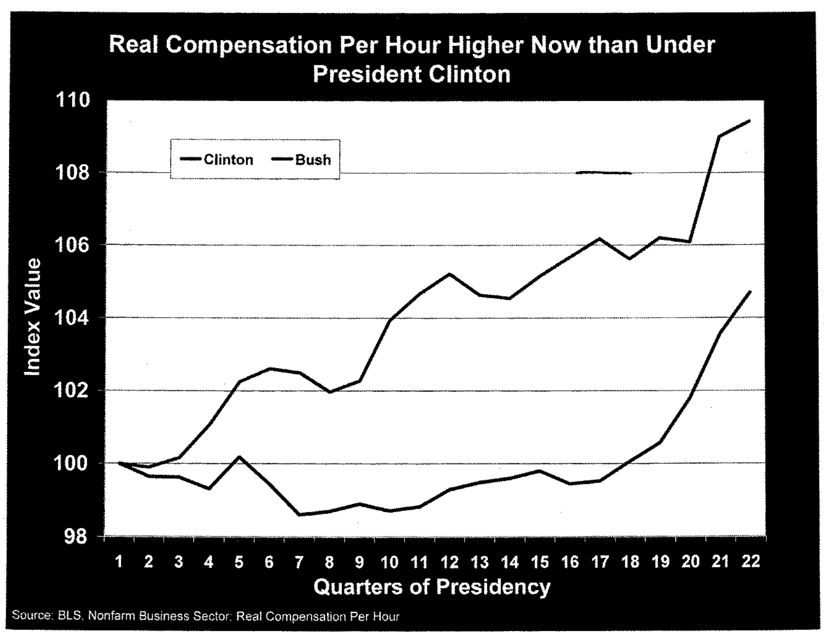
What happened, however, was that because we put tax cuts into place, actually at the right time, which was right at the beginning of this Administration and before 9–11, some of them anyway and some right after, that we were positioned to give the economy some lift through tax incentives and create an atmosphere for more entrepreneurship and more investment, and as a result, it created more jobs. In fact, over that period, we have created 5.7 million jobs just in the last 36 months. That is pretty significant, 5.7 jobs as this chart would show. That is a pretty significant increase in the number of jobs.



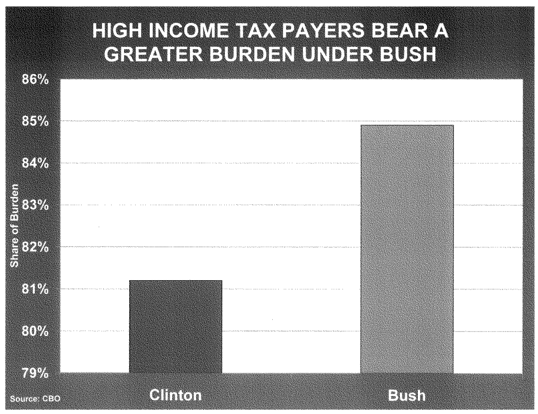
The practical effect of that, however, is even more important, because not only does it give people jobs, what the practical effect of making these tax cuts has been has been that revenues have jumped radically over the last 2 years, especially as the economy has recovered. We have seen the two largest increases in years of revenue increase in our history, and the effect of that revenue increase has been that the deficit has dropped significantly, down from an estimated 450 billion, approximately, to about 270 billion, depending on where we end up this year. That is because the economy is moving aggressively forward. People are working and people are investing and there is a tax atmosphere out here which encourages that.



Now, some have said that during this period, there has been less of a wage growth. Actually, real compensation under this timeframe has exceeded the same type of period under President Clinton's timeframe. Real compensation is a function not only of actual wages, but it is a function of benefit structure.



In addition, some have said that these tax cuts have inordinately benefited the wealthy. Well, the numbers don't support that either. In fact, these tax cuts have benefited dramatically all Americans by generating more economic activity and more revenue to the Federal Government, and the wealthy in this country are now bearing a higher percentage of the tax burden, income tax burden, than those people bore during the years of the Clinton years. People in the high income brackets are paying almost 85 percent of the tax burden today, 85 percent.



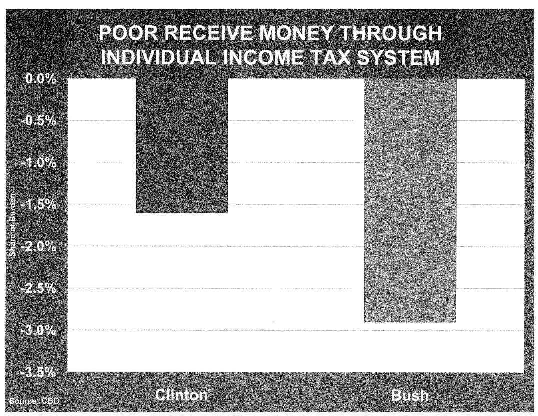
Do you have the comparison of the Clinton years?

During the Clinton years, the people in the high income brackets bore about 81 percent of the tax burden. Today, people in high income tax brackets are bearing 85 percent of the tax burden.

Why is that? It is very simple. When you make taxes fair, people invest in activity that is taxable. When taxes are excessively high, people avoid taxes. High income people know how to avoid taxes. They invest in shelters, basically, in various vehicles that will keep them from having to bear a tax burden that they consider to be too high. When you make the tax burden reasonable, they are willing to take the cost of that tax burden as a cost of doing whatever their investment is.

So the Federal Government receives more revenue. It is a very simple function of human nature, and it is reflected dramatically in these figures, which show that under the President's tax cuts, we actually now have high income taxpayers in this country bearing a larger percentage of the cost of income taxes than they did under the Clinton Administration.

In addition, another interesting fact is that under the Bush tax cuts, low income taxpayers, and that was the chart that was up there before, are actually receiving—low income taxpayers, the people in the bottom 20 percent, don't actually pay taxes on the whole, income taxes. They receive earned income tax credits, basically, which is a payment to them, and then actually that has increased also under this Presidency. So the people in the lowest quadrant of income are receiving more back in benefit than they did in the Clinton years. People in the highest quadrant of income are paying more as a percentage of the burden of taxes than they did in the Clinton years.



So we have actually, by cutting tax rates and making them fair and getting people to do more economic activity and generate more revenue for the Federal Government and at the same time generating more taxes being borne by high income people because they are not avoiding taxes, we have actually made the tax laws in this country significantly more progressive than they were under the Clinton Administration. Now, that is counterintuitive to the "New York Times", but it is the fact. The simple fact is that by reducing taxes and making them fair, we have created an atmosphere where high income people are picking up more of the tax burden, low income people are getting more back out of the Federal Government, and we have created more jobs, more revenue, and more economic activity than any time in our history.

That is all pretty good news, and I know my colleague from North Dakota will have a different take on this, but those are the facts and they are pretty good facts. So I will yield at this time to my colleague for his perception.

[The prepared statement of Senator Gregg follows:]

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For Immediate Release **September 28, 2006**

Senate Budget Committee Chairman Judd Gregg's Opening Statement
Senate Budget Committee Hearing: "State of the Economy and the Budget"

I thank our distinguished witnesses for taking the time to meet with us today. It is now the end of the fiscal year, which is an excellent time to reflect on the economy and focus on future fiscal policy.

Following a series of severe economic challenges – 9/11, the internet bubble, and corporate scandals - the economy has rebounded well due to Republican pro-growth tax policies that have bolstered economic productivity, job creation and tax revenue.

Since August 2003, the economy has grown at an average annual rate of 3.7% and 5.7 million new jobs have been created. This has generated a record real increase in tax revenues, lowering earlier forecasts of budget deficits by more than 20%. Household net worth is a record high, homeownership is near record levels, and energy prices are dropping.

Americans are better off now than they were under the Clinton Administration. Since the 2003 tax cuts, total tax receipts have increased at a faster compound annual rate than when taxes were raised by President Clinton in 1993. Under President Bush, total worker compensation is up 20% and lower-income Americans are paying less in income tax than they were during the Clinton Administration.

Despite liberal allegations to the contrary, the highest-income Americans continue to shoulder the greatest share of the tax burden: 84.9 percent of all individual income tax is paid by the highest-income Americans. Low-income Americans pay virtually no income taxes, and in many cases actually receive payments through the tax system.

It is critically important to the future of the economy that we maintain the pro-growth environment. Tax cuts set to expire over the next few years should be made permanent. Saddling businesses and taxpayers with a higher tax burden that will slow the economy is in no one's best interest.

I would like to thank the witnesses for joining us today and I look forward to hearing their testimony.

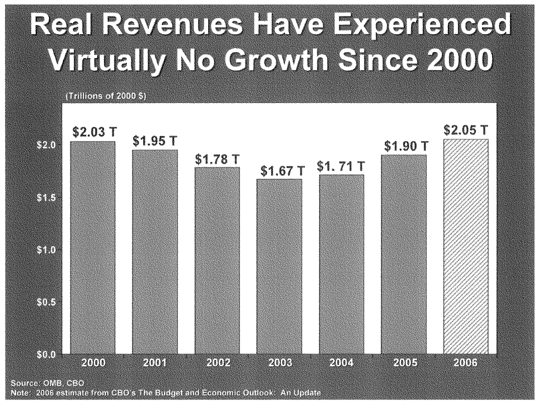
OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Well, I enjoyed this presentation very much. They are facts, but I would say highly selective and leave out a lot of things, and now for the rest of the story.

First of all, I always enjoy these hearings and I appreciate the chairman calling this one, because this really is an important discussion for us to have. Let us go back in history and recall what occurred. It was not the case in 2001 that you were for tax cuts and we were against tax cuts. In fact, the proposal that I put before our colleagues was for 900 billion of tax cuts. The President proposed about twice as much.

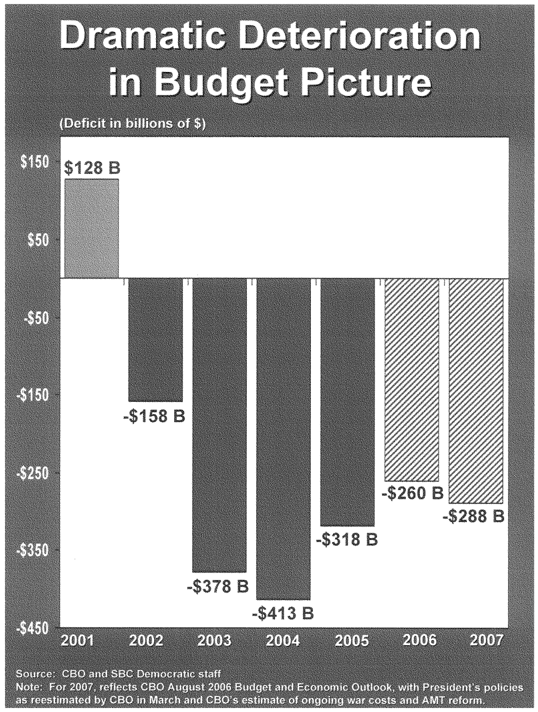
So the question was, first of all, the size of the tax cuts and what kind of tax cuts should there be. The tax cuts the President advocated were much larger in amount, and the President's tax cuts were much more heavily skewed to the wealthiest among us. The tax cuts that we proposed on our side were more affordable, and certainly in light of history, that is clearly the case, and they were also geared to the middle class. I would argue that is where we get the biggest bang for the buck.

The second question is the revenue chart that the chairman put up, talking about revenues I don't know if you put up a chart or just talked about revenues going up, but the rest of the story here is what happened to real revenues adjusted for inflation since 2000: The fact is we are just now getting back to the real revenues that we had in 2000. There hasn't been some giant run-up in revenue. Please. The last few years, revenue has gone up, but from a very low base, much lower than the revenue that we had in 2000.

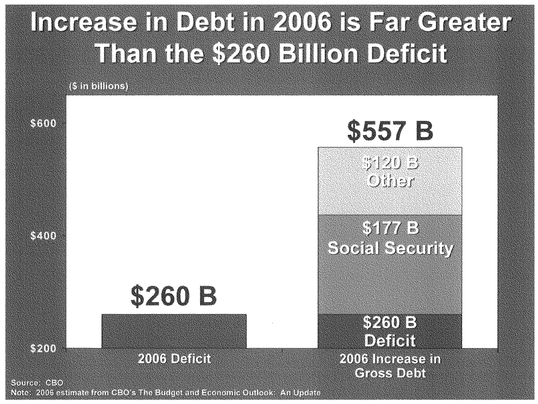


So this talk about a dramatic rise in revenues, please. The fact is we are just now getting back to the real revenues we had 7 years ago.

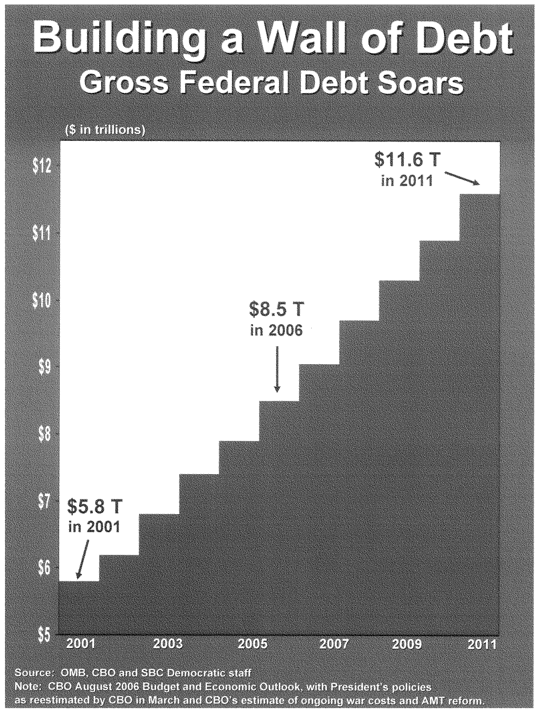
Let us go to the question of deficits. The chairman talked about big improvements in deficits; well, yes, a big improvement from the worst deficits we have ever had. You know, 2 years ago, the deficits were higher than they are now. They were the highest they have ever been, but compared to 6 years ago when we had surpluses, these deficits are terrible, and the deficits understate the seriousness of the situation.



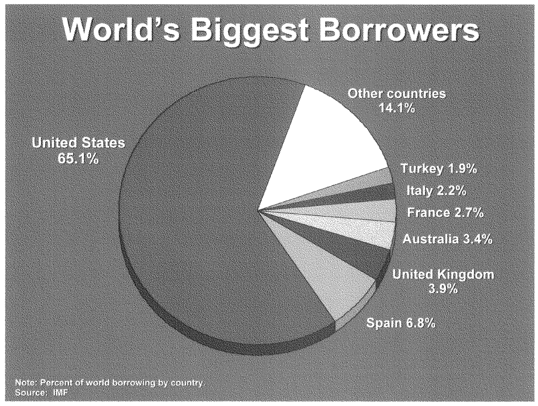
Well, just to make the point, the first year of this Administration where they inherited the fiscal policies of the previous Administration, we had a surplus. Now with the fiscal policies of this Administration, we have run up four of the largest deficits in the country's history, and the deficit substantially understates the red ink, because while the deficit is projected to go up by 260 billion dollars this year, the debt is going to increase by $560 billion dollars. When you measure that against GDP, we find that we are over 4 percent of GDP, debt increasing by over 4 percent of GDP.



Let us go to the next chart. Just visually, here is what is happening to the debt of the country under the policies of our colleagues on the other side under this Administration: The debt at the end of the President's first year—we don't hold him responsible for the first year—was 5.8 trillion dollars; at the end of this year, eight and a half trillion dollars, and if we follow the President's plan, 11.6 trillion dollars 5 years from now. That is about a doubling of the debt of the country and at the worst possible time, right before the baby-boomers retire.



Let us go to the next slide if we could. I asked my staff to go out and look and find out how much borrowing this country is doing in comparison to other countries, and here is what we found: In the last year, according to the International Monetary Fund, we borrowed 65 percent of all the money that was borrowed by countries in world, 65 percent. That is utterly unsustainable. That is what the Controller General of the United States is telling us, this is an unsustainable path, and indeed it is. The next biggest country, by the way, in terms of borrowing was Spain at 6.8 percent, one-tenth of the borrowing that we are doing.



Now let us go to the next one. The "Wall Street Journal" of yesterday had this warning from the Economic Forum: "The Economic Forum warns that the U.S. has budget deficits that will bring ill effects." And it reads: "The U.S.'s huge budget deficit threatens to make the country's economy less competitive according to the study by the World Economic Forum. The institute's annual study of global competitiveness says the U.S. economy is the sixth most competitive in the world, slipping from first place last year." So we slipped five places in a year. "Slipping from first place to last in last year's ranking, a result of mediocre scores from its public financing."

They went on to say: "Serial budget deficits in the U.S. have lead to rising public debt, which means an increasing portion of government spending goes toward debt service. That means less money available for spending on infrastructure, schools, or other investments that could boost productivity. Heavy government borrowing, which means competing for money in financial markets with the private sector, also tends to drive up businesses' borrowing costs."

THE WALL STREET JOURNAL.

WEDNESDAY, SEPTEMBER 27, 2006

Economic Forum Warns U.S. Of Budget Deficit's Ill Effects

By MARCUS WALKER

The U.S.'s huge budget deficit threatens to make the country's economy less competitive, according to a study by the World Economic Forum, an institute in Switzerland.

The institute's annual study of global competitiveness says the U.S. economy is the sixth most-competitive in the world, slipping from first place in last year's ranking, a result of mediocre scores for its public finances.

Switzerland ranks No. 1 in this year's survey, thanks to what the forum sees as a combination of efficient public administration and flexible markets. Three Nordic countries—Finland, Sweden and Denmark—come next, followed by Singapore and the U.S.

The competitiveness study ranks countries according to a range of criteria—including macroeconomic policies, market regulations, technological development, education systems and public institutions—that the forum believes influence an economy's level of productivity, and thereby its ability to sustain economic growth over many years. The ranking combines economic indicators with the findings from a survey of business executives.

"The U.S. remains a very competitive economy," said Augusto Lopez-Claros, the forum's chief economist. "It leads in innovation and patent registrations, has some of the best universities in the world, and it has extremely high levels of collaboration between universities and industry," he said. "However, how you manage your public finances is very important."

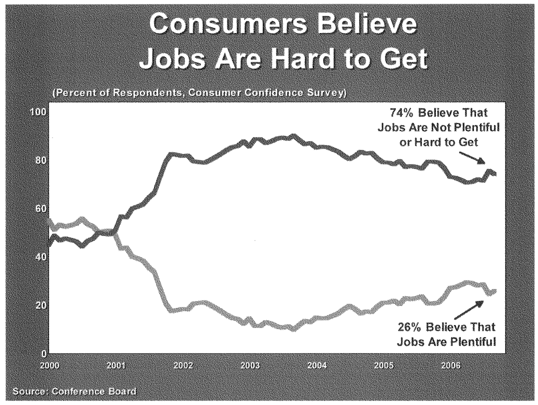
Serial budget deficits in the U.S. have led to rising public debt, which means an increasing portion of government spending goes toward debt service. That means less money is available for spending on infrastructure, schools or other investments that could boost productivity. Heavy government borrowing, which means competing for money in financial markets with the private sector, also tends to drive up businesses' borrowing costs.

Middling scores were awarded to the fast-growing emerging economies of the world considered to be changing the economic balance of power: India ranks 43rd out of 125 countries in the survey, China ranks 54th, Russia 62nd and Brazil 66th.

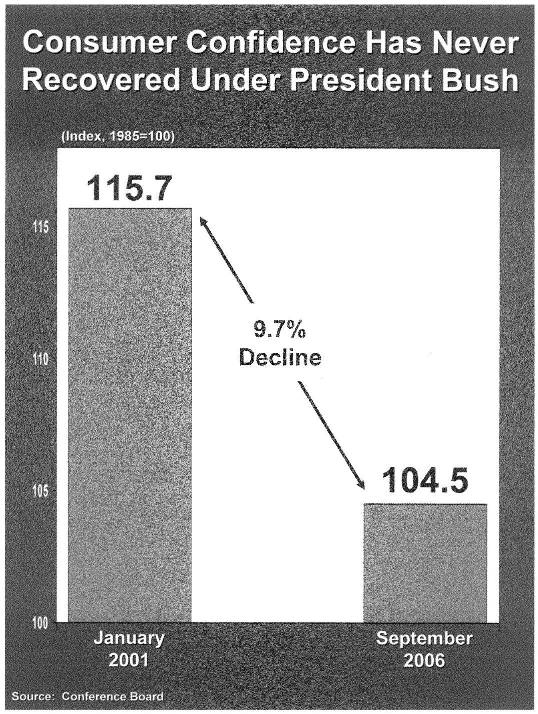
Russia and China, despite good scores for macroeconomic management, are marked down for a lack of transparency and even-handedness in their public institutions, including their bureaucracy and judiciary, and for protections for property rights. Brazil is making progress on improving its public finances, but at too slow a pace, according to Mr. Lopez-Claros. Of the four countries, only India improved its ranking in the survey this year.

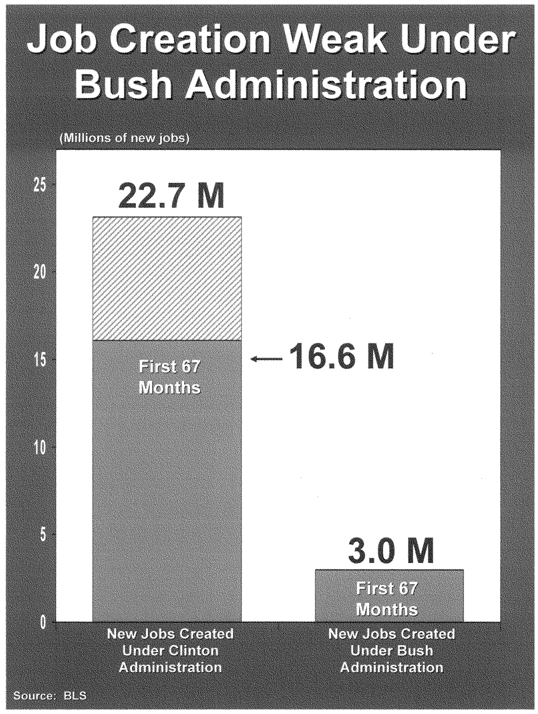
Although many economists and investors believe economic output in these four countries will overtake that of most of the world's established economic powers by midcentury, the World Economic Forum warns that the emerging economies' growth could hit barriers unless they develop more-efficient public institutions.

Let us go to the question of jobs, the jobs chart if we could. There is a lot of talk about jobs and how the economy is improving. The fact is 74 percent of people in this country believe that jobs are not plentiful or are hard to get. Only 26 believe that jobs are plentiful. That is according to the Conference Board.

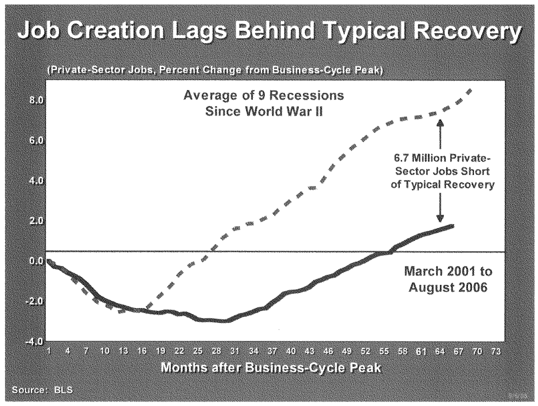


Let us go to the next. Consumer confidence has never recovered under President Bush. In January 2001 when he took over, consumer confidence was 115.7, again according to the Conference Board. Now in September of this year, it is 104.5. That is almost a 10 percent decline. If we compare job creation under this Administration to the previous Administration for the first 67 months, we see under the Clinton Administration, 16.6 million jobs were created. Under this Administration for that same period, 67 months, three million jobs have been created, about one-fifth of the jobs created, actually less than one-fifth of the jobs created under the Clinton Administration in its first 67 months.

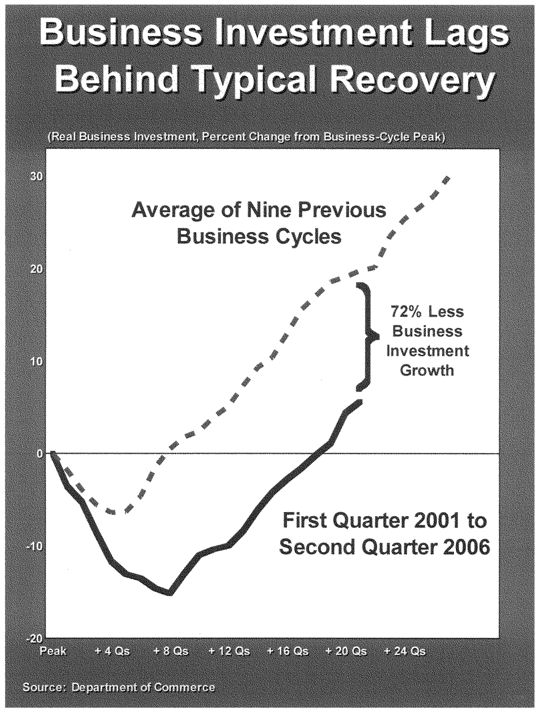

Consumer Confidence Has Never Recovered Under President Bush
(Index, 1985=100)
115.7
115
110
105
100
9.7% Decline
104.5
January 2001
September 2006
Source: Conference Board



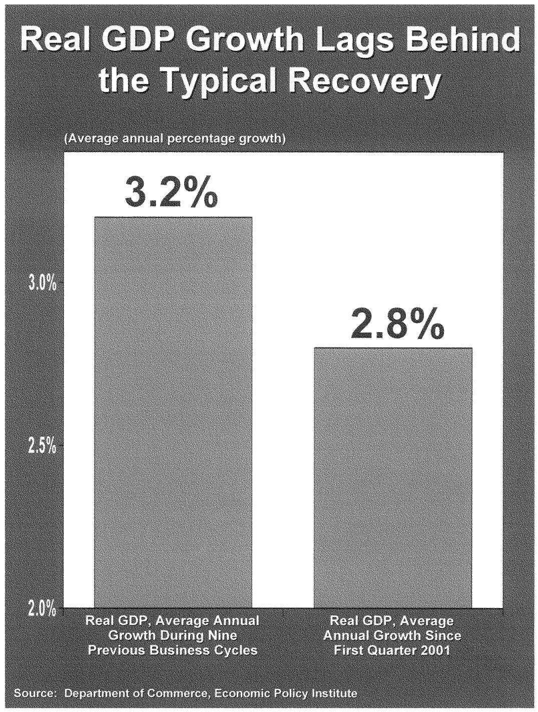
What is most interesting, of course there have been jobs created now that we are in an economic recovery. That always happens. What is the real test is how does this recovery compare to previous recoveries, and by that standard, what we see is job creation is lagging far behind the average of all of the major recoveries since World War II. We have had nine major recoveries since World War II. The pattern of average job creation is the red line. The black line is job creation in this recovery, and this recovery is running 6.7 million private sector jobs short of a typical recovery. Something is wrong.



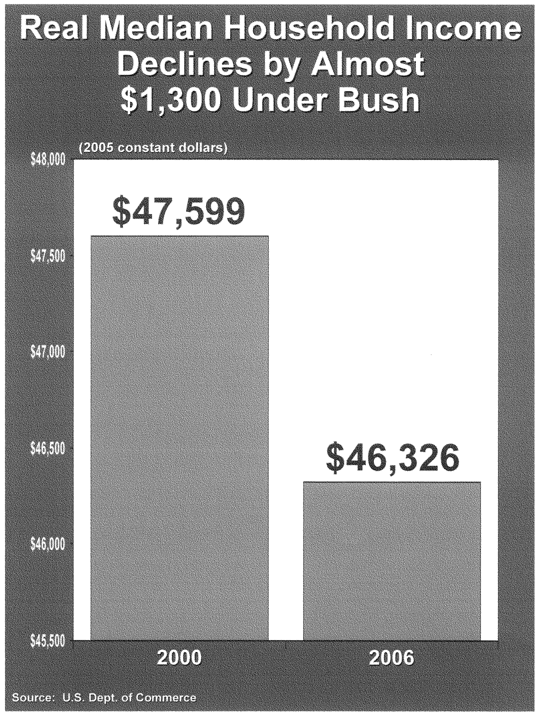
Let us go to the next. Business investment, again looking at the typical recovery, the average of the nine previous recoveries since World War II is the dotted red line. This recovery is the black line. On business investment, we are running 72 percent behind the typical recovery since World War II. Something is wrong.



Real GDP growth lags behind the typical recovery as well. The average in the nine recoveries since World War II, GDP growth of 3.2 percent; this recovery, 2.8 percent.



Let us go to median household income. Median household income in 2000 was $47,599; this year, $46,326. So real median household income has declined by almost $1300.



Look, this recovery—the facts I think are very clear—is not performing as previous recoveries have, No. 1. No. 2, we are running up debt at an alarming rate. It took 42 Presidents 224 years to run up a trillion dollars of debt held by foreigners, U.S. debt held by foreigners. This President has more than doubled that amount in just 5 years. This is an utterly unsustainable course, and the question is what are we going to do about it.

I would suggest to my colleagues neither party can do this job alone. What we really require is a bipartisan comprehensive plan to get this country back on track, and I know my colleague, the chairman, is interested in that approach. I certainly am, and I hope we can get to it.

I thank the chairman.

[The prepared statement of Senator Conrad follows.]

Transcript of Remarks by Senator Kent Conrad (D-ND)
at Senate Budget Committee Hearing on the State of the Economy and Budget
September 28, 2006

Opening Statement

Well, I have enjoyed this presentation very much. They are facts, but I would say highly selective and they leave out a lot of things. And now for the rest of the story.

First of all, I always enjoy these hearings and I appreciate the Chairman calling this one because this really is an important discussion for us to have.

Let's go back in history and recall what occurred. It was not, in 2001, a case of you were for tax cuts and we were against tax cuts. In fact, my proposal that I put before my colleagues was for $900 billion of tax cuts. The President proposed about twice as much. So the question was, first of all, the size of the tax cuts and what kind of tax cuts should there be. The tax cuts the President advocated were much larger in amount and the President's tax cuts were much more heavily skewed to the wealthiest among us. The tax cuts that we proposed, on our side, were more affordable and certainly, in light of history, that's clearly the case. And they were also geared to the middle class. And I would argue that's where you get the biggest bang for the buck.

Second question is the revenue chart that the Chairman put up talking about revenues, or I don't know if you put up a chart or just talked about revenues going up, but the rest of the story is, here is what's happened to real revenues, inflation adjusted, since 2000. The fact is we're just now getting back to the real revenues that we had in 2000. There hasn't been some giant run-up in revenue, please. The last few years, revenue has gone up but from a very low base. Much lower than the revenue that we had in 2000. So this talk about the dramatic rise in revenues, please, the fact is we are just now getting back to the real revenues that we had seven years ago.

Let's go to the question of deficits. The Chairman talked about big improvements in deficits. Well, yeah, big improvement from the worst deficits we've ever had. You know, two years ago, the deficits were higher than they are now, they were higher than they've ever been. But compared to six years ago, when we had surpluses, these deficits are terrible. And the deficits understate the seriousness of the situation. Just to rivet the point, I mean, the first year of this Administration, where they inherited the fiscal policies of the previous Administration, we had a surplus. Now, with the fiscal policies of this Administration, we have run-up four of the largest deficits in the country's history.

And the deficit substantially understates the red ink. Because, while the deficit is projected to go up by $260 billion this year, the debt is going to increase by $560 billion. When you measure that against GDP, you find that we are over 4 percent of GDP - debt increasing by over 4 percent of GDP.

Let's go to the next chart, just visually here's what's happening to the debt of the country under the policies of our colleagues on the other side and under this Administration. The debt at the end of the President's first year, we don't hold him responsible for the first year, was $5.8 trillion, the end of this year $8.5 trillion, and if we follow the President's plan $11.6 trillion five years from now. That is about a doubling of the debt of the country - and at the worst possible time, right before the baby boomers retire.

Let's go to the next slide, if we could, I asked my staff to go out and look and find out how much borrowing this country is doing in comparison to other countries and here's what we found. In the last year, according to the International Monetary Fund, we borrowed 65 percent of all the money that was borrowed by countries in the world - 65 percent. That is utterly unsustainable. That's what the Comptroller General of the United States is telling us - this is an unsustainable path - and, indeed, it is. The next biggest country, by the way, in terms of borrowing is Spain at 6.8 percent - one tenth of the borrowing that we're doing.

Now, let's go to the next chart, the *Wall Street Journal*, of yesterday, had this warning from the [World] Economic Forum. The economic forum warns that the U.S. has budget deficits that will bring ill effects and it reads: "the U.S.'s huge budget deficit threatens to make the country's economy less competitive, according to the study by the World Economic Forum. The institute's annual study of global competitiveness says the U.S. economy is the sixth most competitive in the world, slipping from first place last year." So, we slipped five places in a year. "...slipping from first place in last year's ranking, a result of mediocre scores for its public financing." They went on to say: "... serial budget deficits in the U.S. have led to rising public debt, which means an increasing portion of government spending goes toward debt service that means less money available for spending on infrastructure, schools, or other investments that could boost productivity. Heavy government borrowing, which means competing for money in financial markets with the private sector also tends to drive up business' borrowing costs."

Let's go to the question of jobs, the jobs chart, if we could. There's a lot of talk about jobs and how the economy is improving. The fact is, 74 percent of people in this country believe that jobs are not plentiful or are hard to get. Only 26 percent believe that jobs are plentiful. That's according to the Conference Board.

Consumer confidence has never recovered under President Bush. In January of 2001, when he took over, consumer confidence was 115.7, again according to the Conference Board. Now in September of this year, it's 104.5 - that is almost a 10 percent decline.

And if we compare job creation under this Administration to the previous Administration, for the first 67 months we see under the Clinton Administration 16.6 million jobs were created. Under this Administration, for that same period, 67 months, 3 million jobs have been created - about one-fifth of the jobs created, actually less than one-fifth of the jobs created under the Clinton Administration in its first 67 months.

What's most interesting, of course there have been jobs created now that we are in an economic recovery - that always happens. What is the real test is how does this recovery compare to previous recoveries. And by that standard what we see is job creation is lagging far behind the average of all of the major recoveries since World War II. We have had nine major recoveries since World War II and the pattern of job creation is the red line, the black line is job creation in this recovery and this recovery is running 6.7 million private sector jobs short of the typical recovery. Something is wrong.

Business investment, again, looking at the typical recovery, the average of the nine previous recoveries since World War II is the dotted red line. This recovery is the black line. On business investment we are running 72 percent behind the typical recovery since World War II. Something is wrong.

Real GDP growth lags behind the typical recovery as well. The average in the nine recoveries since World War II, GDP growth of 3.2 percent - this recovery, 2.8 percent.

Let's go to median household income. Median household income in 2000 was $47,599. This year, $46,326. So real median household income has declined by almost $1,300.

Look, this recovery, the facts, I think, are really clear, is not performing as previous recoveries have - number one. Number two, we are running up debt at an alarming rate. It took 42 presidents 224 years to run up a trillion dollars of debt held by foreigners. U.S. debt held by foreigners. This president has more than doubled that amount in just five years. This is an utterly unsustainable course and the question is, what are we going to do about it?

I'd suggest to my colleagues, neither party can do this job alone. What we really require is a bipartisan, comprehensive plan to get this country back on track. And I know that my colleague, the Chairman, is interested in that approach. I certainly am and I hope that we can get to it.

I thank the Chairman.

We will go to Dr. Lazear.

STATEMENT OF EDWARD P. LAZEAR, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. LAZEAR. Thank you very much, Chairman Gregg, Ranking Member Conrad, and Members of the Senate Budget Committee. Good morning and thank you for giving me the opportunity to speak with you about the economy and its relation to tax revenues and the budget.

I would like to begin by summarizing the economy, where we are right now and where I believe that we are headed. The economy is strong, in part as a reflection of pro-growth tax policies. Revenues are up and the deficit is shrinking at a rapid rate.

Some specifics: Real growth of GDP was 3.1 percent over the three quarters of 2005. Although it now appears that GDP growth in the current quarter will be significantly slower than in the first half of the year, the current forecast indicates that growth in 2006 will remain about the same as it was last year and the economy should continue to grow at a robust pace in 2007 and beyond.

Job growth has been strong. The economy has been producing roughly one and a half to two million jobs per year for a total of 5.7 million additional payroll jobs since August of 2003. We expect that trend to continue with some slight moderation.

The unemployment rate, which was 5.1 percent in 2005, is expected to average 4.7 percent for 2006. The most recently released jobs report shows that the unemployment rate declined to 4.7. Additionally, it revealed an increase of 128,000 payroll jobs in August. The continued increase in payroll jobs, even in an environment with low unemployment rates, suggest that the labor market continues to be strong and that its tightness will be reflected in more wage growth as we move into the coming months.

Nominal wage growth has accelerated over the past year, and at an annualized rate, it has been 4.1 percent since January of 2006. As I will discuss shortly, this follows the typical business cycle pattern of productivity increasing, leading to wage increases with a lag. What distinguishes this period from the past is that recent large and unanticipated increases in energy prices have consumed much of the strong nominal wage growth. Workers' paychecks have gone up, but they have had to use a portion of that increase for higher energy costs, such as gasoline and heating fuel.

The increase in the price of gasoline and oil products has been one of the most notable changes in our economy during the past year. Since the beginning of August, we have experienced substantial declines in the price of gasoline and crude oil. Declines in energy prices are already apparent in the latest inflation data. Markets are expecting inflation rates going forward to moderate to around 2.5 percent. This coupled with continuation of high wage growth should translate into increased real earnings for the typical worker next year.

The President's goal of cutting the deficit in half by 2009, which drew the scoffs of many, is now likely to be reached before that date.

One soft spot in the economy is the housing market. It is important to note, however, that the weakness in the housing sector does not seem to be spreading to other sectors of the economy, and recent consumer surveys indicate improving expectations.

In sum, we expect the average growth rate for this year will be similar to that for last year. The economy continues to be robust and healthy.

Underlying these strong numbers is high productivity growth that has made our economy the strongest and most robust in the world. It is the common thread that ties together all of the positive economic news. Productivity growth is closely associated with economic growth and results in higher worker compensation and improved living standards. It moderates inflationary pressure and has proved to be a defining characteristic of our economy.

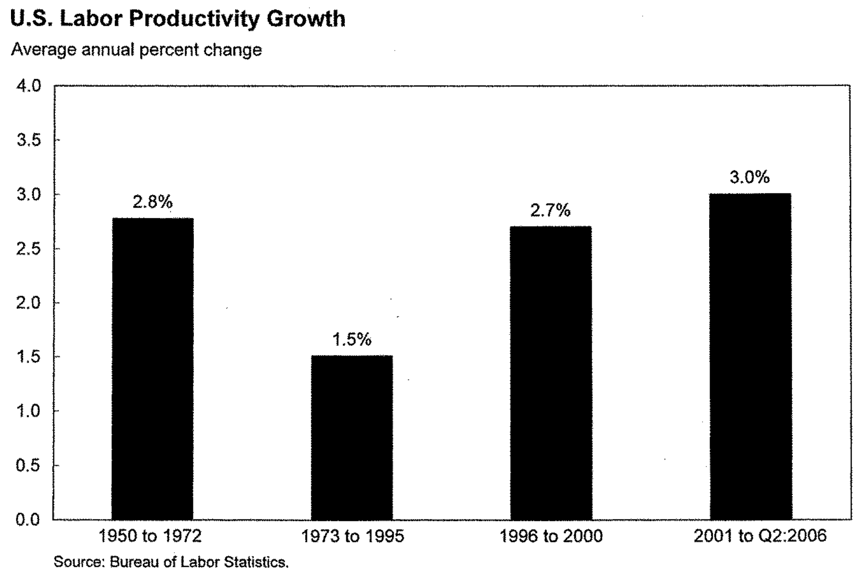


Figure 1

Figure 1 puts out recent productivity growth in a historical perspective. The BLS reports that U.S. productivity growth since the end of 2000 has been 3 percent per year, outpacing the 2.7 percent average from 1996 to 2000. The current growth rate in productivity is substantially above that for the 22-year period that preceded 1995 when productivity growth averaged only 1.5 percent per year.

Productivity growth is important because it is the basis for the growth in hourly worker compensation. Figure 2 shows the relationship. The chart demonstrates the very strong correlation between productivity increases and improvements in real hourly compensation. The red line and blue line move together over any reasonable period of time.

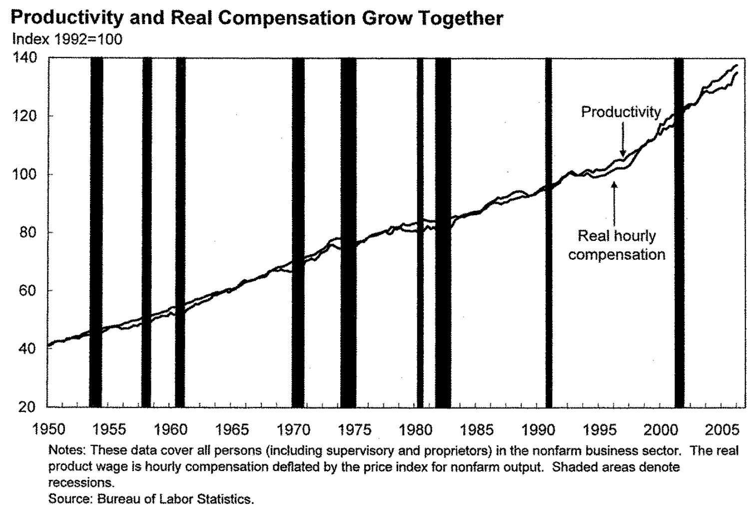


Figure 2

A number of observers have pointed out that profits have grown at a very high rate during this recovery, which is reflected in Figure 3. The red line is showing that profits grew at a high rate over the past 3 years. There is a distinct pattern of profits and employee compensation over the business cycle. After the recession in the early nineties, corporate profits rose dramatically and employee compensation lagged behind. At the same time, productivity grew faster than compensation.

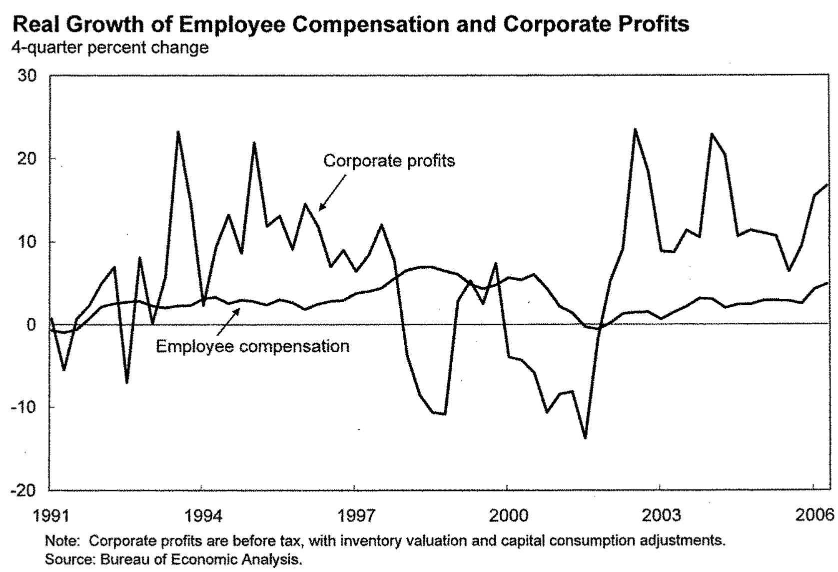


Figure 3

Profit growth outpaced compensation growth until the latter part of the nineties when corporate profits fell dramatically. Note that corporate profits actually declined during most of the period between early 1998 and late 2001.

Just as in the 1990's, the mild recession in 2001 was followed by productivity growth in 2002, and profit growth was again very high while employee compensation growth was relatively low. The pattern that we observed in the past two recessions and recoveries is evident in earlier recessions as well going back at least 40 years. The pattern typically works in the following way: After a recession, productivity growth increases and hourly compensation tends to remain flat. As a result, costs stay low and profits rise. As the labor market gets tight, unemployment rates fall, hourly compensation increases faster than productivity growth, and so total costs rise faster than earnings. The result is that labor costs go up faster than the profit rate, and then the profit rate declines to more normal levels.

Profits are important because they provide the incentive for investment in physical capital, and physical capital growth contributes to productivity growth. With rising compensation, we forecast that profit rates will decline in the future, but that this decline will bring them back to normal levels, and so profit rates will be sufficient to motivate the high levels of investment necessary to grow our economy.

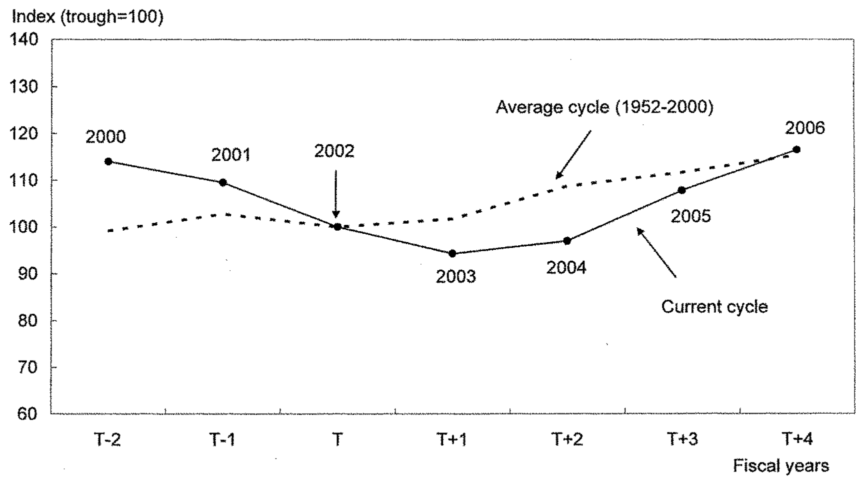
Whether real growth compensation growth will rise to the highest levels that we have seen over the previous expansions remains to be seen, but early indications are that we are a similar path.

Tax cuts passed by President Bush and the Congress have helped the economy grow. Probably most significant was the cut in dividend and capital gains taxes enacted in 2003. However, the lowering of marginal tax rates on earned or labor income was also an important contributor to economic growth.

As budget directors and members of any budget committee surely know, government revenues tend to move directly with the state of the economy. When the economy is good, revenues come in at high rates, and when the economy declines, revenues decline correspondingly. The period since 2003, which has seen a growing economy, has also been one which during which government revenue have increased at high rates. Since 2003, government revenues are up 34.6 percent and the projected growth of revenues from 2005 to 2006 is around 11 percent. Because of this rapid economic growth-together with the continued efforts of Congress and the President to effect discretionary spending restraint, the budget deficit is declining at rates much faster than was anticipated, and we are on the path to meeting the President's deficit goals ahead of schedule.

To determine the effect of tax cuts on revenue, we need to ask what revenues would have been absent these tax cuts. This question can be answered by providing estimates of what the revenue would have been had we not had cut taxes. An exercise of this sort can be done in a number of different ways, and we recognize the inherent uncertainty associated with the calculations.

Real Federal Revenues Around Business-Cycle Troughs



Note: Revenues are deflated by the GDP price index. 2006 revenues as estimated in the Mid-Session Review.
Source: CEA calculations based on OMB and Treasury data.

Figure 4

In Figure 4, we provide a simple comparison using historical data showing the path of revenue growth in this business cycle compared to previous cycles. The solid red line shows what happens during the current cycle's recovery, similarly indexed, by way, with a trough in 2002, compared with previous patterns. With the tax cuts that were enacted in 2003, receipts were below the average of previous recoveries. These lower revenues persisted through 2005. But more important than the level is the growth rate.

Because of the growing economy, which we believe was stimulated at least in part by the tax cuts and growing taxable income, preliminary data suggests that revenues grew between 2004 and 2006 at rates higher than were experienced in earlier recoveries. More refined estimates will be possible when the tax return information for 2006 is available.

Will the tax cuts pay for themselves? As a general rule, we do not think that tax cuts pay for themselves. Certainly, the data presented above do not support this claim. Tax revenues in 2006 appear to have recovered to the level seen at this point in previous business cycles, but this does not make up for the lost revenue during 2003, 2004, and 2005. The tax cuts were a positive step and they have contributed to the enhanced economic growth, additional jobs, higher real disposable income, and low unemployment rates that we currently see today.

Our goal is not to maximize the size of government by generating as much tax revenue as possible, but instead to provide the revenues necessary to make sure that we can operate those programs that society deems necessary while at the same time allowing the private sector to take full advantage of its growth potential.

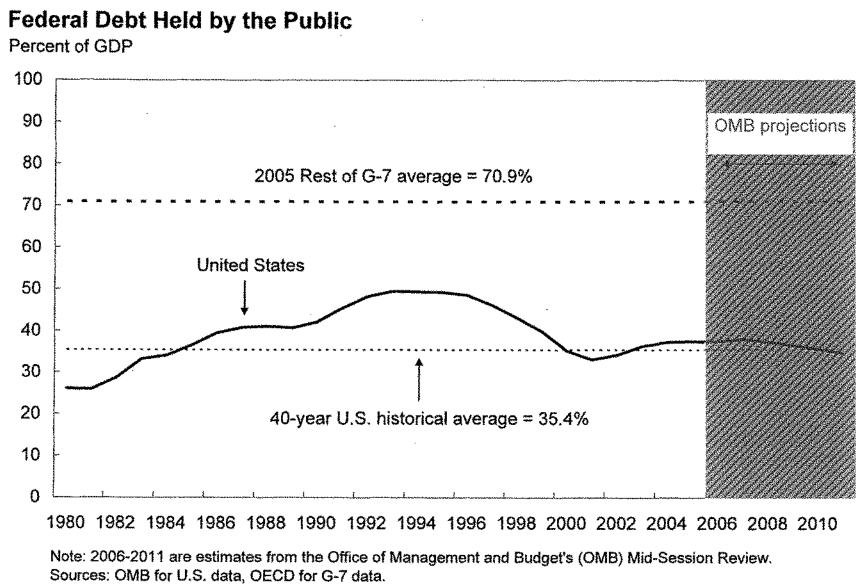


Figure 5

It is also worth noting that because our revenues are growing at such high rates now relative to spending, the ratio of public debt to GDP, which most economists view as the best indication of our long-run budget situation, is expected to decline this year. Not only is our debt-to-GDP ratio improving as a result of our high economic growth and enhanced revenues, but it is also very close to our 40-year historical average and lower than at any point in the 1990's.

As a result, our debt situation is favorable relative both to its past and to the debt situation of other industrialized countries. This should not be taken as a reason to be complacent. Indeed, the opposite is true. If we cannot control our spending both on the discretionary and entitlement sides of the budget, the pattern we are seeing in the current year could easily reverse and we could find ourselves in a debt situation that requires higher and higher interest rate payments relative to our GDP in the future. This is not a burden that we want to pass on to our children and grandchildren.

Where do we go from here? I believe it is important to maintain a positive economic climate so that the labor market will remain strong, workers can find jobs quickly, and so that, coupled with declining energy prices, the typical worker's paycheck will buy more and more goods and services. The best way to do this is to keep our taxes low, to adopt more pro-growth tax policies, and to remain open to international trade and capital flows as well as keeping our economy among the most flexible in the world.

Thank you for giving me the opportunity to speak to you today, and I welcome your questions.

[The prepared statement of Mr. Lazear follows:]

Embargoed for Release, 10:00am, September 28, 2006

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, DC 20502

Testimony of Edward P. Lazear
Chairman, Council of Economic Advisers

Before the
Senate Budget Committee
"State of the Economy and the Budget"
September 28, 2006

Chairman Gregg, Ranking Member Conrad and Members of the Senate Budget Committee, good morning, and thank you for giving me the opportunity to speak to you about the economy and its relation to tax revenues and the budget.

Our goal is to create a positive economic climate so that good jobs are plentiful and workers' paychecks grow. I believe the best way to maximize economic growth is to keep the tax burden on families and entrepreneurs low, expand markets for American goods and services, and pursue other pro-growth policies that unleash innovation and creativity. Economic growth has benefits for the federal budget, too. The substantial revenue growth from our strong economy has helped shrink the deficit for two years in a row.

I'd like to begin by summarizing the economy—where we are right now, and where I believe we are headed. Real growth of Gross Domestic Product (GDP) was 3.1 percent over the four quarters of 2005. Although it now appears that GDP growth in the current quarter will be significantly slower than in the first half of the year, the current forecast indicates that growth in 2006 will remain about the same as growth last year, and the economy should continue to grow at a robust pace in 2007 and beyond.

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Job growth has been strong. The economy has been producing roughly 1-1/2 to 2 million jobs per year for a total of 5.7 million additional payroll jobs since August 2003. We expect that trend to continue with some slight moderation. The unemployment rate, which was 5.1 percent in 2005, is expected to average 4.7 percent for 2006. The most recently released jobs report showed the unemployment rate declining to 4.7 percent—the forecast for this year—and additionally it revealed an increase of 128,000 payroll jobs during the month of August. This continued increase in payroll jobs even in an environment with low unemployment rates suggests that the labor market continues to be strong and that its tightness will be reflected in more wage growth as we move into the coming months.

Nominal wage growth has accelerated over the past year, and at an annualized rate has been 4.1 percent since January 2006. As I will discuss shortly, this follows the typical business cycle pattern of productivity increasing, leading to wage increases though with a lag.

What distinguishes this period from the past is that recent large and unanticipated increases in energy prices have consumed much of the strong nominal wage growth. Workers' paychecks have gone up, but they have had to use a portion of that increase for higher costs of energy such as gasoline and heating fuel. The increase in the price of gasoline and oil products has been one of the most notable changes in our economy during the past year. The period from August of 2005 until August of 2006 witnessed a 22 percent increase in the price of crude oil, and a 32 percent rise in the price of gasoline. High energy prices strain family and business budgets, but throughout this period the economy exhibited resiliency and continued to grow at a rapid pace. Indeed, real growth for the first half of this year averaged about 4 percent on an annualized basis.

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Since the beginning of August, we have experienced substantial declines in the price of gasoline and crude oil. Gasoline prices have dropped 21 percent since early August, and the price of crude oil has gone from a high of $77 per barrel down to $61 now. This is positive news for two reasons. First, it suggests that inflation rates will moderate as we move forward, and so high nominal wage growth such as we have seen in the recent past will translate into real additional buying power for the typical American worker. Second, lower energy prices are a positive force in growing the economy.

The decline in energy prices is already apparent in the very latest inflation data. Markets are expecting inflation rates going forward to moderate to around 2.5 percent. Nominal wage growth of 4.1 percent such as what we saw over the first half of this year, would then translate into increased real earnings for the typical worker.

All of this has implications for the budget. In its Mid-Session Review released last July, the Office of Management and Budget confirmed that strong economic growth is helping to increase Federal revenues and is reducing the budget deficit more quickly than expected. The President's goal of cutting the deficit in half by 2009, which drew the scoffs of many, is now likely to be reached before that date.

A soft spot in the economy is the housing market. We are now experiencing an anticipated slowdown in residential construction and in the pace of housing price increases, and it appears that the housing slowdown will be a significant drag on third quarter growth. It is important to note, however, that the weakness in the housing sector does not seem to be spreading to other sectors of the economy, that other areas of the economy that have not shown much vibrancy, such as non-residential construction are now picking up, and that recent consumer surveys indicate improving expectations.

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In sum, we expect the average growth rate for this year to be similar to that for last year. Our economy continues to be robust and healthy.

Productivity

Underlying these strong numbers is high productivity growth that has made our economy the strongest and most robust in the world. It is the common thread that ties all of the positive economic news together.

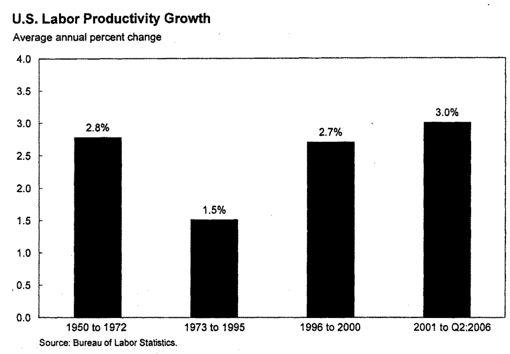

Figure 1

Figure 1 puts our recent productivity growth in historical perspective. The Bureau of Labor Statistics reports that U.S. productivity growth since the end of 2000 has been 3 percent per year, outpacing the 2.7 percent average from 1996 to 2000. The current growth rate in productivity is substantially above that for the 22-year period that preceded 1995, when productivity growth averaged only 1.5 percent per year.

American productivity growth results from many factors, but the most likely candidates that account for the difference between our high productivity growth and the slower productivity growth of many other industrialized nations include labor market flexibility, high levels of investment in both physical and human capital, low taxes, and a culture of entrepreneurship -- coupled with high levels of business formation.

Productivity and Real Compensation Grow Together

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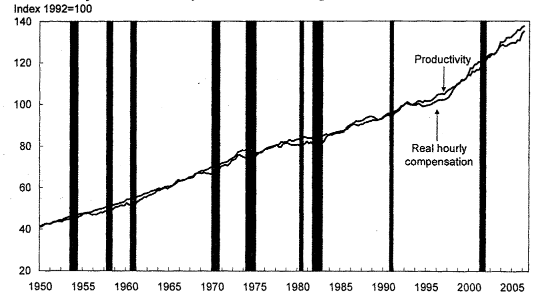

Notes: These data cover all persons (including supervisory and proprietors) in the nonfarm business sector. The real product wage is hourly compensation deflated by the price index for nonfarm output. Shaded areas denote recessions.

Source: Bureau of Labor Statistics.

Figure 2

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Productivity growth is important because it leads to higher living standards and is a key measure of our international competitiveness. Employee compensation tracks the closest with productivity. Compensation is the combination of both benefits and wages.

Figure 2 shows the very strong correlation between productivity increases and improvements in real hourly compensation. The red line and blue line move together over any reasonable period of time. Although there are periods during which the two series diverge, they tend to catch up to one another. In particular, hourly compensation growth sometimes lags productivity growth—especially as the economy comes out of a recession and moves into a recovery. That was the case in the early 1990s. If you examine the chart, you will see that the red line, indicating hourly compensation, falls below the blue line, indicating productivity, for the period during the mid-90s. During the late part of the 90s, the red line rises at a more rapid rate than the blue line so that hourly compensation growth overtakes productivity growth.

The mild recession that occurred at the beginning of this decade was followed by strong productivity growth as shown earlier. But as in the mid-90s, hourly compensation growth has lagged behind. More recently, however, hourly compensation growth has started to pick up, and if these trends continue, the remainder of 2006 will enjoy real hourly compensation gains and will put us on a path toward catching up with earlier productivity increases.

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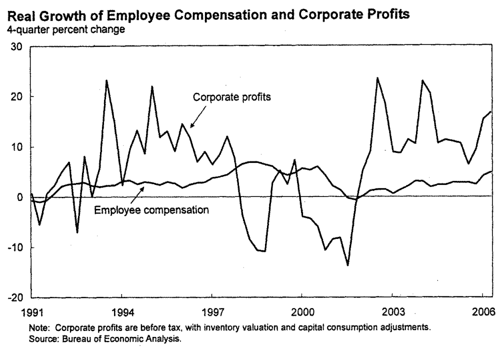

Figure 3

Productivity, Profits, and Compensation

A number of observers have pointed out that profits have grown at a very high rate during this recovery, which is reflected in Figure 3. The red line, showing profits, grew at a high rate over the past three years.

Two additional points are apparent from looking at Figure 3. First, corporate profits are more volatile than employee compensation. The red line jumps around to a much greater degree than does the blue line, and the extremes are significantly more pronounced. Indeed, the four-quarter growth rate in profits was over 20 percent in the third quarter of 1993, the first quarter of 1995, the fourth quarter of 2002, and the second quarter of 2004.

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Second, there is a distinct pattern of profits and labor compensation over the business cycle. After the recession in the early 1990s, corporate profits rose dramatically and employee compensation lagged behind. At the same time, productivity grew faster than compensation, as we saw earlier in Figure 2. Profit growth outpaced compensation growth until the latter part of the 1990s when corporate profits fell dramatically. Note corporate profits declined throughout most of the period between early 1998 and late 2001.

Just as in the 1990s, the mild recession in 2001 was followed by productivity growth in 2002 and profit growth was again very high, while employee compensation growth was relatively low. The pattern that we observed in the past two recessions and recoveries is evident in earlier recessions as well, going back at least 40 years.

The pattern typically works in the following way. After a recession, productivity growth increases and hourly compensation tends to remain flat. As a result, costs stay low and profits rise. As the labor market gets tight, unemployment rates fall, hourly compensation increases faster than productivity growth and so total costs rise faster than earnings. The result is that as labor costs go up faster the profit rate then declines to more normal levels.

Profits are important because they provide the incentive for investment in physical capital, and physical capital growth contributes to productivity growth. With rising compensation, we forecast that profits rates will decline in the future, but that this decline will bring them back to normal levels and so profit rates will be sufficient to motivate the high levels of investment necessary to grow our economy. Whether real compensation growth will rise to the rates that we have seen over the previous expansions remains to be seen. But early indications are that we are on a similar path.

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Tax Cuts, Economic Growth, and the Budget

The tax cuts passed the Congress and signed into law by President Bush have helped the economy grow. Probably most significant was the cut in dividends and capital gains taxes enacted in 2003. However, the lowering of marginal tax rates on labor income was also an important contribution to economic growth.

Lower tax rates enable workers to keep more of their earnings, stimulating work effort and labor force participation. Lower tax rates also encourage greater innovation, entrepreneurial activity, and small business formation. Lowering the tax rate on capital income has encouraged greater investment, which is seen as the main driver of economic growth. For example, there is preliminary evidence that the 2003 reduction in capital income taxes stimulated investment. In the nine quarters prior to the mid-2003 tax cuts, private non-residential investment fell at an average rate of 6.7 percent. In the 12 quarters since the cut, private non-residential investment has grown at an average rate of 6.1 percent.

Government revenues tend to move directly with the state of the economy. When the economy is strong, revenues tend to come in at high rates, and when the economy declines, revenues tend to decline correspondingly. The period since 2003, which has seen a growing economy, has also been one during which government revenues have increased at high rates. Since 2003, government revenues are up 34.6 percent, and the projected growth of revenues from 2005 to 2006 is around 11 percent.

Because of this rapid economic growth – together with the continued efforts of Congress and the President to effect discretionary spending restraint – the budget deficit is declining at rates much faster than was anticipated, and we are on the path to meeting the President's deficit goal ahead of schedule.

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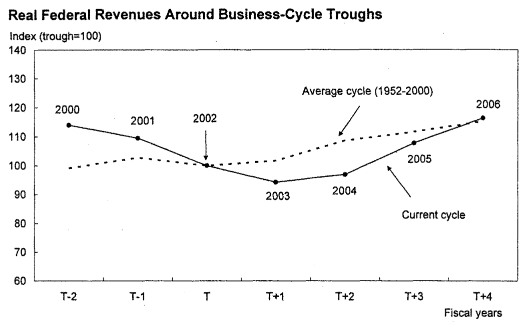


Note: Revenues are deflated by the GDP price index. 2006 revenues as estimated in the Mid-Session Review.
Source: CEA calculations based on OMB and Treasury data.

Figure 4

To determine the effect of tax cuts on revenue, we need to ask, "What would revenues have been absent these cuts?" This question can be answered by providing estimates of what revenue would have been had we not cut taxes. An exercise of this sort can be conducted in a number of different ways, and we recognize the inherent uncertainty associated with the calculations. In Figure 4, we provide a simple comparison using historical data, and show the path of revenue growth in this business cycle compared with previous cycles. We index real revenues for each of the eight previous business-cycle troughs (from 1952 through 2000) so that they equal 100 in the year of the trough. The dotted blue line in Figure 4 shows the average of these cycles. The horizontal axis denotes time, and the year labeled "T" is the trough of the recession. The figure shows that revenues tend to decline as the economy moves from the year before the trough into the trough, and then tend to increase the year after. The blue dotted line goes down from T minus one to T and then rises from T to T plus one.

The solid red line shows what happened during the current cycle's recovery (similarly indexed, with a trough in fiscal year 2002) compared with previous recoveries. With the tax cuts that were enacted in 2003, receipts were below the average of previous recoveries. These lower revenues persisted through 2005. But more important than the levels is the growth rate. Because of the growing economy (which we believe was stimulated at least in part by the tax cuts) and growing taxable income, preliminary data suggests that revenues grew between 2004 and 2006 at rates higher than were experienced in earlier recoveries. More refined estimates will be possible when tax return information for 2006 becomes available.

Will the tax cuts pay for themselves? As a general rule, we do not think tax cuts pay for themselves. Certainly, the data presented above do not support this claim. Tax revenues in 2006 appear to have recovered to the level seen at this point in previous business cycles, but this does not make up for the lost revenue during 2003, 2004, and 2005. The tax cuts were a positive step and have contributed to the enhanced economic growth, additional jobs, higher real disposable income, and the low unemployment rates that we currently see today. Our goal is not to maximize the size of government, but to provide revenues to make sure that we can operate those programs that society deems necessary, while at the same time allowing the private sector to take full advantage of its growth potential.

pattern that we are seeing in the current year could easily reverse, and we could find ourselves in a debt situation that requires higher and higher interest payments relative to our GDP in the future. This is not a burden that we want to pass on to our children and grandchildren.

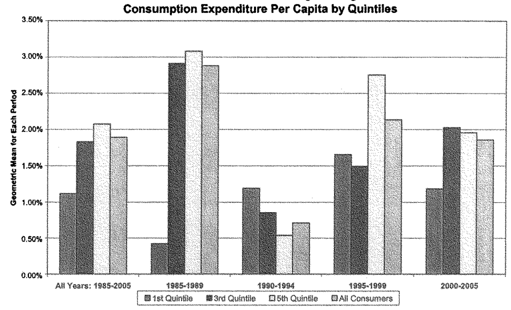
The Future

Where do we go from here? I believe it is important to maintain a positive economic climate so that the labor market will remain strong, workers can find jobs quickly, and so that, coupled with declining energy prices, the typical worker paycheck will buy more and more goods and services. The best way to do this is to continue our pro-growth tax agenda, to remain open to international trade and capital flows, and to keep our economy among the most flexible in the world.

Thank you for giving me the opportunity to speak to you today, and I welcome your questions.

Figure 4.

Five Year Geometric Mean of Annual Percentage Change in NIPA's Personal Consumption Expenditure Per Capita by Quintiles

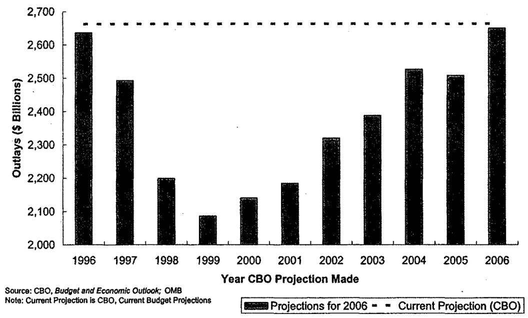


Source: Bureau of Labor Statistics, *Consumer Expenditure Survey (CEX)*, http://www bls gov/cex/#data; US Department of Commerce: Bureau of Economic Analysis. NIPA,. Series ID: PCECCA http://research.stlouisfed.org/fred2/categories/110

Notes: Consumption per capita by each quintile was calculated as follows: 1) calculate % share of CEX total expenditure for each quantile (where Total Expenditure = Number of "Total Complete Income Reporters" [or "All Consumer Units" for 2004] times the mean as reported in the CEX survey) and 2) Appy that percentage share to NIPA's Aggregate "Personal Consumption Expenditure" and divide by fifth of population.

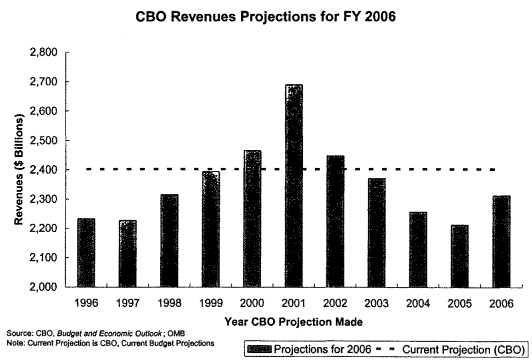
Figure 5.

CBO Outlay Projections for FY 2006



Source: CBO, *Budget and Economic Outlook;* OMB
Note: Current Projection is CBO, Current Budget Projections

Figure 6.



Senator GREGG. Thank you, Doctor.

I am going to reserve my time until the end of the questioning period, because we have a number of Senators here. I want them to get their points in.

So let us start with Senator Alexander for the first questions.

Senator ALEXANDER. Thank you, Mr. Chairman, for your courtesy.

Senator GREGG. Thank you for coming.

Senator ALEXANDER. In the President's State of the Union Address, he proposed the American competitive initiative, which included a proposal to double the Federal investment of basic research over 10 years and to improve the teaching in math and science structure so we can keep our edge in science and technology. A number of Senators, actually 70, 35 Democrats and 35 Republicans, have sponsored similar legislation this year. Last Tuesday, Senator Frist and Senator Reid, the Republican leader and the Democratic leader, introduced a comprehensive piece of legislation that took the President's proposal, all the various Senators' proposals, and worked it through three different committees.

It was a very remarkable piece, a pretty good start on competitiveness.

I note that in July, the President of China, Mr. Hu, went to the Great Hall of the People and assembled the whole Government of China, Communist Party leaders, his Academy of Sciences and Engineering, and committed that country to a 15-year plan to make it a nation of innovation, including investments in research, remodeling universities, improving "K" through 12, and recruiting outstanding scientists from the United States and back to China to help grow jobs.

So my questions are about this: We talk about pro-growth policies and we often talk, at least on our side of the aisle, about tax cuts. I agree those are pro-growth policies. Do you agree that investments in keeping our edge in science and technology are also pro-growth for our economy, and do you expect the President and the Administration to get behind the Frist-Reid legislation, which can't pass this week, but would have a very good opportunity, given its broad support, to pass the Senate in November and then a chance to pass the House in this Congress?

Mr. LAZEAR. Thank you. We certainly agree that investment in education, science, education specifically, but education in general, is a very high rate of return investment. When we look at the kinds of things that an economy can do to grow productivity, to grow GDP, to grow wages, investments in human capital come in at or near the top. If you look across the world and you ask which economies are growing, which ones are progressing at the highest rates, which ones are bringing their poor into the middle class, they are the economies that have the highest levels of education. They are the ones that are making the biggest investment in education.

So I fully subscribe to your view that education and investing in skills in general is probably one of, if not the most, important things that we can do to grow the economy. It certainly has been something that has been on the President's mind since he began his Administration. "No Child Left Behind", of course, was one of his initial endeavors, and I think it is a step in the right direction, obviously not the only step that one needs to take, but I am completely with you in terms of the importance of the investment.

Senator ALEXANDER. I bring it up this morning because this is one of those rare occasions where this is not a Republican bill that was offered to the Democrats which they then amended or vice versa. This was actually a piece of legislation that probably two dozen Senators of both parties worked on together with the Administration about which there is unanimous support and there is an opportunity for the Administration, if it makes it a priority in the next few weeks, to make it happen.

One other question: I was listening to the Senator from North Dakota's comments about the dire straits of the economy. I asked the International Monetary Fund to give me some information about the United States' position in the world in terms of Gross Domestic Product, and they gave this fact: They said in 1995, the United States produced about 25 percent of all the Gross Domestic Product in the world for about four or 5 percent of the people, which is our population. Last year, 2005, the United States produced 28 percent of all the world's Gross Domestic Product for about four or 5 percent of the people.

Now we hear all these claims that the economy is bad and jobs are going down and things are terrible, but if those figures are true, does that not mean that the United States is not only remarkably rich in terms of Gross Domestic Product, but over the last 10 years, we have gotten richer even at a time when China and India and other parts of the world are growing and Europe is trying to do better? How would you characterize that growth in our share of the Gross Domestic Product over the last 10 years?

Mr. LAZEAR. Yes, sir. I certainly agree that we have had very strong economic growth. If we compare the United States to the other G–7 countries, which is usually the comparison that we think is probably most appropriate, because then we are talking about countries at a similar standard of living, the United States is the leading country right now. I always view that as particularly remarkable, because it is easier to have high growth rates when you are catching up than it is to have high growth rates when you are the leader.

If there are other economies that you can mimic, if there are other economies to which you can converge, that is an easier task than pushing out the frontier. Our economy has been particularly successful at pushing out the frontier. I believe that that is attributable in large part to the flexibility of the economy, to the fact that we allow for very strong markets, for essentially unimpeded capital movements, labor markets are flexible, and very strong entrepreneurship, which I think is an absolute key to the growth that we see in the United States. We have rapid and relatively easy business formation in this country, and that is an important component of our economic growth.

So those are all very positive features.

Senator ALEXANDER. Thank you, Mr. Chairman.

Senator GREGG. Thank you.

Senator CONRAD.

Senator CONRAD. Mr. Chairman, I wanted to take a moment, if we could, because this is going to be Senator Sarbanes' last hearing in the Senate Budget Committee, and I think we need to take a moment and reflect on his contributions not only to this committee, but to the Senate.

Last night, we had a dinner which we recognized the four members who are retiring this year, Senator Sarbanes being one of the four. I want to say that I am going to miss Senator Sarbanes. There has been a no more valuable member on this committee to me than Senator Sarbanes. He is truly a remarkable man, not only highly intelligent, but wise and of an extraordinary good nature.

I note that his wife, Christine, is here. Christine, it is good to see you as well. The Sarbanes couple are truly a team, and I have had a chance to travel with them, to get to know their family. They are really an extraordinary couple and we deeply appreciate their contribution to this committee and to the U.S. Senate and to our country.

My favorite story about Senator Sarbanes was told last night, that he was selected when he was still in high school, about to graduate from high school, as an all-star and was to play in an all-star game in Baltimore, and he was to be the starting shortstop. He went to the game and they had preparations before the game, and the coach put him at second base. Paul went to the manager and inquired, you know, I had been selected for the game as a shortstop, and the coach kind of put him off and kept putting him at second base, and he went back to the coach and said, You know, again, I was chosen to be the shortstop, and the coach finally said to him, Look, Sarbanes, you are going to play second base; I am playing Kaline at shortstop. Of course, the Kaline was Al Kaline, one of the greatest baseball players of all time. You know, sometimes you draw the short straw.

Senator GREGG. I think Senator Bunning struck Al Kaline out three times that day.

Senator BUNNING. And he was on my team.

Senator CONRAD. I think Al Kaline went to the Major Leagues when he was 18 or 19 years old.

Senator BUNNING. Seventeen.

Senator CONRAD. Seventeen years old.

So, Paul, you know, maybe you could have had another career, a parallel career, one in the Major Leagues. Paul, we are truly going to miss you, and I am going to miss you very, very much, both as a friend and a colleague.

Senator GREGG. Let me join you, Senator Conrad, in those thoughts and echo them. Obviously, Paul has been an immense person in the Senate for many, many years and a brilliant contributor to our activities. I am going to miss him too, although I am not going to miss his amendments. I used to cringe whenever he came to a markup, because I knew his amendments were just going to be terrorizing us. He will be missed immensely because he has been a force for positive and good government, and that is what it is all about.

Senator SARBANES. Well, thank you. I very much appreciate the very generous comments of the chairman and of my good friend, the ranking member. Thank you very much for that.

Senator CONRAD. Christine, thank you so much.

And I will defer to Senator Sarbanes for any questions he may want to ask of the witness.

Senator SARBANES. Mr. Chairman, I will be very brief, but having heard Senator Conrad say I am good natured, I don't want to counter that.

Mr. Lazear, what is the view down at the Council of Economic Advisers? And I understand the chairman and ranking member touched on this before I got here, but I was planning to raise it myself. What is your view down there about getting this testimony to the committee in accordance with our rules ahead of time, which of course then gives us a better opportunity to prepare substantively for the hearing? This isn't the first time this has happened. Is the CEA operating on a different premise or assumption than the committee is operating on and, if so, we need to know that, and if not, why aren't you measuring up to standard?

Mr. LAZEAR. I will just simply apologize to you, Senator, and say that it is the first time on my watch and we will check into it in the future. So you do have my apologies for that mishap.

Senator SARBANES. I think I am correct in saying, though, that it has occurred previously. It now seems to be becoming standard operating practice at the CEA.

Mr. LAZEAR. If so, as I said, I don't know about that. I am relatively new to the CEA, but we will check into it.

Senator SARBANES. Well, I wish you would do that. I mean, I think it is a good rule and it is there for obvious reasons, and most witnesses, at least, comply with it, and I think in some respects, there is probably more excuse for someone from the private sector who isn't equipped maybe to produce the statement the same way as the Council.

While I have you, let me ask you is the Council still out in the hinterlands in terms of its location? You are no longer in the Executive Office Building; is that right?

Mr. LAZEAR. Most of us are not. We do have an office in the Executive Office Building that we retain. As you probably know, after 9–11, two-thirds of EEOB was shut down for remodeling, most of which was security related, and so most of the people in that building were moved out to neighboring offices, and we have an office about a block down the street from the EEOB, and it requires a bit of commuting between the two, but we have managed to do it.

Senator SARBANES. Do you have an assurance that you are going to go back into that building once the remodeling is complete, or has, in effect, the banishment of the CEA from the immediate policy confines of the White House been accomplished?

Mr. LAZEAR. I expect that we will go back, but, unfortunately, it looks like the remodeling will take us at least until 2009, probably 2010, possibly 2011. So a promise from this Administration, unfortunately, would not be worth a whole lot in terms of committing future Administrations to moving us back.

Senator SARBANES. That is like those promises we got from the President about the deficit early on in the first term of the Administration. They weren't realized either. Correct?

Mr. LAZEAR. Well, as I testified earlier, you know, the deficit numbers have been looking much better than we expected, and they are moving in the right direction.

Senator SARBANES. I will spare you quoting the President's statements during the course of his first term about what was going to happen to the deficit. Senator Conrad has done a first-rate job of outlining that problem.

The Federal revenues are what share of the GDP now?

Mr. LAZEAR. The deficit? I am sorry.

Senator SARBANES. No. The revenues.

Mr. LAZEAR. The deficit is approximately 2 percent.

Senator SARBANES. No. The Federal revenues.

Mr. LAZEAR. Revenues are about—it would be about 10 percent.

Senator BUNNING. No. You have got the wrong question.

Senator GREGG. I think you said what percent of GDP are the Federal revenues. I think they are about 18.1 percent right now.

Mr. LAZEAR. Oh, I am sorry. Revenues are actually above that. I think we are at 18.2 percent right now.

Senator GREGG. The average?

Mr. LAZEAR. I am sorry. I misunderstood your question, Senator. The average, depending on which period you look at, is about 18.1 percent.

Senator SARBANES. The chart you showed had revenues back up at the line recovering. You know that chart you put up there?

Mr. LAZEAR. This one?

Senator SARBANES. Yes. That figure in 2006, that would be at 18 percent of GDP; is that correct?

Mr. LAZEAR. Actually, that would be using the numbers from the mid-session review, which is consistent with a $300 billion deficit. So that is what this number is based on.

Senator SARBANES. I want to know what percent of GDP is Federal revenue.

Mr. LAZEAR. I believe that is 18.2 at that point.

Senator SARBANES. And back when you started, what it was it?

Mr. LAZEAR. Which year, sir?

Senator SARBANES. 2000.

Mr. LAZEAR. In 2000, let us see. Do we have that number here? We can get that number for you. Bear with me for a second and I will get you the exact number.

Senator SARBANES. I don't want to impose on my colleagues. Let me ask you this.

Mr. LAZEAR. Yes, sir.

Senator SARBANES. A 1 percent increase in the share of the GDP in Federal revenues would be worth how much money?

Mr. LAZEAR. A 1 percent increase of GDP?

Senator SARBANES. No. Of revenues as a share of GDP, a one point increase. If it was 19 percent instead of 18 percent, how much more revenue is that?

Mr. LAZEAR. About $130 billion, because GDP is 13 trillion, approximately. So you are talking about 1 percent of that number, sir.

Senator SARBANES. Yes. So if it was 2 percent, we would be close to wiping out the deficit; is that correct, if you added two points?

Mr. LAZEAR. That is right.

Senator SARBANES. What was it back in 2000?

Mr. LAZEAR. Let me see if I can find that for you. I have to get my glasses. Pardon me, sir.

OK, 2000 was 20.9.

Senator SARBANES. So if we were not even at that level, but somewhere near that level, we would have eliminated the deficit. Correct?

Mr. LAZEAR. Well, that assumes that the economy would be the same. Your assumption is that GDP would be the same and that we would simply take 20.9 percent of the GDP number that we have right now. I would not be willing to make that assumption.

Senator SARBANES. OK. As a calculation, that would be correct, would it not?

Mr. LAZEAR. Again, sir, if you assume that GDP was the same, then that calculation would be correct.

Senator SARBANES. Thank you, Mr. Chairman.

Senator GREGG. Our resident all-star Hall-of-Famer, Senator Bunning.

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

In all the charts and figures that the gentleman from North Dakota showed, there was no inclusion of 9–11, no inclusion of the Afghan War, no inclusion of the Iraqi War, no inclusion of Hurricane Katrina or Rita. The income levels did not include any health care and pension benefits that were added on top of the income levels. So I want that to be taken into consideration when you consider the numbers that were expressed by my good friend from North Dakota.

Earlier this week, the "Wall Street Journal" indicated that more investors are starting to factor in the Fed Fund rate cuts that the Feds have made. Do you believe this is true and do you have any comment on the affect on the economy of the Fed policies of recent years?

Mr. LAZEAR. Well, as you know, the Federal Reserve had raised rates for 17 consecutive times and then ceased raising rates a couple of periods ago.

Senator BUNNING. I am very familiar with that.

Mr. LAZEAR. Inflation now seems to be coming under control. I think that the numbers that we have seen for the past——

Senator BUNNING. Do you believe there was inflation in those 17 months?

Mr. LAZEAR. Well, there is no doubt that measured inflation was higher, quite significantly higher.

Senator BUNNING. When they started raising interest rates?

Mr. LAZEAR. I don't believe when they——

Senator BUNNING. Maybe in the last 2 months.

Mr. LAZEAR. Well, actually no. The last year had higher inflation than the previous year, but the question that I think most economists argue about has to do with whether this was a one-time increase in prices associated with an energy increase or whether it would be sustained inflation. I think that is the issue that the Fed has been arguing about as well.

Senator BUNNING. Internally?

Mr. LAZEAR. Well, you know, right, internally. I don't know what they are arguing about internally, but only the statements that they have made are statements that I hear. As you know, we are an independent body and we have no access to any additional information.

Senator BUNNING. You have the minutes of their meetings, just like we do, a month later.

Mr. LAZEAR. Correct. That is right, sir. When we look at what they have been saying, they have had the same kinds of arguments that I think other economists have had, which is are we more concerned about inflation or are we more concerned about making sure that the economy continues to grow at a high rate.

That is a balancing act that the Fed has to engage in. We are confident that the Fed attempts to do that the same way that we attempt to think about these issues. They have the same data that we have, as you pointed out, and I think the recent numbers on inflation are encouraging.

Senator BUNNING. I have an even more important question. Some economists suggest that the blame for the American deficit lies in Asian emerging economies. Asian central banks drive their currency down by buying American Treasury bonds, reducing interest rates, and allowing Americans to buy even more Asian exports. To what degree do you think China's current practices have contributed to the growing U.S. deficit?

Mr. LAZEAR. There is no doubt that investment in the current account surplus to which you refer is the other side of the current account deficit that we see in terms of trade. So when we are running a current account deficit, it is necessarily the case that some other country, at least, is running a current account surplus. In fact, we have seen this with China investing at very high levels in U.S. Treasuries.

Senator BUNNING. You have to get to the point of my question though. The basic point of my question is to what degree do you think China's current practices have contributed to the growing U.S. deficit, in other words, the undervaluation of the Won.

Mr. LAZEAR. Well, as you know, Treasury speaks for us in terms of the value of the dollar relative to other currencies.

Senator BUNNING. We are trying not to let them do that.

Mr. LAZEAR. I would prefer to defer to my colleague, Hank Paulson, on speaking about currency.

Senator BUNNING. We will have a bill that will change that.

Mr. LAZEAR. All right. I will wait for it.

Senator SARBANES. Hasn't he said that it is undervalued?

Mr. LAZEAR. I am sorry?

Senator BUNNING. Paulson has said it is undervalued.

Mr. LAZEAR. Hank is not shy. I will let him speak for himself.

Senator SARBANES. He has made public statements to that effect.

Senator BUNNING. The thing that he really said was that there wasn't manipulation. He didn't say that it was undervalued, just to correct the record.

Mr. LAZEAR. Again, I would rather let the Secretary speak for himself.

Senator BUNNING. All right. I will question him when we see him.

Thank you, Mr. Chairman.

Senator GREGG. Thank you.

Senator CONRAD.

Senator CONRAD. Thank you, Mr. Chairman. Let me just go to a speech that the Controller General of the United States gave, General Walker, about the situation that we are in as a country. These are remarks from a speech he gave to the certified public accounts in August of this year. He said: "The U.S. Government is on an imprudent and unsustainable fiscal path." Let me go to the second statement there. No. Let us go to the third one. "The executive branch is only giving 5-year projections for their budgets. Why? Because we go in the tank after 5 years; the numbers start looking bad after 5 years."

Let us go to the next one. This is General Walker again in a speech to the accountants: "Right now, the miracle of compounding is working against us because we are the world's largest debtor nation, and if interest rates start going up, the effect that that will have could be dramatic because we are adding debt at or near record rates, and if interest rates start going up, since the duration of our debt is pretty short, we will start feeling it pretty quickly."

Finally, so the bottom line is, he said, the status quo is not acceptable. It is not sustainable. Faster economic growth can help, but there is no way we are going to grow our way out of this problem. Anybody who tells you we are going to grow our way out of this long-range problem, No. 1, hasn't studied economic history, and No. 2, would probably flunk basic math. The numbers just don't work."

I would ask you, Dr. Lazear, are there any of these statements that have been made by Controller General of the United States that you disagree with?

Mr. LAZEAR. I think I fundamentally agree with his statements, but I want to make sure that we interpret the statements as talking about the long-run situation. It is absolutely clear to me that the path that we are on in terms of growth and entitlements, Medicare, Medicaid, Social Security, cannot be sustainable. We have to think about ways to address that problem. I think the President has been clear on that as well.

So I don't think that these statements are at variance with the Administration's view on it.

Senator CONRAD. But it is a very different message that he is delivering than the message I hear you delivering here today. I hear you delivering kind a good news message, everything is going great, but I hear the Controller General of the United States delivering a very much more sobering message, one that we are on a course that is utterly unsustainable where we are piling up debt at a rate that is unsustainable and that it threatens our future economic strength.

Mr. LAZEAR. Again, I would distinguish the short run from the long run, Senator. In the short run, I think things are getting better, the fact that the deficit has gone down significantly greater than anticipated. We are now below what I think is the magic number. The magic number at this point is about 2.4 percent deficit, which means we are at that number or below the deficit—the debt-to-GDP ratio is shrinking. So our public debt-to-GDP ratio will actually be shrinking.

That is true over the short run, but if we allow expenditures to grow, if we allow the budget to get out of control in the future and if we believe these projections about where we are going to go in the future, we will certainly allow them to get out of control. That will cause some very serious long-run difficulties, and I certainly agree with that. I think that that is probably one of the greatest problems that we face as a country, and we need to address it.

Senator CONRAD. Let me say that this analysis of the deficit as 2.4 percent of GDP to me misses the point. The deficit is going to go up 260 billion this year. The debt is going to go up 560 billion, and what people seem to miss here is that it is the debt that has to be repaid, and this is the level of debt increase. The debt of this country, gross debt, at the end of this year will be eight dollars and a half trillion dollars, and we are going to add 600 billion dollars, almost 600 billion dollars, this year, 557 billion dollars. We are going to add, according to projections, 600 billion dollars or more every year for the next 5 years.

So we are going be at 11 and a half trillion dollars 5 years from now just as the baby-boomers start to retire. That is what causes so many of us deep concern, and what I hear you saying is that that concerns you as well.

Mr. LAZEAR. What I am saying is that we encountered some unanticipated shocks, some of the ones that Senator Bunning had pointed out. The question that every society faces when they encounter an unanticipated adverse event is how do we finance those over time. No one would ever suggest that you are going to finance that at one point in time fully by that particular year's worth of income.

So the question is how do you smooth it over time, and the issue is are we smoothing too much or are we smoothing too little or are we just about right.

Senator CONRAD. I don't see us smoothing anything. The debt this year, and you just described the economy as strong, we are going to increase the debt by almost $600 billion.

Mr. LAZEAR. That is what it means to smooth. You borrow to take care of——

Senator CONRAD. But sir, sir, not only are we going to add almost 600 billion dollars to the debt this year, we are going to add three trillion dollars over the next 5 years. I don't see where the smoothing is coming. The only thing that is happening here is we are running on a charge card.

Mr. LAZEAR. As I said, the number that I think most economists think about is the ratio of the public debt to GDP. That is what we think of as the long-term target. Now, we can disagree over whether we are too high right now, whether we should be much lower. We are at about our historic average, slightly about, but pretty close to our historic average. The historic average, I showed on the chart.

Senator CONRAD. The historic average includes World War II.

Mr. LAZEAR. No, no. Sorry. The 40-year average.

Senator CONRAD. I thought you said the historic average.

Mr. LAZEAR. I am sorry. We only went back 40 years. We used the same numbers that OMB uses.

Senator CONRAD. I just say to you that we are now running up debt at a rate that is by, I think, most objective observers' analysis absolutely unsustainable. That is what the Controller General is telling us, and we are using an accounting system that you know is cash. If we were going on an accrual system, the way most of the institutions have to do in this society, these deficits would be much, much larger.

I thank the chairman.

Senator GREGG. Senator Grassley.

Senator GRASSLEY. Dr. Lazear, your predecessor at CEA, Dr. Mankiw, wrote a paper entitled "Dynamic Scoring: A Back of the Envelope Guide". That is the name of it. The paper suggested the dynamic effects of tax cuts on labor will offset about 17 percent of the static revenue loss and the dynamic effects of the tax cuts on capital will offset about 50 percent of the static revenue loss.

These results are interesting for two reasons, and I want you to comment. First, they suggest that while tax cuts do not pay for themselves from the perspective of the budget, they do have a significant impact on the economy. Second, in order to offset 50 percent of the revenue loss, a tax cut on capital would have to increase

GDP by more than one dollar for each one dollar of revenue loss. Are you familiar with the study and what are your views, then, on the issue of dynamic scoring?

Mr. LAZEAR. Yes, sir, I am familiar with the study, and I would say, Senator, that it is actually consistent with the numbers that I put up earlier. Actually, if you don't mind, I will refer back to that for a second.

Nick, if you could put up, I think it is Figure 4.

This makes your point in a slightly different way, but I think it is completely consistent with what you are saying. If you look at the effect of the tax cuts, which is the difference between the red line and the dotted blue line, look at 2003, and you will see that there is a decline in revenue there; but what you also see is that the revenue growth between 2004 and 2006 is quite steep. We believe that that revenue growth is at least in part attributable to the tax cuts themselves, and that is the dynamic aspect of what we are talking about here.

Now, as a consequence of that, you will also see that the revenues in 2006 are back to where they would have been but for the tax cuts. In other words, even if we hadn't cut taxes, we would be back right at about the same level because of the additional growth of the economy. Again, that is the dynamic scoring aspect of this issue.

As you know, we don't do dynamic scoring in most of our analyses. Treasury right now is undergoing what they call a dynamic analysis to try to incorporate some of these issues. CBO is doing the same thing, and a variety of private think tanks have been working on this as well. So there are a number of different ways to incorporate these kinds of estimates. I think, you know, Greg Mankiw's estimates that you mentioned are one set of estimates, but I think all of us agree that there are dynamic effects. The question is simply how large are they. This chart seems to suggest that at least in the short run, they are pretty significant and it is certainly something we need to take into account.

Senator GRASSLEY. I yield back the rest of my time.

Senator GREGG. Thank you, Senator Grassley.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman. I want to pursue this idea of the public debt being held by foreign buyers. What would happen if the United States prohibited foreign investors from purchasing our debt?

Mr. LAZEAR. Well, right now, we are running a current account deficit, which, again, on the other side of that is the capital account surplus. We are bringing in a great deal of money from abroad, which is funding our investment. Our investment level still happens to be very strong, but that is coupled with a pretty high level of personal consumption, as you know. What that means is that we rely pretty heavily on foreign investment right now as a source of funds. For growth, for investment, that capital is extremely important to our economy.

Just to give you a couple of numbers to put this in perspective, we estimate that about 45 million American jobs are in firms that are engaged in significant international trade. We estimate that about one in twenty Americans is employed in a foreign-owned firm, and so they are an important source of contribution to the American economy. If that were to reverse, if that were to come to an abrupt end, obviously it would have significant impacts, adverse impacts, on the economy.

Senator ALLARD. So if you look at, you know, our account deficits, it seems as though when our economy is doing better, it increases, and when our economy is doing poorer, like during the Depression or maybe at the end of the 1970's when we had the misery index, the account deficits were in the positive range. So would you say, then, in terms that we have an account deficit, it can be a sign that our economy is doing great?

Mr. LAZEAR. Well, again, I would put it a slightly different way. What I would say is when we have a capital account surplus which suggests that others are anxious to invest in the American economy, that is a good sign, because it tells us that not only are we willing to put money in this economy, not only do we think that there is a good future, but people who have no other inherent stake in this economy also agree with us.

Senator ALLARD. They will get a greater return on the investment than a savings account or whatever?

Mr. LAZEAR. Exactly, and they are not in this game for charity. They are not in this game for patriotism, but because they think it is going to bring a higher rate of return. So I would simply view that as evidence that other people in other countries agree with our investment sentiments.

Senator ALLARD. I want to move on to energy. Right now, we are blessed with a drop in the cost of gasoline at the fuel pump, but I think that there is still a good deal of frustration. When the economy looked like it was good, you would explain it to people and they wouldn't believe you because every time they would pull up to the gas station to get a tank of gas, that impacted them so personally in their checkbook, but now we are seeing that dropping down dramatically.

The Organization for Economic Cooperation Development has estimated that a $10 decrease in the price of a barrel of oil will increase the level of Gross Domestic Product by two-tenths percent. Since August, the price of a barrel of West Texas intermediate has declined significantly. Would it be reasonable to assume that the lower energy prices could provide an unexpected boost to our current economic growth in the coming months?

Mr. LAZEAR. We believe it will be helpful to economic growth. Whether the number is 2 percent, I have actually seen numbers as high as—sorry—.2 percent. I have actually seen numbers as high as .4 percent. You know, I wouldn't want to venture an exact number, but it certainly is a positive force. I think that one of the good things about the economy is that because we have had high productivity growth over the past few years, we have been able to withstand what really was quite a significant energy price increase, and we did it without seeing job loss, without seeing productivity loss, without seeing output loss.

All of those things are good signs, and I think they are a testament to the robustness of the economy and the resiliency of the economy. So going forward, I think that your point is well taken. As we look to these declines that we are now seeing, and we are certainly happy that those declines have occurred, we do expect that this will have a positive affect on the economy, possibly as early as fourth quarter.

Senator ALLARD. Yes. I think that the fact that our economy did so well during a time of very high gas prices speaks very clearly about the strength of the President's economic initiative to stimulate the economy and keep it going, because I can remember the last time we had high gas prices at the pump, it was, again, during the late seventies, and that is when it really had an adverse impact.

So thank you for your comments.

Mr. LAZEAR. Thank you, sir.

Senator GREGG. Thank you.

I had a set of questions I was going to ask you, but we are running into a time issue here. There is going to be a vote, and I would like to get the next panel's testimony before we have to go into potentially a series of votes. So I want to thank you for coming.

Mr. LAZEAR. Thank you, Senator.

Senator SARBANES. Mr. Chairman, could I just clarify one thing?

Senator GREGG. I would like to move this along, if you don't mind.

Senator SARBANES. I won't take long. I want to followup on what Senator Allard was saying.

Mr. LAZEAR. Yes, sir.

Senator SARBANES. I was actually taken aback by your assertion that other people in other countries are willing to hold our debt and that shows that they have confidence and strength in the U.S. economy, which you just made. Correct?

Mr. LAZEAR. Correct. I am surprised you are taken aback.

Senator SARBANES. Well, I am taken aback because, as I understand it, more and more of that debt is being held by governments, not by individuals, and Senator Bunning made, I thought, a very effective point, that they are doing that in order to affect the exchange rate and to gain a trade advantage. That is why Japan and China have these huge, huge holdings, and the shift has been from—it doesn't represent a judgment by private individuals. It represents a governmental decision in those countries designed, I think, to help them gain a trade advantage, which is, I think, the point that Senator Bunning was trying to make.

So they are over there playing a very shrewd game to our disadvantage, and you are sitting there as the Chairman of the Council of Economic Advisors telling us that everything is hunky-dory.

Senator GREGG. I think we will take that as a rhetorical question.

Senator SARBANES. OK.

Senator GREGG. Thank you very much for your input and thank you for your time, Dr. Lazear.

Mr. LAZEAR. Thank you.

Senator GREGG. We will now turn to our second panel, which is made up of three distinguished scholars from three very distinguished policy groups. We have Dr. Kevin Hassett, who is Director of Economic Policy at the American Enterprise Institute; Mr. Chris Edwards, who is Director of Tax Policy from CATO Institute; and Peter Orszag, who is the Deputy Director of Economic Studies at

Brookings Institute. All three have a long track record of substantive and thoughtful input on American policy on a variety of different levels, and we appreciate these three witnesses taking the time to come here today to testify.

We will start with you, Dr. Hassett.

STATEMENT OF KEVIN HASSETT, DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. HASSETT. Thank you very much, Chairman Gregg and Ranking Member Conrad. I would also like to take a moment to thank Senator Sarbanes for his public service and say that I have testified many times over many years and I have always found our exchanges to be stimulating and challenging, and he really will be missed.

I am going to abbreviate somewhat my remarks compared to what I handed in and try to give you the highlights, and I will skip over a good deal of what I have written about the outlook as it coincides fairly closely with what Chairman Lazear stated. The one thing I would like to add is the final concluding point from my overview of the economic outlook, which is that right now, it seems like the forecasters that I trust the most, like Moody's Economy.com and so on, just non-political economists, think that we are heading for a successful soft landing, and I think that if we do head for that, it is just worth mentioning on the record that that is an impressive policy accomplishment for the Federal Reserve.

Indeed, if we look back at last summer, in stopping where they did, the Federal Reserve officials took something of a calculated risk. Inflation pressures were still present. Growth was still strong, and in similar circumstances in the past, the Fed has continued to tighten. I think right now, their judgment not to do so looks pretty good given the data that we have seen since then, and I think a tip of the cap is in order for Mr. Bernanke and his colleagues.

I mentioned in my written testimony that I wanted to bring a somewhat different light on the question of the distribution of growth. There has been concern in my circles that the current economy may somehow be different than economies in the past and that economic growth might not be shared as equally as it has been in the past. There are a number of statistics that are consistent with that perspective. Between 2000 and 2006, for example, real wages which exclude benefits increased .6 percent per year while real hourly compensation, which includes benefits, increased 1.3 percent per year.

Additionally, the Census Bureau recently reported that real median household income grew only 1.1 percent from 2004 to 2005. It also reported that this was the first year since 1999 in which such an increase was reported. These statistics have received a great deal of attention in the press, and on their face, the data would suggest that ordinary Americans are not sharing in the economy's growth, and that would be quite a bit of a break from past experience.

It is important to note, however, that, first of all, these measures don't take the Tax Code into account. In my testimony, I have a couple of charts from a chapter in a book edited by Rebecca Brank and Sheldon Dansinger that I wrote with my co-author at AEI, Anne Moore. As of 2004, for example, the total income and payroll tax liabilities for the two sample families in my testimony declined sharply over the last decade, and accounting for those changes in taxes is important as we think about what is going on for the median person.

There are also a number of other factors that we need to account for when we are thinking about how the middle person is doing, because no person stays right in the middle every year. Economists have long believed that one of the things to look at when you are assessing the welfare of individuals is their consumption. Just because GDP has been rising a lot lately, so has aggregate consumption. It has grown 17.24 percent since 2001. This is interesting because consumption very often in the statistics is much more equally distributed than income and wealth.

So what my staff and I did is we went back to the consumer expenditure survey and took the share of consumption that goes to the middle class and then used that share to try to estimate their consumption in recent years given the increase in liquid consumption. I think that those data reject the view that we are evolving toward an economy where we are significantly less friendly toward the middle class. Indeed, the rate at which consumption by the middle class is increasing has even accelerated in recent years. There is a figure in my testimony that indicates that.

I think that we should also recognize as we look at these data that we did have an adverse shock to inflation. The real growth at the top line consumer price index was 1.7 percent for 2001 to 2002, but it accelerated all the way up to 3.8 percent between 2005 and 2006, marking the highest increase in the last 15 years.

Inflation surprises have, of course, occurred before, and when they do, we know what happens. Real wage growth is lower than expected, but then as those wages are re-contracted as workers go back and say, Hey, that deal I made last year wasn't so good because of inflation surprised on the up side, then their wages catch back up. In addition, energy prices have surprised on the down side lately, as was mentioned by Chairman Lazear, and those reductions should pave the way for further real wage gains, but it is worth emphasizing that the pattern that we see in the consumption data is consistent with a view that workers recognize that their wages are going to catch up and smooth their consumption through the negative surprise.

In the near-term budget outlook section of my testimony, I talk about what has been going on with the near-term budget. Figures 5 and 6, I think are notable for thinking about how we got to the place we are where we have a deficit. The dotted line in Figure 5 shows the latest projections for outlays in 2006 and compares them to past CBO projections for spending in that year. Going back to the first year, such a forecast is available, in 1996.

I think the chart tells an unambiguous story, that spending was much higher than projected back at the end of the Clinton Presidency or the beginning of the Bush one. While it is important to note that these projections keep real discretionary spending constant going forward, the numbers are, nonetheless, startling. 2006 outlays, for example, were $479 billion higher than the CBO projected outlays would be, you know, for that year back in 2001.

Since the 2006 looks like it will be 260 billion or so, one could conclude that we could currently have a surplus if government had stayed on the spending course that was incorporated into that outlook.

Figure 6 provides a similar comparison, this time for revenues. As I am running out of time, I won't go through the details, but if you look at the revenue chart, then what you see is for some years, revenues are lower than they thought they would be in 2006 for some past projections, and for some years, they are higher. So there is ample room for debate in there between supply side optimists and pessimists about whether the tax cuts paid for themselves, but I think that even the supply side pessimists would have to concede that relative to the times when we had large surpluses, revenues have surprised less on the down side than spending did on the upside.

In the remainder of my testimony, I have a discussion of the literature on budget rules. I know that members on both sides of the aisle in this committee, at least, are in favor of some kind of new budget legislation. I think the literature suggests that those work.

In the final section of my testimony, I talk about the longer-term outlook and agree with Senator Conrad that it is really quite troubling and discuss why I think the misconception about what a tax increase or a benefit cut really is when we are talking about entitlements might be an unnecessary obstacle to bipartisan agreement about how to afford. I think not moving forward is not an option and the fact that cleaning up these misconceptions might help move toward bipartisan agreement, I think is an optimistic sign.

And that is how I close my testimony. Thank you.

[The prepared statement of Mr. Hassett follows:]

Testimony Submitted
To
The United States Senate
Committee on the Budget

September 28th, 2006

Kevin A. Hassett*
AEI

Dr. Kevin A. Hassett is Director of Economic Policy Studies at the American Enterprise Institute.

Chairman Gregg, Ranking Member Conrad, Members of the Committee; It is an honor to appear before you today to discuss, "The State of the Budget and the Economy."

Economic Growth Has Been Strong, But Is Moderating.

Economic growth has been solid for some time. As my first chart indicates, after the 2001 recession, top line GDP growth has been strong for going on five years. Since 2002, annual GDP growth has averaged a very healthy near 3 percent, a rate that is expected to continue in 2007.

This strong growth has had a major impact on labor markets. After seeing an additional 128,000 jobs created in August, the economy has now produced 5.2 million jobs since August 2001. Along with these job gains has come a steady improvement in unemployment. The unemployment rate peaked at 6.3% in June of 2003, two years after the end of the recession. By August of this year, it was down to 4.7 percent, a rate so low that it may well be below what economists think of as the "natural rate" of unemployment.

The job gains have been fairly evenly spread geographically, with employment increasing in 48 out of the 50 U.S. states over the past 12 months ending in July.

In order to keep inflation under control in the face of all of this growth, the Federal Reserve has tightened monetary policy significantly, raising the federal funds rate from a low of 1 percent in 2003 to its current 5.25. There are many signs that this tightening has had the desired effect of slowing the economy, but not so much as to push us into a recession. The latest Moody's Economy.com forecast for the remainder of the year, for example, calls for growth to moderate to about 2.6 percentage points.

To be sure, this growth outlook balances a number of risks. In particular, the housing market appears to be in the throws of a significant downturn, and promises to be a significant drag on growth going forward. But other areas of the economy appear to be picking up the slack. Most notably, nonresidential investment appears to be poised for healthy growth, in part because of the positive outlook for corporate profits.

If this is a successful "soft-landing" it will be an impressive policy accomplishment. In the past, Federal Reserve actions have often slowed the economy so much as to induce a recession. In stopping where they did, Federal Reserve officials took something of a calculated risk. Inflation pressures were still present, and growth was still strong. In similar circumstances back in May 2000 Mr. Greenspan and the committee pushed the federal funds rate all the way up to 6.5. Stopping well below that level, the current Fed clearly expected inflation pressures to ease because of the cumulative impact of policy measures that were already in train. The latest inflation numbers have indeed been surprisingly tame, suggesting that a tip of the cap is in order to Mr. Bernanke and his colleagues.

The Distribution of Growth

There has been concern in many circles that the current economy may somehow be different than economies of the past, and that economic growth might not be shared as equally as it has been in the past.

Between 2000 and 2006, for example, real wages--which exclude benefits--increased 0.6 percent per year; while real hourly compensation, which includes benefits, increased 1.3 percent per year. Additionally, the Census Bureau recently reported that real median household income grew 1.1 percent from 2004 to 2005, though it also reported that this was the first year since 1999 in which such an increase was reported. On their face, these data would not suggest that ordinary Americans are sharing in the nation's growth.

It is important to note however that these measures do not take the tax code into account. For example, figures 2 and 3 illustrate the tax burdens for a family of four living on $27,300 per year and for a single parent with two children living on $14,000 have decreased over time. As of 2004, the total income and payroll tax liabilities for these two families were $1,208 and -$2,613, respectively, compared to $5,190 and -$719 ten years prior. These changes underscore the notion that statistics that exclude tax effects do not tell the whole story.

There's another way to measure how people are doing: consumption. Just as GDP has been rising, so has aggregate consumption. Between 2001 and the second quarter of this year, adjusted for inflation, consumption of Americans grew 17.24 percent.

The Department of Labor's Consumer Expenditure Survey provides detailed consumption data on a cross section of Americans; we can use this to estimate how much of our aggregate consumption went to each income group in recent years.

These data reveal that the middle class has been doing pretty well for itself. Breaking the income distribution up into five "quintiles," we tracked the consumption experience of the middle quintile (or middle class) in recent years. The data tell a striking story: Consumption has increased for the middle class.

The data reject the view that we are evolving toward an economy that is less friendly toward the middle class. Indeed, the rate at which consumption by the middle class is increasing has accelerated in recent years. As figure 4 indicates, the average annual consumption growth for the middle class was less than 1 percent in the period from 1990 to 1994, rose to 1.5 percent in the period from 1995 to 1999, and jumped to more than 2 percent in the period from 2000 to 2005. The middle class is even doing better than the upper crust: The growth of their consumption expenditures exceeded the growth rate in the highest income category between 2000 and 2005. Consumption is becoming more equal across these income classes.

We also should recognize that we have had an adverse shock to inflation. The real growth rate of the top line CPI, for example, was 1.7 percent between 2001 and 2002, but has accelerated to 3.8 percent between 2005 and 2006, marking the highest increase in the last 15 years.

Inflation surprises, have, of course, occurred before. When they do, real wage growth is lower than expected, but then as those wages are recontracted, real wage growth picks up again. There are signs that this normal pattern is holding up, given recent wage movements.

In addition, energy prices have surprised on the downside lately. Last month, for example, the West Texas Intermediate spot oil price saw its largest monthly decline since April 2003, with a drop of 11.8 percent. These reductions should pave the way for further real wage gains in coming quarters.

It is worth emphasizing that this pattern, while still conjecture, as it is forward looking, is supported by the recent strength in consumption. As is well known, consumers tend to smooth out income fluctuations when setting their consumption. If they are optimistic about future wage gains, then they will maintain healthy consumption even when real wages disappoint. This appears to have been the case in recent years.

The Near Term Budget Outlook

The strong economy has stimulated tax revenues, and CBO projections are still catching up with the good revenue news. According to Under Secretary of the Treasury Randal Quarles, tax receipts have been quite high in the current quarter, running 11.7 percent higher than a year ago, which itself was 14.6 percent higher than the previous year.

All of that extra revenue, has not, however, closed the large gap between spending and revenues. The latest CBO estimate projects a $260 billion deficit for 2006 with steady increases predicted for the next four years. Why has the fiscal balance changed so much?

Figures 5 and 6 help shed light on the picture. The dotted line on the figure 5 shows the latest projections for outlays in 2006, and compares them to past CBO projections for spending in that year, going back to the first year such a forecast is available, 1996. The chart tells an unambiguous story. Spending is much higher than was projected back at the end of Clinton presidency or the beginning of the Bush one. While it is important to note that these projections keep real discretionary spending constant going forward, the numbers are startling. 2006 outlays, for example, were $479 billion higher than the CBO projected outlays would be in 2001. Since the 2006 deficit looks like it will be $260 billion, one can conclude that we would currently have a surplus if government had stayed on the spending course incorporated into the 2001 outlook.

Figure 6 provides a similar comparison, this time respecting revenues, but has a more ambiguous implication. Revenues in 2006 have been much higher than expected in some years, and lower than expected in others. This likely reflects a number of factors. The 2001 outlook incorrectly (in retrospect) ratcheted up growth expectations right before a recession and 9/11. Relative to 2000 or 1999's long run projection for 2006, revenues were fairly close to what was projected, even though those projections did not include the subsequent tax cuts.

In the end, whether you believe that tax cuts stimulated enough growth to significantly pay for themselves depends on whether you believe the appropriate baseline for comparison is 2001, 1999, or perhaps some other year. But even a supply side pessimist would have to concede that relative to the times when we had large surpluses, revenues have surprised less on the downside than spending did on the upside.

Going forward, it seems clear that one factor leading to the worsening fiscal balance has been the absence of effective budget rules.

In Homer's Odyssey, when Odysseus sailed past the sirens, he had his crew put wax in their ears and lash him to the mast so he could listen to the song without being lured to his doom.

In the past, politicians have enacted budget rules that similarly restrain them from temptation.

For example, Congress passed the Balanced Budget and Emergency Deficit Control Act of 1985, commonly known as the Gramm-Rudman-Hollings Act, which set maximum amounts for the deficit. Each year, the deficit targets would decrease, until the budget was balanced in fiscal 1991. If the deficit limits were exceeded, the president was required to cut non-exempt spending by a uniform percentage to bring the budget back in balance, a process called sequestration.

Facing large deficits in 1990, Congress passed the Budget Enforcement Act, which enacted pay-as-you-go rules that required across-the-board cuts in non-exempt mandatory spending if proposed new spending and revenue measures would increase the deficit. The law also imposed discretionary spending caps. These provisions were allowed to expire in 2002.

Did those budget rules work? Critics have argued that they can't work, because Congress can always vote to ignore any constraints it puts on itself. That would be like tying Odysseus to the mast, but giving him a knife to cut his way out.

But a review of the literature conducted by Massachusetts Institute of Technology economics professor James Poterba concluded that budget rules can and sometimes do work. While Congress could in principle ignore budget rules, in practice they have tended not to do so, which has historically led to smaller deficits. [1]

[1] Poterba, James, "Do Budget Rules Work," in, *Fiscal Policy: Lessons From Empirical Research*, A.Auerbach ed. (Cambridge: MIT Press, 1997) pp.53-86

The Longer Term Budget Outlook

As the members of this committee so often emphasize in their public statements, the near term picture, as vexing as it is, is not nearly as important as the long run outlook. Figure 7 portrays the sharp increase in government spending that is projected to occur in coming years. If policy is unchanged, then the U.S. will see its share of government to GDP approach that of Sweden and other European countries, and will face ever more difficult borrowing conditions, or striking tax increases, or both. Given the literature on government size and economic growth, one would expect soaring government share to push us onto an economic path similar to that currently experienced in much of Europe.

The lion's share of the problem is attributable to the aging of our society. This puts pressure on Social Security and especially Medicare.

It seems that one obstacle to the kind of bipartisan cooperation necessary for entitlement reform is disagreement concerning the source of the rebalancing, with some arguing that tax increases are preferable to benefit cuts, and some taking the opposite view.

As an economist, it seems that this debate is often muddled by misconceptions.

Suppose, to start, that we live in a world of absolute certainty and rational individuals. In this world, everyone knows what their income will be until the day they die. In this world, if an individual pays $10 in Social Security tax today, but gets back $10 in present value when he retires, then his net benefit is zero. A rational individual in this case would not think of the $10 as a tax, or as anything at all. It's the net benefit that matters. If he pays in $14 and gets out $16, then the system increases his lifetime income by $2. The same is true if he pays in $2 and gets out $4.

If you want to raise money from this fellow, then you could do it by increasing his tax to $11 and leaving his $10 benefit unchanged, or, reducing his benefit to $9 and leaving his tax unchanged. Either way, you take a dollar from him.

Restoring balance in this example requires that the net benefit be reduced. Money is money. Since the net benefit is the true tax, a benefit reduction is as much of a tax hike to a rational individual as an explicit tax hike.

While the example focused on Social Security, the same analysis could also apply to Medicare. In this case, we ask individuals to pay money into the system with the promise that they will receive health benefits in the future with a certain value. If the individual values a dollar of health benefits as being worth a dollar (which he would not if we give him too many health benefits) then a tax increase and a benefit cut will not be much different economically.

If we add uncertainty, needy individuals, and redistributional objectives, then the labels matter more of course. However, the situation is ambiguous enough that it is safe to say that lines in the sand over labels make little sense economically, and that the opposing sides in this debate are far closer on the true economic content than they may realize. That is reassuring, because the long-run outlook is so bleak that business as usual is not an option.

Figure 1.

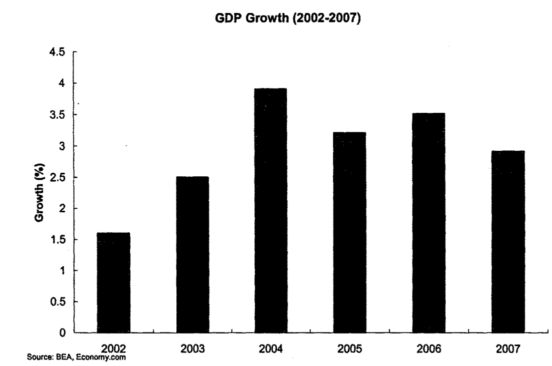


Figure 2.

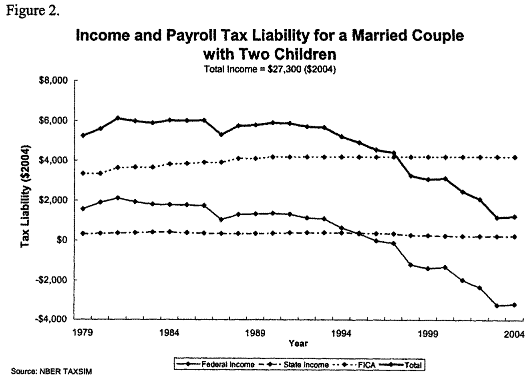
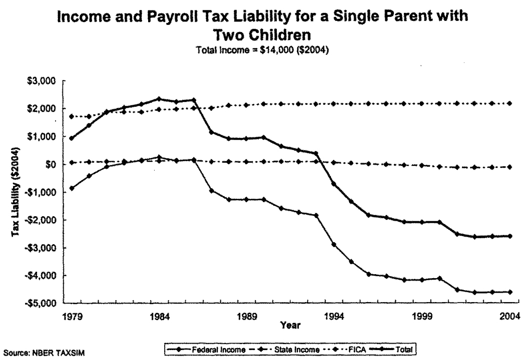
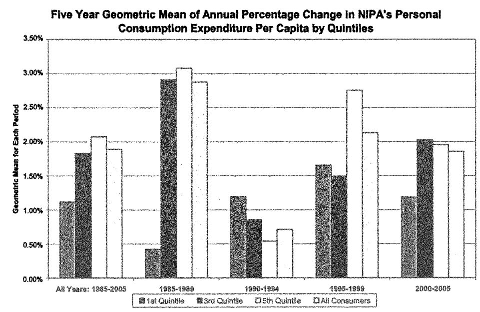


Figure 3.



Source: NBER TAXSIM

Figure 4.



Source: Bureau of Labor Statistics, *Consumer Expenditure Survey (CEX)*, http://www.bls.gov/cex/#data; US Department of Commerce: Bureau of Economic Analysis. NIPA,. Series ID: PCECCA http://research.stlouisfed.org/fred2/categories/110

Notes: Consumption per capita by each quintile was calculated as follows: 1) calculate % share of CEX total expenditure for each quantile (where Total Expenditure = Number of "Total Complete Income Reporters" [or "All Consumer Units" for 2004] times the mean as reported in the CEX survey) and 2) Appy that percentage share to NIPA's Aggregate "Personal Consumption Expenditure" and divide by fifth of population.

Figure 5.

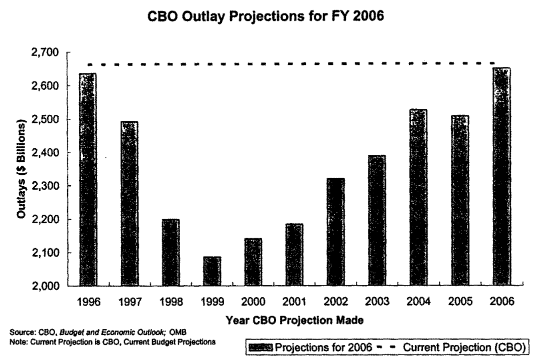


Figure 6.

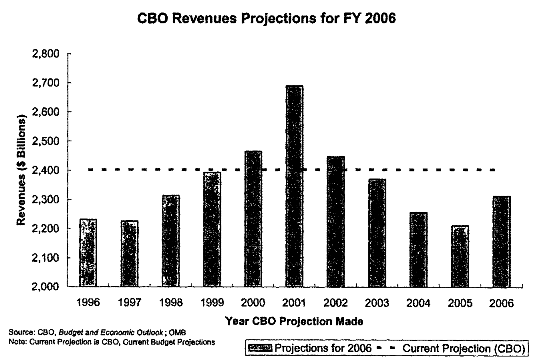
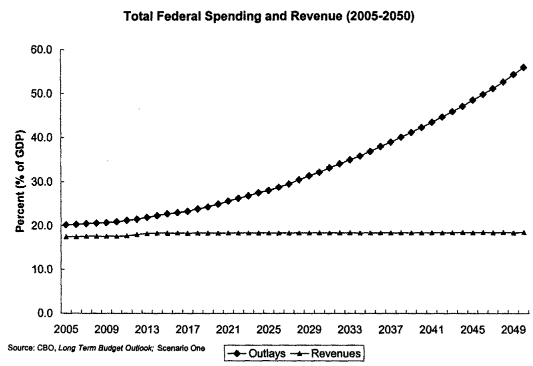


Figure 7.



Senator GREGG. Thank you, Doctor. I appreciate that, those thoughts.

Mr. EDWARDS.

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

Mr. EDWARDS. Thank you very much, Mr. Chairman, and thanks for hold the committee, as with other members, and thanks for having me testify today.

The economy is certainly continuing a solid expansion, and we do appear to be in the middle of a long boom like we enjoyed in the eighties and nineties. I suspect that a lot of the current good economic performance mainly has to do with America's entrepreneurs and dynamic global markets and not so much with Federal policymakers; however, Federal spending and taxation does play an important role in aiding or impeding growth.

The Federal Government extracts $2.7 trillion in taxes and borrowing from the private economy every year. That has two basic impacts. The first basic impact is that it shifts resources from the more productive private economy to the less productive government economy. The large increases in spending in recent years will reduce growth because current taxes will have to be higher than otherwise.

The second basic impact of all that spending is that the method we use to extract the taxes from the economy is particularly damaging with a complex Tax Code. So to sustain our current strong expansion, I think they need to look at both limited spending and going to a simpler, more efficient Tax Code.

Those opposed to recent tax cuts argue that tax cuts financed by deficits don't do much for the economy, and it is true that recent tax cuts would have had more tick if we had limited spending as well and matched tax cuts with spending cuts. There is a crucial point to make here though, that all tax cuts are not created equal. About 45 percent of recent tax cuts since 2001, you can call a social policy tax cut, such as the child tax credits. Those sorts of tax cuts do not reduce distortions in the Tax Code and don't really have much of an impact on GDP. They simply push tax burdens on to future generations.

About 55 percent of recent tax cuts since 2001, however, you can call supply side tax cuts, such as the dividend and capital gains tax cuts. Those reduce distortions in the Tax Code, boost GDP growth, and they also don't lose the Federal Government as much money as the static revenue calculations suggest.

The greatly different impacts of different types of tax cuts can be seen in a joint committee taxation study last year. They did a micro simulation analysis of different types of tax cuts to see what the GDP impact would be. They found that a corporate tax rate cut boosted GDP growth in the long run twice as much as an individual income tax cut, and they found that a corporate tax cut boosted GDP four times as much as an expansion in the personal exemption, which is sort of like a social policy tax cut.

So if you look at recent tax cuts, there is no doubt in my mind that the dividend and capital gains tax cut have helped the economy grow strongly and we certainly can see the impacts on Wall Street. Dividend payouts by large corporations have soared since the dividend tax cut passed in early 2003.

Regardless of whether one supports recent tax cuts, it is clear that we have a gigantic long-term spending problem. The GAO, basic GAO, sort of business-as-usual scenario shows Federal spending rising from 20 percent of GDP this year to about 45 percent of GDP by 2040, and the long-term problem is actually really worse than that, because we risk here, moving forward, sort of an economic death spiral. If Congress tries to jack up tax rates to meet rising spending, that will cause greater tax avoidance, slower growth, and less tax revenue, perhaps prompting Congress to jack up taxes even higher than the GAO numbers indicate.

So what we need to do is we have got a bleak future here for young Americans unless we do some serious spending reforms. We need tougher budget rules, and I certainly laud the chairman for his SOS bill. I guess it is S. 3521. He has got some great ideas regarding limiting entitlement spending and discretionary spending. I think an even more basic idea we should consider is putting an overall cap on total growth and total outlays by the Federal Government every year.

A number of States have such caps, and it just seems like such a simple and obvious idea, we ought to consider it Federal. The idea is you would cap total outlays every year by some indicator, like personal income, or it could cap total outlays with some fixed percentage number, like four or 5 percent. That would make it very easy for Congress to plan their outlays in the future, and it would make it very easy for the public and groups in the private sector to see whether Congress is cheating or whether they are following their budget rules. With a cap in place, Congress could consider their annual budget resolution. They would look at where the spending cap that is in the statute of law was and it could include reconciliation bills in your annual resolution to get spending under the cap. If the end of the fiscal year comes around and Congress hasn't met the cap, the President would be required to sequester spending, sort of like under GRA's role in 1990 in the Budget Enforcement Act.

So it is clear budget rules are clearly not working. We have got non-stop deficits. In most years over the recent decade, we have had large deficits. We have got these gigantic unfunded obligations that have built up. We clearly need to experiment with new types of budget rules. I think the ideas in the chairman's SOS bill are great, but I also think we need to look at a cap on overall Federal outlays.

Thanks for having the hearing. I am happy to answer any questions.

[The prepared statement of Mr. Edwards follows:]

Statement of

Chris Edwards
Director of Tax Policy Studies, Cato Institute

before the
United States Senate, Committee on the Budget

regarding
The State of the Economy and the Budget

September 28, 2006

Mr. Chairman and members of the committee, thank you for inviting me to testify today on the economic and budget situation. The U.S. economy is continuing its solid expansion, and we appear to be in the middle of a long boom, as the nation enjoyed during the 1980s and 1990s. I suspect that much of the good economic performance of recent years has little to do with the actions of federal policymakers. Instead, the activities of America's entrepreneurs, continued advances in technology, and the dynamism of global markets are the main drivers of U.S. economic growth and job creation.

However, federal spending, tax levels, and the tax structure play important roles in aiding or impeding growth. I will discuss some of the relationships between fiscal policy and growth in light of recent tax and budget developments.

Background: The Cost of Federal Spending

To support its large budget, the federal government will extract $2.4 trillion in taxes and about $300 billion in borrowed funds from families, businesses, and investors in fiscal 2006. That extraction transfers resources from the more productive private sector to the generally less productive government sector of the economy. Many studies have shown that, all else equal, the larger the government's share of the economy, the slower economic growth will be.[1]

It is clear that a larger federal budget results in slower growth when you consider that a big share of spending is aimed at "social" goals, not at spurring growth. Indeed, 50 percent of the federal budget goes to transfers, which are typically justified on "fairness" grounds, not economic grounds.[2] For example, the largest federal program, Social Security, has a negative impact on growth the way it is currently structured. People may support the current Social Security system for non-economic reasons, but economists believe that its pay-as-you-go structure reduces national savings and economic growth.

An additional problem is that extracting the taxes needed to support federal spending is a complex and economically damaging process. As a result, substantially more than one dollar of private activities are displaced for every added dollar of spending. Those added costs are called "deadweight losses," which are inefficiencies created by distortions to working, investment, and entrepreneurship. Those distortions reduce the nation's standard of living

The Congressional Budget Office found that "typical estimates of the economic [deadweight] cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised."[3] Studies by

Harvard's Martin Feldstein have found that deadweight losses are even larger. He noted that "the deadweight burden caused by incremental taxation … 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."[4]

What this means is that the large increases in federal spending of recent years will create a substantial toll on the economy because current or future taxes will be higher than otherwise to fund the expansion. There is no free lunch on the spending side of the federal budget, but we can minimize the damage of raising federal funds by continuing to reform the most distortionary aspects of the income tax system.

Tax Cuts and Deficits

Policymakers opposed to recent tax cuts have argued that tax cuts that are "financed by deficits" don't do much good for the economy. It is true that recent tax cuts have not benefited the economy as much as they would have if they had been matched by spending cuts.[5] To the extent that recent tax cuts have added to federal deficits, a burden is imposed on future taxpayers (assuming that federal spending is not affected).[6]

However, there is a crucial point to consider with regard to the debate over recent tax cuts and budget deficits—***not all tax cuts are created equal***. Tax cuts that reduce the worst distortions in the tax code will spur economic growth and will not create as large a revenue loss as static calculations suggest. Such high-value tax cuts represent long-term reforms to the federal fiscal system that should be implemented regardless of the current budget balance. By contrast, further tax reductions that do not simplify the tax code or make it more efficient should be avoided, or at least not considered unless they are matched by equal spending cuts.

Here are some general rules to use in maximizing the pro-growth benefits of tax cuts:

- Reduce the highest marginal tax rates because those rates create the largest deadweight losses. High marginal tax rates exacerbate every distortion in the tax code. A flatter tax structure with lower rates would be much more efficient than today's graduated, or "progressive," structure.[7]

- Reduce taxes on the most mobile tax bases because that would create the largest increase in productive activities and the largest reduction in tax avoidance. Capital, in particular, is becoming increasingly mobile in today's competitive global economy.

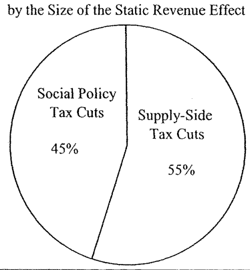
- Reduce taxes on savings and investment. That would increase the nation's capital stock, boost productivity, and raise worker wages. Simulations by Harvard's Dale Jorgenson and Kun-Young Yun found that the potential welfare gains from replacing current income taxes with consumption-based taxes is "very large" at more than $2 trillion.[8]

Numerous studies have found that tax cuts on capital income are particularly beneficial to the economy. A 2005 Joint Committee on Taxation study presented the results of a macroeconomic simulation of hypothetical personal and corporate income tax cuts.[9] They found that a corporate tax rate cut (matched by spending cuts) boosted U.S. output twice as much in the long run as an individual rate cut of the same dollar magnitude.

Tax cuts that reduce tax code inefficiencies and spur growth are called "supply-side" tax cuts. Tax cuts that are not aimed at spurring growth can be called "social policy" tax cuts.

Federal tax legislation since 2001 has been a mix of supply-side and social policy cuts. Figure 1 shows that about 55 percent of recent tax cuts have been supply-side tax cuts, including the reductions in individual rates, the dividend and capital gains tax cuts, small business expensing, and the liberalization of savings accounts. The other 45 percent of recent tax cuts have been social policy tax cuts, including the new 10 percent income tax bracket, the expansion of the child tax credit, and various education tax benefits.[10]

Figure 1. Tax Cuts Enacted in 2001 and 2003 by the Size of the Static Revenue Effect



Source: Chris Edwards, Cato Institute, based on OMB estimates for fiscal years 2012-2016. Supply-side tax cuts include individual rate cuts (except the 10 percent bracket), dividend and capital gains tax cuts, small business expensing, and savings vehicle liberalization. Social policy tax cuts include the child tax credit, marriage penalty relief, education incentives, and other cuts.

The economic impact of recent social policy tax cuts, if combined with higher deficits, is mixed at best because those cuts generally do not reduce the deadweight losses of the tax system. By contrast, supply-side tax cuts boost long-term economic growth.[11] The dividend and capital gains tax cuts of 2003, for example, have helped to reduce long-recognized distortions caused by the double taxation of corporate equity. The markets have responded strongly to the dividend and capital gains cuts, indicating that the prior high rates were creating substantial distortions.

The average per-share dividend payout for corporations in the Standard & Poor's 500 has increased 50 percent since the tax cut passed in early 2003.[12] Meanwhile, the Standard & Poor's 500 stock market index soared by more than 20 percent in the year following the 2003 cuts. Also note that capital gains tax receipts have risen from about $50 billion annually in 2003 to more than $80 billion this year, despite the rate cut from 20 to 15 percent.[13] Of course, dividend payouts and capital gains realizations are partly on the rise due to the economic expansion, but the strong positive effects we have seen makes it tough to argue that these cuts are not contributing to current growth.

Recent supply-side tax changes have also included individual rate cuts. Cutting the top income tax rate from 40 to 35 percent was particularly good policy because the top end is where the largest efficiency gains can be achieved.[14] Those in the top brackets have the most flexibility in adjusting their taxable income, and their actions create substantial impacts on the economy.[15] People with high incomes often have unique talents as executives, surgeons, entrepreneurs, and other high-value occupations. About three-quarters of the top 1 percent of federal taxpayers report small business income.[16] Numerous studies have found that marginal tax rate changes have substantial effects on small business hiring and investment.[17] Note that the bipartisan Tax Reform Act of 1986 reduced the top marginal rate to just 28 percent. Thus, recent tax cuts have moved in the right direction, but have not fully reversed the rate increases passed in 1990 and 1993.

In addition to extending recent supply-side tax cuts on the individual side, Congress should reduce the excessively high U.S. corporate tax rate. Many countries have cut their corporate tax rates in recent years to attract foreign investment and promote growth. The average top corporate tax rate across the 25 countries of the European Union is 27 percent, which compares to the U.S. federal and average state rate of 40 percent.[18] In today's competitive global economy, policymakers need to respond to foreign reforms and cut U.S. income tax rates.

Spending Increases, Not Tax Cuts, Are the Problem

Have tax cuts or spending increases caused today's large budget deficits? Federal outlays have increased from $1.9 trillion in fiscal 2001 to $2.7 trillion by fiscal 2006, an increase of $800 billion. By contrast, the tax cuts enacted in 2001 and 2003 have reduced federal revenues by roughly $200 billion this year.[19] Thus, recent spending increases are four times more important in explaining the current budget deficit than are recent tax cuts.[20]

Another way to think about recent tax cuts is that they have helped reverse the large tax increases of 1990 and 1993. CBO data shows that those tax increases increased federal revenues by a combined 1.1 percent of GDP over the first five years after each was enacted. The 2001 and 2003 tax cuts reduced revenues by a similar magnitude of 1.2 percent of GDP over the first five years after each was enacted.[21]

Looking ahead, Congress should extend the supply-side tax cuts of recent years beyond the current 2010 expiration.[22] To allay fears about the effects of tax extensions on the deficit, Congress should set a goal of eliminating the deficit with spending cuts by 2011. After all, "American citizens are not under-taxed by their government, rather the government spends too much," as Senator Judd Gregg (R-NH) recognized in his "Stop Over Spending Act of 2006" (S. 3521).[23] The country faces a huge entitlement crunch in the future, but the government is spending too much right now, as Senator Gregg notes. Cutting unwarranted spending will free up space for extending supply-side tax cuts and dealing with the entitlement problem.

Regardless of whether or not one supports recent tax cuts, it is clear that there are gigantic long-term fiscal problems on the spending side of the budget. The Government Accountability Office has projected a long-range business-as-usual scenario for the budget.[24] The projections assume that entitlement programs are not reformed, and that other programs and taxes stay at the same size as today relative to GDP. Under that scenario, federal spending would grow from 20 percent of GDP today to a staggering 45 percent of GDP by 2040. Such a European-sized government would bring with it slow growth, lower wages, a lack of opportunities, and many other pathologies.

Unfortunately, the long-term fiscal situation could be even worse than that. The GAO's "static" estimates ignore the economic death spiral that would occur if taxes were raised in an attempt to fund higher spending. Higher taxes would result in greater tax avoidance, slower growth, less reported income, and thus less than expected tax revenue, perhaps prompting policymakers to jack up tax rates even higher.

Consider Social Security and Medicare Part A, which are funded by the federal payroll tax. On a static basis, the cost of these two programs as a share of taxable wages is projected to rise from 14 percent in 2005 to 25 percent in 2040.[25] But as tax rates rise, the tax base will shrink. To get the money it would need to pay for rising benefits, and taking into account this dynamic effect, the government would have to hike the payroll tax rate to about 30 percent by 2040.[26] That would be a crushing blow to working Americans, who would have to pay this tax in addition to all the other federal and state taxes they pay.

Note that on top of these federal costs, state and local governments are also imposing large and unfunded obligations on future generations. State and local governments have rapidly rising levels of bond debt, and they have unfunded costs for their workers' pension and health plans that could total more than $2 trillion.[27]

Reform Options

These figures suggest a bleak fiscal future awaiting young Americans and taxpayers without major reforms. There are many actions that should be taken right away to reduce deficits and unfunded obligations.

- Social Security should be cut by indexing future initial benefits to the growth in prices rather than wages.

- Medicare deductibles and premiums should be increased. Those changes could be phased-in over time, but it is important to get the needed cuts signed into law to reduce the exposure of taxpayers.

- Medicaid should be block-granted and the federal contribution to the program restrained or cut. This was the successful strategy behind the 1996 welfare reform.

- Federalism should be revived and federal aid to the states cut sharply. Aid to the states does not make any economic sense. It has been a bastion of "pork" spending, and it has created massive bureaucracies at all three levels of government. With the coming entitlement crunch, the federal government simply cannot afford to be Santa Claus to the states any longer.

Of course, such cuts are politically difficult for Congress to make. That is why new budgeting structures are needed to get a handle on rising spending and deficits. Considering that federal outlays have increased 45 percent in the last five years and the government has run deficits in 33 of the last 37 years, it is obvious that current budget rules are not working very well.

That is why I applaud Senator Gregg for his budget reform proposals in the Stop Over Spending Act of 2006 (S. 3521).[28] The Act contains new rules to control deficits, restrain entitlement spending, cap discretionary spending, limit "emergency" spending, and create a commission to eliminate waste in federal programs.

Sadly, imposing such sensible budget reforms has drawn opposition.[29] Some people argue that new budget restrictions are not needed because Congress has the power to restrain spending anytime it wants. But political scientists have long recognized that the self-interested actions of individual policymakers often lead to overall legislative outcomes that undermine the general welfare. Indeed, frequent statements by many policymakers make it clear that their top priority is to target spending to interests in their states, not to legislate in the national interest. If left to their own devices, many members become activists for narrow causes, while broader concerns such as the size of the federal debt are ignored.

New and improved federal budget rules are needed to channel the energies of members into reforms that are in the interests of average citizens and taxpayers. Without tight budget rules, Capitol Hill descends into an "every man for himself" spending stampede—a budget anarchy that creates unsustainable budget expansion and soaring deficits. That is why there have been numerous, and often bipartisan, efforts to create new budget procedures, such the 1974 Budget Act, the 1985 Gramm-Rudman-Hollings Act, and the 1990 Budget Enforcement Act.

Senator Gregg's bill, S. 3521, simply proposes to add restraints to the federal budget that are common in the 50 states.[30] Virtually all the states have statutory or constitutional requirements to balance their budgets. Governors in 42 states have line-item veto authority. Most state constitutions include limitations on government debt. A number of states have commissions similar to the "CARFA" proposed in S. 3521, which would reevaluate spending programs at regular intervals.[31] More than half the states have some form of overall tax and expenditure limitation (TEL).[32] Also, the states are fiscally constrained by the need to prevent their bond ratings from falling.

Capping Total Federal Spending

Senator Gregg's proposals are an excellent starting point for discussing budget reforms, but Congress should also consider a more comprehensive budget control idea. That is to impose a statutory cap on the annual growth in total federal outlays, including discretionary and entitlement spending.[33] Deficits are a byproduct of the overspending problem, and such a cap would target that core problem directly. The basic principle of a budget growth cap is that the government should live within constraints, as average families do, and not consume an increasing share of the nation's output.

Prior budget control efforts have imposed caps on discretionary spending, but not entitlement spending. Yet the rapid growth in entitlement spending may cause a major budget crisis, and thus should be included under any cap. There has been interest in capping entitlements in the past. In 1992, the bipartisan Strengthening of America Commission, headed by Sens. Sam Nunn (D-GA) and Pete Domenici (R-NM), proposed capping all non-Social Security entitlement spending at the growth rate of inflation plus the number of beneficiaries in programs.[34] The Entitlement Control Act of 1994 (H.R. 4593) introduced by Rep. Charles Stenholm (D-TX) would have capped the growth in all entitlement programs to inflation plus one percent plus the number of beneficiaries. Both of those proposals included procedures for sequestering entitlement spending with broad cuts if the caps were breached.

A simple way to structure a cap is to limit annual spending growth to the growth in an economic indicator such as personal income. Another possible cap is the sum of population growth plus inflation. In that case, if population grew at 1 percent and inflation was 3 percent, then federal spending could grow at most by 4 percent. That is the limit used in Colorado's successful "TABOR" budget law. Whichever indicator is used should be smoothed by averaging it over about five years.

An interesting alternative would be to simply cap total federal spending growth at a fixed percentage, such as four percent. That would make it easy for Congress to plan ahead in budgeting, and would prevent efforts to change caps by fudging estimates of economic indicators. Another interesting advantage of a fixed percentage cap is that it would provide an incentive for Congress to support a low inflation policy by the Federal Reserve Board.

With a spending cap in place, Congress would pass annual budget resolutions making sure that discretionary and entitlement spending was projected to fit under the cap for upcoming years. Reconciliation instructions could be included to reduce entitlement spending to fit under the cap for the current budget year and to reduce out-year spending to fit under projected future caps. Thus, as under Senator Gregg's bill, such a spending cap would utilize regular reconciliation bills to reduce excess growth in entitlement programs.

The Office of Management and Budget would provide regular updates regarding whether spending is likely to breach the annual cap, and Congress could take corrective actions as needed. If a session ended and the OMB determined that outlays were still above the cap, the president would be required to cut, or sequester, spending across the board by the amount needed. The GRH and the BEA included sequester mechanisms that covered only portions of the defense, nondefense, and entitlement budgets. A broader sequester, as under Senator Gregg's bill, would be a better approach.

A shortcoming of a statutory spending cap and other budget rules is that Congress would always have the option of rewriting the law if it didn't want to comply. But a cap on overall spending would be a very simple and high-profile symbol of restraint for supporters in Congress and the public to rally around and defend. An overall cap on spending growth of, say, four percent is easy to understand, and watchdog groups would keep the public informed about any cheating by policymakers. Over time, public awareness and budgetary tradition would aid in the enforcement of a cap.

Conclusion

Federal policymakers need a change in mindset and tougher budget rules to ward off large tax hikes as entitlement costs soar in future years. To extend the recent tax cuts and ensure continued strong economic growth, policymakers need to scour the budget for programs and agencies to cut.[35] The proposed rules in Senator Gregg's bill (S. 3521), or a growth cap on total spending, should be part of the solution to get the budget under control. Clearly, current budget rules have not worked very well, and we should experiment with new rules to try and get a grip on the overspending problem.

Thank you for holding these important hearings. I look forward to working with the committee on its agenda for federal budget reform.

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[1] See James Gwartney and Robert Lawson, "Economic Freedom of the World: 2004 Annual Report," Fraser Institute, 2004, and see James Gwartney and Robert Lawson, "Economic Freedom of the World: 2005 Annual Report," Fraser Institute, 2005. For a summary of academic studies, see Daniel J.

Mitchell, "The Impact of Government Spending on Economic Growth," Heritage Foundation, March 15, 2005. To state this relationship more precisely, if the government increases its share of the economy beyond a certain modest level of about 15 percent, then growth begins to suffer.

[2] Transfers are 50 percent of total program outlays (outlays excluding interest). See Chris Edwards "How to Spend $2.8 Trillion," Cato Institute Tax & Budget Bulletin no. 39, August 2006.

[3] Congressional Budget Office, "Budget Options," February 2001, p. 381. For a general discussion, see Chris Edwards, "Economic Benefits of Personal Income Tax Rate Reductions," U.S. Congress, Joint Economic Committee, April 2001. See also William Niskanen, "The Economic Burden of Taxation," presented at a conference at the Federal Reserve Bank of Dallas, Texas, October 22-23, 2003.

[4] Martin Feldstein, "How Big Should Government Be?" *National Tax Journal*, Volume 50, no. 2, June 1997, pp. 197-213.

[5] Tax cuts matched by spending cuts produce much stronger growth effects in the long run. See the various simulations in Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," JCX-4-05, March 1, 2005.

[6] If higher deficits create a "starve the beast" effect resulting in lower spending, then tax cuts now will not lead to equally large tax increases later.

[7] For estimates, see Dale Jorgenson and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, MA: MIT Press, 2001).

[8] Jorgenson and Yun, p. 280.

[9] Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," JCX-4-05, March 1, 2005.

[10] Based on the dollar values of extending the cuts between 2012 and 2016. See Office of Management and Budget, *Midsession Review Fiscal Year 2007*, July 11, 2006, Table S-6. The estate tax is not included.

[11] For example, see Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," JCX-4-05, March 1, 2005.

[12] Data from Standard and Poor's Investment Services, www.standardandpoors.com/indices.

[13] CBO, "The Budget and Economic Outlook, Fiscal Years 2007 to 2016," January 2006, p. 92.

[14] See Emmanuel Saez and Jonathan Gruber, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research, Working Paper no. 7512, January 2000. Saez and Gruber found that the elasticity of taxable income for those earning less than $100,000 was only as third as large as for those earning more than $100,000.

[15] The magnitude of economic benefits from tax rate cuts can be estimated by looking at the increase in the size of the tax base. In particular, the change in compensated taxable income determines the magnitude of the change in deadweight losses. See Martin Feldstein, "The Effect of Taxes on Efficiency and Growth," *Tax Notes*, May 8, 2006, p. 679.

[16] Scott Hodge and Scott Moody, "Wealthy Americans and Business Activity," Special Report no. 131, Tax Foundation, August 2004.

[17] See the following National Bureau of Economic Research papers by Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen: "Entrepreneurs, Income Taxes, and Investment," NBER Working Paper 6374, January 1998; "Income Taxes and Entrepreneurs' Use of Labor," NBER Working Paper 6578, May 2000; and "Personal Income Taxes and the Growth of Small Firms," NBER Working Paper 7980, October 2000.

[18] Chris Edwards, "Catching Up to Global Tax Reforms," Cato Institute Tax & Budget Bulletin no. 28, November 2005.

[19] Based on CBO's estimate of the revenue loss from EGTRRA and JGTRRA in fiscal 2012 as a share of GDP, then applied to GDP in fiscal 2006. I have not included the alternative minimum tax.

[20] Note that this estimate of federal revenue losses is on a static basis. The actual loss is likely to be smaller because of the positive economic effects of the cuts.

[21] Chris Edwards, "Social Policy, Supply-Side, and Fundamental Reform: Republican Tax Policy, 1994 to 2004," *Tax Notes*, November 1, 2004, p. 691.
[22] In addition, Congress should use the revenue from expiring social policy tax cuts for additional supply-side tax cuts, such as reducing the corporate tax rate.
[23] U.S. Senate, Committee on the Budget, "The Stop Over Spending Act of 2006," Senate Report 109-283, July 14, 2006, p. 3.
[24] Government Accountability Office, "21st Century Challenges: Reexamining the Base of the Federal Government," GAO-05-325SP, February 2005, Figure 2, p. 8.
[25] *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds* (Washington: Government Printing Office, April 5, 2005), p. 166. These are the intermediate assumptions.
[26] Estimate based on Martin Feldstein, "Prefunding Medicare," National Bureau of Economic Research, Working Paper no. 6917, January 1999, p. 4.
[27] Chris Edwards and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: $1.4 Trillion," Cato Institute Tax & Budget Bulletin, September 2006.
[28] U.S. Senate, Committee on the Budget, "The Stop Over Spending Act of 2006," Senate Report 109-283, July 14, 2006.
[29] Ibid., p. 61, for comments by Senator Kent Conrad (D-ND).
[30] For background on state budget processes, see National Association of State Budget Officers, "Budget Processes in the States," January 2002.
[31] Chris Edwards, "Sunsetting to Reform and Abolish Federal Agencies," Cato Institute Tax & Budget Bulletin no. 6, May 2002.
[32] Michael New, "Limiting Government through Direct Democracy," Cato Institute Policy Analysis no. 420, December 13, 2001.
[33] For background, see Chris Edwards, "Capping Federal Spending," Cato Institute Tax & Budget Bulletin no. 32, March 2006. Also see Brian Riedl, "Restrain Runaway Spending with a Federal Taxpayers' Bill of Rights," Heritage Foundation, August 27, 2004.
[34] The commission was sponsored by the Center for Strategic and International Studies.
[35] For detailed discussion of federal programs that should be cut, see Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, 2005), www.downsizinggovernment.com.

Senator GREGG. Thank you, Mr. Edwards. I appreciate those comments.

Dr. ORSZAG.

STATEMENT OF PETER ORSZAG, DEPUTY DIRECTOR OF ECONOMIC STUDIES, BROOKINGS INSTITUTION

Mr. ORSZAG. Thank you, Mr. Chairman and Members of the Committee.

Today as a Nation, we are neither paying our way nor investing sufficiently in our workers. The Nation's net national saving rate is hovering around 2 percent of national income. I would say there is no good outcome that comes from the world's leading economic power only saving 2 percent of its income. It means that we either only invest 2 percent of our income, which will starve workers in the future of the productive capital that they need to have higher wages, or it means that we borrow the difference from foreigners, which is increasingly what we are doing. That, however, is not a free lunch. We owe the money back. We are mortgaging our future income by borrowing such massive amounts from foreigners. Roughly half of the public debt now is owned abroad.

The second problem is stagnant real income and more risk for middle class families. Family incomes are basically flat. If you look at the consumer expenditure survey itself, which Dr. Hassett already mentioned, and just look at consumption levels in that survey, consumption levels for the middle quintile are also flat. Across a wide variety of indicators, outcomes for middle class families look like since 2000 they are basically stagnant.

At the same time, families face increased income risk. The probability of a 50 percent decline in income over a 2-year period has more than doubled since the early 1970's. So middle class families and lower income families are facing both stagnant real incomes and increased risk, and we need to address that problem too.

Unfortunately, the tax cuts have exacerbated both problems. By 2015, they will have contributed roughly $5 trillion to the Nation's debt. That is 25 percent of our GDP, and ultimately because the tax cuts have to be paid for, they will reduce real incomes for the vast majority of families, more than three-quarters of families, once you take into account the necessary spending reductions or other revenue increases to offset the cost of the tax cuts.

But everyone says, Well, maybe those costs are worth it because the tax cuts boost growth, and it is true that in the short run, they have had some modest effect on economic performance, but we could have gotten that same kick much more cheaply if we had pursued other policies; and, more importantly, over the long term, the vast bulk of the studies suggest that because the tax cuts are deficit financed and because they were not particularly well designed to promote economic growth, their long-term impact on the economy is negative, not positive.

So we have both problems being exacerbated. Ultimately, the tax cuts increase national debt, reduce national saving, impair long-term economic performance, reduce incomes for most families, and also reduce after-tax income volatility, which families are also struggling with. So what should we do instead of that approach? And I think Senator Alexander actually touched upon it. There is a better way in which we invest in education, research, technology, and increase national saving.

The basic alternative view in which the way to promote economic growth, broad-based participation in that growth, and improved economic security is the basis for a new project at Brookings that I direct called the ”Hamilton Project“ where we are putting out a lot of ideas about exactly how to go about doing that.

So what do we need to do? First, increase national saving, obviously, we need to get the fiscal deficit under control, because the fiscal imbalance is a major contributor to that low national saving rate that I mentioned. I am sure we will talk about ways to get the fiscal imbalance reduced. Beyond that, we need to raise personal saving, and by far, the best way to raise personal saving in the United States is to make it easier and more automatic for households to save.

I would note that there was legislation introduced yesterday that Senator Conrad was a cosponsor of, along with Senator Smith and I believe two or three other Senators on a bipartisan basis, to create an automatic IRA so that workers that go to work at firms that don't sponsor a pension plan would automatically be enrolled in an IRA. The evidence is overwhelming that these sorts of "EZ-Pass" approaches or automatic saving approaches work and we should be pursuing them much more vigorously.

In addition to that, in my written testimony, I provide another idea that I think is worthy of attention. We in the United States spend roughly $500 billion a year through the Tax Code providing incentives for health care, retirement, homeownership, and other socially beneficial activities. Almost all of that is done in the form of deductions or exclusions, which link the size of the tax break to someone's marginal tax bracket. Not only does that skew the benefits toward higher income households, but it is economically inefficient, because unless you think that high income households are more responsive to that incentive or generate larger benefits when they do respond, it doesn't make any sense to provide a larger tax break to one particular set of households than another.

In a recent paper with Fred Goldberg, who was the IRS Commission under the first President Bush, and Lily Batchelder of New York University we argued that basically all of those tax incentives should be reconsidered and done on a uniform credit basis rather than with a deduction or exclusion, which would both be fairer and more efficient, and there are very few opportunities that we face in the United States to improve both equity and efficiency, and I would urge you to seriously consider that as an approach.

So the bottom line is there is a much better way to promote economic growth than tax cuts that run up the deficit, reduce national saving, and ultimately will impair incomes for most families.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Orszag follows:]

"Promoting Fiscal Discipline and Broad-Based Economic Growth"

Testimony before the Senate Budget Committee
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Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today. To summarize my testimony, we are neither paying our way nor investing sufficiently in our workers. The nation's low saving rate and the combination of real income stagnation and increased income risk for most families represent the most pressing economic problems facing the country:

- The low saving rate, which is closely tied to the Federal budget deficit, generates massive borrowing from abroad and mortgages the future incomes of Americans.

- Stagnant income and increased income risks for middle- and low-income families threaten a backlash that could significantly reduce growth.

The 2001 and 2003 tax cuts substantially exacerbate both problems. The tax cuts increase government borrowing and reduce national saving. In addition, they widen income inequality and will ultimately reduce incomes for most middle- and low-income families, while diminishing the effectiveness of the tax system in cushioning fluctuations in after-tax income.

Proponents of the tax cuts argue that these costs are worth bearing because the tax cuts generate economic growth. The tax cuts, however, have had at best a modest positive effect on short-term economic growth—and any such positive effect could have been accomplished at lower cost through other means. Furthermore, the tax cuts will likely *reduce* economic growth over the long run. The tax cuts thus increase government debt, reduce national saving, increase income volatility, reduce incomes for most families in the long run, and impair long-term economic growth.

A much better approach to promoting economic growth involves increasing national saving and making investments in education, research, and economic security. This approach is likely to be both more effective at generating growth and more likely to result in broad-based participation in that growth. It is the basis of a new project, The Hamilton Project, at Brookings.[2]

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[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of the Brookings Institution or the members of the Advisory Council of The Hamilton Project. This testimony draws upon joint work with Lily Batchelder, Michael Deich, Bill Gale, Jon Gruber, and Tim Taylor, among others.
[2] For more information on The Hamilton Project, see www.hamiltonproject.org.

I. Economic background

The background for my testimony is provided through two sets of charts about the United States economy. The first set explores the nation's low national saving rate, its connection to the budget deficit, and its consequences. The second set examines income stagnation and volatility.

National saving and the budget deficit

The first chart shows that net national saving has declined markedly over the past five years. Although it has rebounded slightly since the beginning of this year, net national saving remains less than 3 percent of national income, roughly half the rate of the 1990s. The chart also shows the close connection between how much the Federal government saves or dissaves—that is, the surplus or deficit in the Federal budget -- and how much the nation as a whole saves. Put simply, the more the Federal government borrows, the less the nation as a whole saves. More rigorous econometric work suggests that an increase in the Federal budget deficit of 1 percent of Gross Domestic Product (GDP) reduces national saving by between 0.5 percent and 0.8 percent of GDP.[3] In other words, the deterioration in the Federal budget since 2000 can explain perhaps as much as two-thirds of the decline in net national saving over the same period.

The decline in national saving, driven mostly by the increase in the budget deficit, is triggering a massive increase in borrowing from abroad. The second figure shows net national saving and net domestic investment—that is, saving and investment minus depreciation—as a share of national income over the past two decades. As the figure indicates, net domestic investment, after climbing steadily during the late 1990s and then declining sharply in 2001 and 2002, now appears to have stabilized at approximately 8 percent of national income, roughly its level in the mid-1990s. This net domestic investment must be financed either by net national saving or borrowing from abroad. Over the past few years, it has increasingly been financed by borrowing from abroad, as net national saving has declined. The increase in borrowing from abroad is reflected in the growing current account deficit, which has increased from under 2.5 percent of national income in 1998 to more than 7 percent in 2005.

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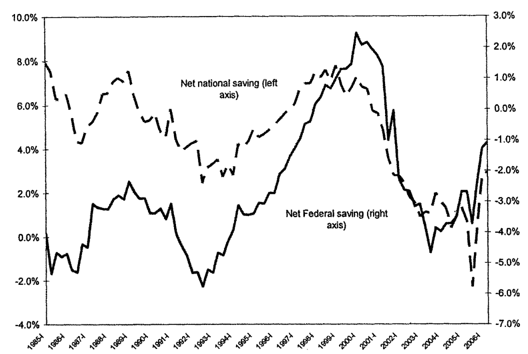
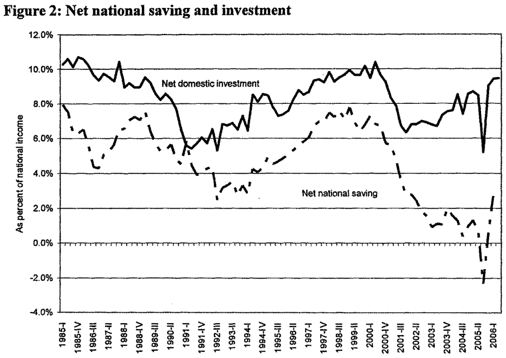
[3] William G. Gale and Peter R. Orszag, "Budget Deficits, National Saving, and Interest Rates" *Brookings Papers on Economic Activity,* no. 2 (Fall 2004), pp. 101-87.

Figure 1: The federal budget and net national saving



Source: Author's calculations based on data from the Bureau of Economic Analysis.

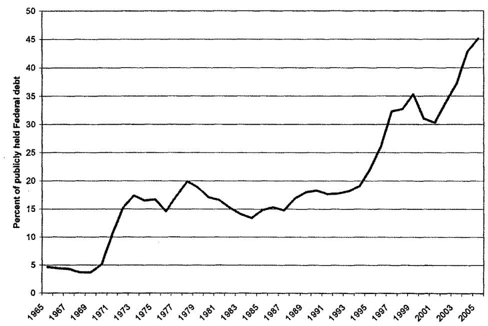
Figure 2: Net national saving and investment



Source: Author's calculations based on data from the Bureau of Economic Analysis.

The increase in borrowing from abroad is manifesting itself most prominently in foreign ownership of Federal government debt. Figure 3 shows the share of publicly held debt that is owned by foreigners. Almost half of the nation's publicly held debt is now owned by foreigners, up sharply from roughly a quarter a decade ago. The increase in the foreign share has been particularly rapid over the past few years.

Figure 3: Foreign ownership of Federal debt



Source: Department of the Treasury

Under the conventional view of deficits, which is consistent with the story told by Figures 1 through 3, ongoing budget deficits decrease national saving, which then manifests in reduced domestic investment, increased borrowing from abroad, or some combination thereof. Over the past few years, the main adjustment channel appears to have been increased borrowing from abroad. The external borrowing requires that more of the returns from the domestic capital stock accrue to foreigners over time, thereby reducing future national income, with the loss in income steadily growing. Under this mainstream view, the costs imposed by sustained deficits tend to build gradually, rather than occur suddenly. Federal Reserve Chairman Ben Bernanke recently expressed precisely this worry: "I am quite concerned about the intermediate-to-long-term federal budget outlook . . . . By holding down the growth of national saving and real capital accumulation, the prospective increase in the budget deficit will place at risk future living standards of our country."[4]

[4] Greg Ip, "Bernanke Wants Lower Deficits, Doesn't Rule Out Tax Increases," *Wall Street Journal*, sec. A, March 15, 2006, 2.

The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than the conventional analysis suggests, however. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of business and consumer confidence both at home and abroad. The unfavorable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment where deficits are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the fiscal deficit, financial markets, and the real economy.

Income stagnation and volatility

The next two figures document the second challenge facing policy-makers: that income growth has been stagnant at the same time that income volatility has increased significantly.

Figure 4 shows the pattern of growth in productivity and real median family income. Although the two series tracked each other closely between 1947 and 1973, they appear to have gotten a divorce since then. The primary reason is a substantial increase in wage inequality, with stunning increases especially at the very top of the wage distribution. According to data compiled by Emmanuel Saez and Thomas Piketty, the top 1 percent of wage earners accounted for 5.6 percent of total wages in 1975. By 2004, their share had risen to 11.2 percent. The top 0.1 percent—that is, one out of a thousand workers—accounted for 1.3 percent of aggregate wages in 1975 and 4.4 percent in 2004.[5]

The final figure shows that over the past two decades, even as macroeconomic fluctuations in GDP and unemployment have declined relative to previous decades, the volatility of family incomes has grown markedly. As Jacob Hacker of Yale University has shown, the probability that an American family will experience a drop in family income of 50 percent or more in any two-year period has doubled from 7 percent in the early 1970s to 17 percent today (see Figure 5).

[5] Table B2, http://elsa.berkeley.edu/~saez/TabFig2004prel.xls.

Figure 4: Productivity and family income

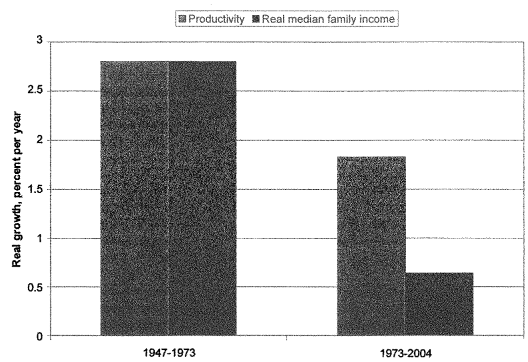
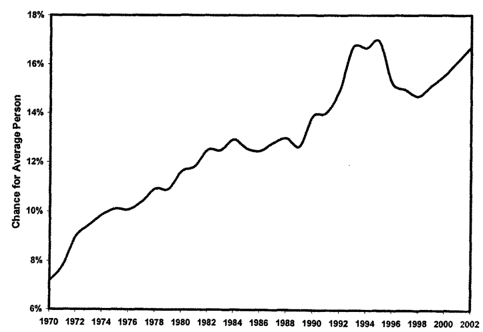


Figure 5: Predicted probability of family income decline of 50 percent or greater



Source: Calculations by Jacob Hacker based on PSID, University of Michigan; CNEF, Cornell University.

II. The role of the tax cuts

The tax cuts have exacerbated both of these problems. The revenue loss associated with the tax cuts amounts to roughly 2 percent of GDP. In 2006 alone, the tax cuts entail a budgetary cost (including additional interest on the government debt from the tax cuts since 2001) of $258 billion. It is noteworthy that the budget deficit projected by the Congressional Budget Office for this year is $260 billion. The tax cuts have clearly played a substantial role in expanding the budget deficit, which in turn (see Figure 1) has reduced national saving.

The tax cuts explain much of the deterioration in the budget outlook since the start of 2001. Roughly 70 percent of that deterioration comes from the tax cuts and spending increases, rather than from economic and technical factors outside policymakers' control. Of those policy changes, the tax cuts account for almost half the cost (Table 1). Increases in domestic spending (excluding homeland security) account for only about 6 percent of the cost of legislation enacted since the beginning of 2001.

Table 1: Deficit impact of legislation enacted since 2001

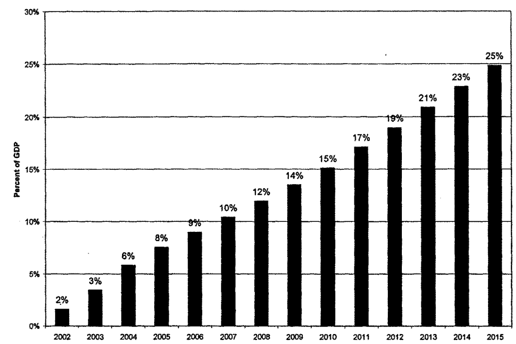
Type of legislation	*Share of legislation cost 2002-2011*
Tax cuts	49%
Defense, homeland security, international	35%
Entitlements	10%
Domestic discretionary (excluding homeland security)	6 %

Source: CBPP calculations based on Congressional Budget Office data. Assumes extension of the President's tax cuts, continuation of Alternative Minimum Tax relief, a gradual phase-down of operations in Iraq and Afghanistan, and funding of the defense requests in the President's FY 2007 budget.

If the tax cuts are extended without being offset, and are not erased over time by the Alternative Minimum Tax, they will increase the federal debt by $5 trillion in 2015, or by 25 percent of GDP in that year (see Figure 6). This additional debt reduces the capital stock owned by Americans and imposes a drag on future economic performance.

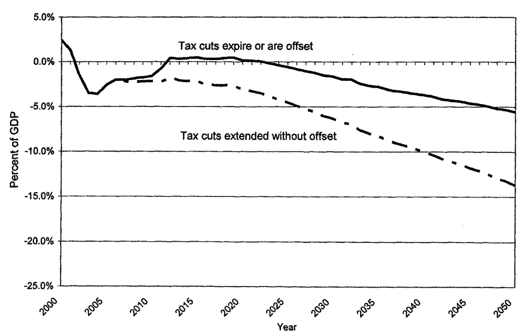
Figure 7, which is based on projections from the Center on Budget and Policy Priorities, provides further insight into the impact of extending the tax cuts (without offsetting their cost) on the budget outlook. As the figure suggests, despite the fact that the long-term problem facing the Federal budget is primarily the cost of health care, extending the tax cuts without offsetting their cost would have a material adverse effect on the budget through 2050 and beyond.

Figure 6: Additional public debt, as share of GDP, attributable to tax cuts



Source: Author's calculations based on data from CBO and Tax Policy Center.

Figure 7: Budget balance through 2050



Source: Center on Budget and Policy Priorities

The tax cuts also exacerbate the problems facing middle-class families. To measure the effects of the tax cuts across the distribution of income, I use the micro-simulation model developed at the Tax Policy Center and examine the percentage change in after-tax income. If everyone's after-tax income changes by the same percentage, the distribution of after-tax income would remain the same before and after the tax cuts.

Table 2 reports the results, using estimated figures for 2010. After-tax income rises by 0.2 percent in the bottom quintile and by 4.1 percent in the top quintile. It rises even further within the top quintile, with a 6.1 percent increase for the top 1 percent. Thus, the tax cuts raise after-tax income by a greater percentage for high-income households than for all others. Table 2 is a misleading guide to the effects of the tax cuts on most families, however. It assumes that the tax cuts need never be offset by spending reductions or other revenue increases; it can thus create the misleading impression that everyone must be better off, because the direct tax-cut benefits are included but the requisite costs in terms of spending cuts or other tax increases are ignored.

Table 2: Distributional effect of tax cuts in 2010[1]

Cash Income Percentile[2]	*Change in After-Tax Income (Percent)[3]*
Lowest Quintile	0.2
Second Quintile	1.7
Middle Quintile	2.4
Fourth Quintile	2.4
Top Quintile	4.1
All	3.4
Addendum	
80-99 Percentile	3.3
Top 1 Percent	6.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Table 3: Distributional effect of tax cuts in 2010 with equal dollar financing[1]

Cash Income Percentile[2]	*Change in After-Tax Income (Percent)[3]*
Lowest Quintile	-26.6
Second Quintile	-9.1
Middle Quintile	-4.2
Fourth Quintile	-1.6
Top Quintile	2.7
All	0.0
Addendum	
80-99 Percentile	1.4
Top 1 Percent	5.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law. Financing equals $1922 per tax unit.
(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The tax cuts must be financed in the future by some combination of tax increases and spending cuts, but at this point, it is impossible to say what specific changes will occur if the tax cuts are extended. As a result, I examine two hypothetical scenarios, which were developed in previous work with Bill Gale and others. In both scenarios, for ease of comparison, the financing is set so that the annual costs of the tax cuts would be fully paid in that same year. The first scenario assumes that each household pays the same dollar amount to finance the tax cuts. Under this scenario, each household receives a direct tax cut based on the tax cuts, but it also "pays" $1,922 per tax unit (in 2010 dollars) in some combination of reductions in benefits from government spending or increases in other taxes. Something close to this scenario could occur if the tax cuts were financed largely or entirely through spending cuts. I refer to this as "lump-sum" or "equal-dollar" financing, with results presented in Table 3.[6]

The second scenario assumes each household pays the same percentage of income to finance the tax cuts. In this case, each household receives a direct tax cut based on the Bush tax cuts, but also pays 2.6 percent of its income each year. Something close to this scenario could occur if the tax cuts were financed through a combination of spending cuts and progressive tax increases. I refer to this as "proportional financing," with results presented in Table 4.

[6] This is the equivalent of the hypothetical lump-sum tax that is used in differential incidence analysis in standard academic research, applied to tax units rather than individuals.

Table 4: Distributional effect of tax cuts in 2010 with proportional financing[1]

Cash Income Percentile[2]	*Change in After-Tax Income (Percent)[3]*
Lowest Quintile	-2.5
Second Quintile	-1.2
Middle Quintile	-0.7
Fourth Quintile	-0.9
Top Quintile	0.5
All	0.0
Addendum	
80-99 Percentile	-0.2
Top 1 Percent	2.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law. Financing equals 2.6 percent of cash income.
(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The results under both financing scenarios are similar: More than three-quarters of taxpayers are made worse off by the tax cuts. For example, under equal dollar financing, those made worse off include almost every household in the bottom 40 percent of the income distribution, 94 percent in the middle quintile, and even 80 percent in the fourth quintile. As with the results ignoring financing, the tax cuts are highly regressive; the difference is that after-tax income now actually declines for most families, rather than increasing by a smaller percentage than for high-income families.

To be sure, this analysis assumes no effect on economic growth from the tax cuts. As discussed below, however, the long-term effect of the tax cuts is unlikely to be a large positive impact on economic growth, and if anything is likely to be negative. Nonetheless, as a rough illustration, consider the effects if the tax cuts raised each component of pre-tax household income by 1 percent. This assumption is generous, since a 1 percent increase in income exceeds the potential growth effects from the tax cuts in almost all recent studies. Even the Treasury Department's central estimate, assuming that the tax cuts are offset by spending reductions, involves an increase of 0.7 percent.[7] When the offsetting spending reductions or revenue increases are properly included, most households would be worse off, even with a 1 percent increase in pre-tax cash income, than they would have been without the tax cuts.[8] *In other words, even an economic growth effect larger than the optimistic estimate projected by the Treasury*

[7] Office of Tax Analysis, U.S. Department of the Treasury, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," July 25, 2006.
[8] For equal-dollar financing, more than two-thirds of households are worse off, including almost everyone in the bottom 40 percent of the income distribution, almost 90 percent of those in the middle quintile, and a majority of those in the fourth quintile.

Department itself is not sufficient to rescue most households from being worse off if the tax cuts were made permanent, once the financing of the tax cuts is included.

The tax cuts as an example of "YOYO economics"

The tax cuts represent what Jared Bernstein has called the YOYO approach to economics—you're on your own.[9] YOYO economics emphasizes the paramount importance of individual incentives almost to the detriment of all else, while paying little attention to market failures, the reality of individual decision-making as highlighted by the growing field of behavioral economics, or even the fact that government sets the rules under which markets operate. Thus under the YOYO view of economics, the most auspicious way to boost private saving is to remove income and contribution limits on tax-preferred saving, the best way of boosting productivity is to cut taxes, and so on. Improving economic performance is simply a matter of "getting government out of the way."

In my view, YOYO economics is not only misleading and historically inaccurate. The obsession with tax cuts has led to significant budget deficits that depress national saving and expand the current account deficit. And instead of a deep respect for market forces tempered by knowledge of their limitations, the assumption that unfettered markets always produce the best of all possible outcomes in all possible situations has meant that policy has not leaned against the wind of inequality and insecurity, for to do so under the YOYO view would mean increased distortions and less growth.

The tax cuts also exacerbate the volatility of family incomes. A progressive tax system helps to smooth fluctuations in household income, because they mean that households pay a smaller portion of their income in lower-income years and a larger portion in higher-income years. Because the tax cuts make the tax code less progressive, they reduce its effectiveness as a household income stabilizer and thereby worsen the volatility highlighted in Figure 5 above.

The tax cuts and economic performance

Some defenders of the tax cuts argue that despite the increase in government debt, reduction in national saving, ultimate reduction in income for middle-class families, and reduction in income smoothing associated with the tax cuts, one should focus on the effects of the tax cuts in promoting economic growth. The tax cuts are not and have not been a particularly effective growth strategy, however. Over the long term, they are likely to *reduce* economic growth rather than increase it.

The tax cuts did provide *some* short-run economic stimulus, but that is a minimalist goal: almost any tax or spending package would have stimulated a recessionary economy to some extent. The more relevant question is whether the policies

[9] Jared Bernstein, *All Together Now: Common Sense for a Fair Economy* (Economic Policy Institute: Washington, 2005).

offered a good anti-recessionary bang for the tax cut buck. Although the tax cuts from 2001 to 2003 were well-timed to provide a short-run economic stimulus, they were poorly designed for this task. Studies consistently show that the bang for the buck of the tax cuts was relatively low, while the effect of alternative policies would have been significantly higher. In particular, a tax cut or spending increase that was aimed more at those with middle and low incomes would have provided a much larger "bang for the buck" in terms of stimulating the economy in the short-run than the Bush tax cuts did.[10]

Some proponents of the tax cuts argue that the current economic recovery shows that the tax cuts are "working." There are three flaws in this argument. The first is that much if not most of the recovery is tied to other forces, not the result of the tax cuts. The second is that there were more cost-effective mechanisms available to boost the economy in the short run. The final point is that the current recovery is actually not particularly strong, compared to previous recoveries. If the tax cuts have been so effective at spurring economic activity, and if the tax cuts are primarily responsible for the path of economic performance, one wonders why investment, labor supply, and other key indicators have not performed better. As just two examples, Figures 7 and 8 show the performance of private-sector payroll employment and of real business fixed investment during this recovery compared to previous business cycles. Both indicate that, if anything, this recovery lags behind the historical norm. Other indicators similar suggest a weak recovery.[11]

Several studies, using different methods and models, have sought to quantify the effect of the tax cuts on *long-term* economic growth. These studies have generally reached the same conclusion: Making the tax cuts permanent is likely to reduce, not increase, national income in the long term.[12] If the tax cuts are to raise economic growth over the long term, they must have a powerful enough direct effect on incentives for work, saving, and investment to overcome the drag on growth caused by higher budget deficits. The tax cuts, however, are not well-designed to provide strong incentives for additional saving, investing, and work.[13] As a result, after taking the drag from the higher budget deficits into account, the net effect from the tax cuts is likely to be a reduction in long-term growth.

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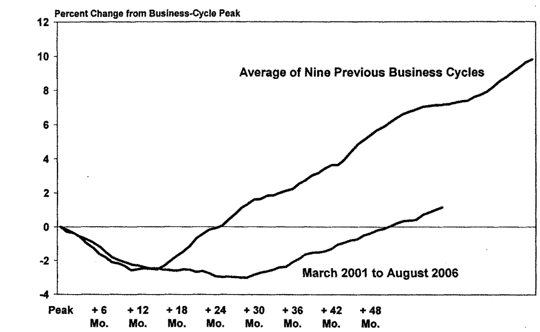
[10] See, for example, William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Short-term Stimulus," *Tax Notes,* November 1, 2004.

[11] For further discussion, see Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Does This Recovery Measure Up?" Center on Budget and Policy Priorities, August 2005.

[12] For a recent review, see Marc Labonte, "What Effects Have the Recent Tax Cuts Had on the Economy?" CRS Report for Congress, April 2006.

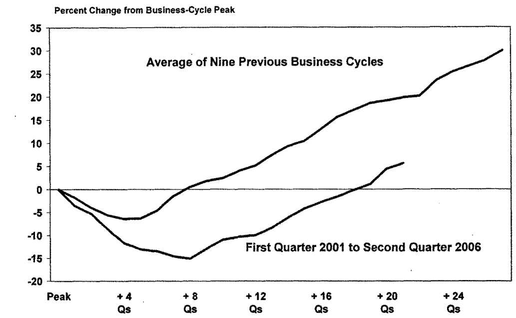
[13] Many households in the bottom half of the income distribution owe little or nothing in federal income taxes. Others higher up in the income distribution are subject to the Alternative Minimum Tax, which was only temporarily reduced by the tax cuts. As a result, a study using the tax model at the U.S. Department of the Treasury showed that the 2001 tax cut, when fully phased-in, would provide *no* reduction in marginal tax rates for 76 percent of households. Similarly, calculations using the Tax Policy Center microsimulation model indicate that, if both the 2001 and 2003 tax cuts were made permanent, 60 percent of filers, who collectively represent more than 40 percent of taxpayers and report 30 percent of all taxable income, would not see a reduction in marginal tax rates, relative to pre-2001 tax law.

Figure 7: Private-sector payroll employment for current and previous business cycles



Source: Calculations based on data from the Bureau of Economic Analysis.

Figure 8: Real business fixed investment for current and previous business cycles



Source: Calculations based on data from the Bureau of Economic Analysis.

III. An alternative growth strategy

The tax cuts increase government debt, reduce national saving, impair long-term economic growth, ultimately reduce incomes for most families, and increase income volatility. The Hamilton Project is dedicated to an alternative economic vision, one that promotes growth, broad-based participation in growth, and economic security, all of which can be mutually reinforcing.

Economic growth will ultimately be stronger and more sustainable if all individuals have the opportunity to contribute to and benefit from it. When public policy excessively favors relatively few, growth suffers because the nation misses out on much of our people's potential for innovation and productivity. For example, without a quality public education, the middle-income child is less likely to become the highly productive worker of the future; without adequate access to capital, the potentially successful moderate-income businesswoman is less likely to get her business off the ground. Furthermore, in political economy terms, excluding significant parts of the population from the fruits of economic growth also risks a backlash that can threaten prosperity.

In addition, economic security can increase economic growth. Many policymakers and analysts have been trained to believe that providing more security to families must come at the expense of economic performance and that these two goals are thus contradictory objectives. Especially over the long term, however, the traditional view misses three key points. First, a basic level of security frees people to take the risks—for example, starting a business, investing in their own education, or trying an unconventional career—that lead to economic growth. Second, if hardship does occur, some degree of assistance can provide the resources to help a family thrive again. For families experiencing short-term difficulties, a safety net can thus be a springboard to a better future. Finally, a basic level of economic security can lessen political demands for protectionism and other growth-diminishing policies. To be sure, providing too much security can harm economic growth by excessively blunting incentives to work, innovate, and invest, and some developed nations have gotten the balance wrong in this way. Policymakers must thus seek the right balance, recognizing that both the form and amount of economic security can affect economic growth and individual well-being.

Given this alternative framework, what policy changes would be beneficial? In this section, I discuss some specific steps to boost growth by increasing national saving, improving education, and strengthening economic security. The Hamilton Project will be releasing additional proposals on topics ranging from technology to health care and tax reform in the coming months.

Increase national saving

Higher national saving would reduce the current account deficit, raise future economic growth, and increase future living standards. Since national saving is equal to private saving minus the budget deficit, the key to raising it is to increase private saving and reduce the budget deficit.

The options for tackling the nation's fiscal imbalance, at least over the next decade or so, are well-known. The only real solution to the nation's fiscal imbalance is some combination of reduced spending and increased revenue. Restoring fiscal discipline will require painful adjustments, and it is unrealistic to think that the required adjustments can be undertaken entirely on one side of the budget or the other. The principal problem at this point is one of political choice and will. The combination of serious and intermediate-term deficits and longer term entitlement imbalances is so large that the regular political process seems unlikely to produce a solution. Any specific proposal is apt to be immediately and sharply attacked. Moreover, these attacks taint the proposals put forward and tend as a consequence to take them off the table. Instead, the president and the leaders of both parties in both houses need to come together in a special process.

With regard to private saving, the most important change is to make saving easier.[14] The current system is too complicated. Faced with difficult choices presented by 401(k)s and IRAs, many people simply procrastinate, which often means they don't save. You shouldn't need a Ph.D. in finance to figure out how to navigate a savings account.

[14] For more information, see www.retirementsecurityproject.org. See also William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (The Hamilton Project, Washington, DC, April 2006).

How could we make saving easier? The most promising approaches involve an automatic 401(k) for workers at firms offering pensions and an automatic IRA for other workers. The 401(k) and IRA were originally designed for retirement saving, but today both accounts can be used for a variety of purposes. They are the best saving vehicles we have, and we can make them better by automating them:

- Automatic 401(k). Under the automatic 401(k), workers would be automatically enrolled unless they chose not to participate. Their contribution rate would automatically rise over time, and their funds would be invested in a diversified, low-cost portfolio. That is, at each stage of the process, workers would enjoy pro-saving defaults, and they could always make different choices, such as opting out entirely or picking different portfolios. These changes matter. Participation rates among new low-wage workers have jumped from less than 15 percent to 80 percent when automatic enrollment is put in place. No other imaginable change boosts participation as much. The automatic 401(k) is becoming more common among employers, and Congress recently cleared away the legal issues that had been discouraging other firms from joining. So it's time for the rest of corporate America to help workers save.

- Automatic IRA. Not all employers sponsor retirement plans: In 2004, more than 71 million people worked for an employer without one. An automatic IRA would help these workers save.[15] Under this system, companies not offering a pension would have to set up direct payroll deposits to IRAs for their workers. Costs would be minimized through a no-frills design that would take advantage of payroll systems that are already in place. Again, the defaults would set workers in a "pro-saving" direction unless they opted out.

In addition to making it easier to save, it would be beneficial to replace the existing "upside down" set of tax incentives for retirement saving, which mostly subsidize asset shifting by higher-income households rather than new saving by middle- and lower-income households, with a simple 30 percent match for everyone. The result would be a stronger incentive to save for 80 percent of households.[16] New randomized evidence also suggests that transforming the incentive from a *credit* (that is, money returned to the tax filer in the form of a reduction in tax liability or a refund) into a *match* (that is, money deposited directly into the retirement account) would be more effective at inducing retirement contributions.

This approach to saving differs dramatically from the approach implied by you're-on-your-own economics. Rather than focusing saving efforts on the middle-class and on lower-wage earners, the you're-on-your-own approach would direct the bulk of new incentives toward those who already save significant amounts. One common proposal, for example, would increase the maximum amount that can be saved on a tax-

[15] J. Mark Iwry and David John, "Pursuing Universal Retirement Security Through Automatic IRAs," (Retirement Security Project, Washington, DC, February 2006).
[16] William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (The Hamilton Project, Washington, DC, April 2006).

preferred basis, such as by raising the amount that can be contributed to an IRA or a 401(k). Yet fewer than 10 percent of 401(k) participants, and about 5 percent of those eligible to contribute to IRAs, make the maximum contribution allowed by law. Simply increasing the maximum contribution amounts would have no effect on the vast majority of families and individuals who currently face no bar against making further tax-preferred contributions. Instead, raising the contribution limits would largely provide windfall gains to households that already make the maximum contributions to tax-preferred accounts and save additional amounts in other accounts. Most of the response to higher contribution limits likely would be a shifting of assets from ordinary accounts to tax-preferred accounts. The expanded tax preference thus would mostly subsidize saving that would have occurred anyway, rather than encourage new saving. As a result, if the expanded tax preferences were deficit financed (i.e., through government borrowing), the subsidies might well lead to a reduction rather than an increase in net national saving. Thus, these policies would fail to improve either household preparation for adverse economic shocks or social equity, and could even reduce net national saving.

Education

Education is an essential ingredient in broad-based growth, since it promotes both opportunity and productivity. And just as investments in physical capital carry a rate of return, investments in human capital do also. Indeed, studies suggest that the real rate of return on investments in education and training programs—in terms of the payoff to lifetime earnings relative to the up-front costs—is between 7 and 10 percent per year.

The Hamilton Project has already released two discussion papers to improve education; it will release more in the future.[17] One paper argues that teacher quality could be improved significantly by placing less emphasis on teacher credentials at the time of hiring and more emphasis on teacher effectiveness while on the job. This proposal is supported by research suggesting that qualifications such as teacher certifications provide almost no information about which applicants will prove to be the most effective teachers. Adopting the proposal would result in a larger number of teachers being hired each year—some with and some without certification—but a more rigorous filter—involving performance on the job—for those teachers to receive tenure. The other discussion paper calls for Summer Opportunity Scholarships so that economically disadvantaged children can attend summer school or a summer enrichment program. This proposal is supported by research documenting summer learning loss, in which children from disadvantaged families, who have fewer opportunities for summer enrichment, experience greater losses in skills during summer vacations than do their more advantaged counterparts; these effects tend to cumulate over many summers.

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[17] Robert Gordon, Thomas J. Kane, and Douglas O. Staiger, "Identifying Effective Teachers Using Performance on the Job," (The Hamilton Project, Washington, DC, April 2006); Molly E. Fifer and Alan B. Krueger, "Summer Opportunity Scholarships: A Proposal to Narrow the Skills Gap," (The Hamilton Project, Washington, DC, April 2006).

Economic security

Higher private saving and quality education not only bolster economic growth; they also better prepare families for periods of economic difficulty. Although greater saving and more education can improve economic security, though, they are not a panacea. It is therefore critical to devise market-friendly ways to help families and workers deal with economic difficulties. Effective programs must strike a difficult balance. As noted above, providing too little assistance not only can directly inhibit risk-taking and productivity, but also can trigger a backlash against policies that are broadly beneficial yet impose concentrated costs on specific firms or industries; at the same time, assistance must be designed to avoid creating harmfully distorting incentives that impair overall growth.

The harder cases, in which the need for balance is most critical, involve programs that provide crucial insurance but also may have significant incentive effects, such as in affecting decisions to work and save. An example is the nation's unemployment insurance (UI) system. The innovation, competition, and shifts in business practices that fuel the dynamism of the American economy also create a turbulent labor market with substantial turnover. On an average day in 2005, for example, about 3.7 million people who had lost their jobs through no fault of their own were unemployed and actively looking for work. The current unemployment insurance system helps cushion the shock of job loss and facilitate reemployment by providing limited income support for up to six months to workers who become unemployed through no fault of their own. Yet that system has not been fundamentally altered since its inception in the 1930s, and the time has come to consider changes.

The Hamilton Project has released two discussion papers that take rather different approaches to restructuring UI. Jeffrey Kling of the Brookings Institution notes that the current system offers no assistance to workers who become reemployed at a lower wage and face significantly lower lifetime earnings—which occurs for about one-third of people who take new jobs after being laid off.[18] Kling proposes a fundamental restructuring of the unemployment insurance system: Wage-loss insurance would provide long-term assistance to laid-off workers who are subsequently reemployed at lower salaries; a newly created borrowing mechanism and system of self-funded accounts would assist workers during periods of unemployment. This proposal, Kling argues, would better protect workers against the long-term effects of involuntary unemployment, better target benefits toward those who most need assistance, and encourage reemployment. Kling's budget-neutral reform would provide help to workers coping with the longer-term hardships against which they are least able to protect themselves. If adopted, the new system would cut in half—from 14 percent to 7 percent—the share of

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[18] Jeffrey R. Kling, "Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts" (The Hamilton Project, Washington, DC, September 2006).

laid-off workers with wage declines who experience very large drops in earnings at their new jobs.

An alternative approach to reforming the unemployment insurance system is described in a discussion paper by Lori Kletzer of the University of California at Santa Cruz and the Institute for International Economics and Howard Rosen of the Institute for International Economics and the Trade Adjustment Assistance Coalition.[19] Kletzer and Rosen believe that UI should remain focused on providing assistance during short-term periods of unemployment. To make UI more responsive to a labor market that has changed substantially since the program was created in 1935, Kletzer and Rosen propose three broad changes to UI. First, they would establish national standards regarding the level and duration of UI benefits, program eligibility (expanding eligibility to include part-time and seasonal workers and reentrants to the labor force), and program financing (raising the maximum federal taxable wage base). Second, they would allow self-employed workers, and perhaps others, to make a limited amount of tax-favored contributions to newly created personal unemployment accounts. Contributions would be matched by the federal government. Funds could be withdrawn later to cushion severe economic loss or to pay for training or a job search. Finally, Kletzer and Rosen propose supplementing UI with a wage-loss insurance program that would offset some of the earnings lost by those who are laid off and then reemployed at lower wages.

Both papers recognize the need to reform UI and to add a wage insurance component. A significant difference between them, though, is the relative emphasis on long-term protection against reduced wages. Kling believes that this should be the focus of a system to help displaced workers, whereas Kletzer and Rosen hold that short-term income support during the period between termination and reemployment should continue to be the mainstay of a comprehensive unemployment system. In addition, the Kling proposal would be revenue neutral, while the Kletzer-Rosen proposal would increase funding for UI and related programs.

A third discussion paper released by The Hamilton Project considers broader changes in how the nation could address economic security. Jacob S. Hacker of Yale University proposes the creation of Universal Insurance focused on providing temporary and partial relief from severe economic shocks.[20] This Universal Insurance program would be available to nearly all American families. To limit potential incentive problems and to target relief effectively, Hacker's proposal would provide only fractional and temporary insurance and would only be triggered if certain qualifying conditions were met, and if family income suddenly declined by more than 20 percent or out-of-pocket health costs exceeded 20 percent of income. Although most families would be eligible, the program would be most generous for lower-income families, which have the fewest resources of their own. Hacker estimates that his proposal would reduce by half the risk of a family income decline of 50 percent or more. He argues that this type of insurance—

[19] Lori Kletzer and Howard Rosen, "Reforming Unemployment Insurance for the Twenty-First Century Workforce," (The Hamilton Project, Washington, DC, September 2006).
[20] Jacob S. Hacker, "Universal Insurance: Enhancing Economic Security to Promote Opportunity," (The Hamilton Project, Washington, DC, September 2006).

covering a range of risks but limited to particularly dramatic cases to minimize incentive problems—is likely to provide a stronger platform for enhancing economic security in a world of rapidly changing risks than the current fragmented collection of categorical programs. As the nation struggles with the consequences of increased income volatility, this proposal should be actively debated along with other potential policy responses.

A final idea I'd like to highlight was developed by Lily Batchelder of NYU, Fred Goldberg of Skadden Arps, and me.[21] As noted above, a progressive tax system can help to smooth after-tax income volatility. We could make the tax code both more progressive and more efficient at the same time by reforming the way we provide incentives for many activities. The nation devotes roughly $500 billion a year in tax incentives to subsidizing socially beneficial activities (such as retirement saving, health care, education, and home ownership). The vast majority of these incentives take the form of deductions or exclusions, which link the size of the tax break to a household's marginal tax bracket. In the absence of evidence that high-income households are more responsive to the incentives or generate larger social benefits than low-income households, though, the subsidies should instead be delivered in the form of uniform, refundable credits, so that they do not vary by income—which would be both more efficient and more equitable than the current system. It would make the tax code more progressive, which would help to cushion fluctuations in after-tax income, at the same time as making the system more efficient.

Conclusion

The United States has many great strengths—entrepreneurship, flexibility, education, and openness to new people and new ideas—which are qualities that the world economy rewards. Without a change in course, however, the lifetime prospects of today's younger Americans will be unnecessarily and unfairly inhibited—undermining the traditional vision of ever-increasing opportunity for succeeding generations. Regardless of whether a substantial focus on marginal tax rates may have been appropriate when such rates were 70 percent or higher, that day has long passed, and therefore such a focus is no longer relevant. The time is overdue for an alternative economic growth strategy, one that is more attuned to the situation in which the nation now finds itself and that is dedicated to promoting broad-based participation in growth along with economic security. Increasing national saving, improving education, and revamping the nation's approach to economic security would all represent steps in the right direction.

[21] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford Law Review* (forthcoming). See also Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Reforming Tax Incentives into Uniform Refundable Tax Credits," Brookings Institution Policy Brief #156, August 2006.

Senator GREGG. That you, Doctor.

Senate Bunning.

Senator BUNNING. You surprised me, Mr. Chairman.

Senator GREGG. I thought I would let you start. We are going to have a vote here, and I want to make sure everybody gets a chance.

Senator BUNNING. Looking to the tax burden as a share of GDP, we see a definite trend of receipts heading back to their historical levels of about 18 percent of GDP. If we keep the tax rates where they are, then the projections are that receipts will stay near this historical range; however, if we raise taxes by allowing recent tax cuts to expire, the projections are that we will see the tax burden rise to over 20 percent of GDP.

Can you comment on what impact the tax burden of this level would have on the economy? Is, as some of our colleagues suggest, the only path to fiscal restraint a return to record levels of taxation?

I ask all of three of you that question.

Mr. EDWARDS. I would say the way to think about particularly the supply side tax cuts that have been passed in 2001 and 2003 is that they are long-term reforms that do good things for long-term growth in the U.S. economy, and the Joint Committee on Taxation study that came out last year that I cited in my testimony is a good example of that. A cut to taxes on capital income boost long-run growth even taking into account other affects, like changes in interest rates.

Something I would point out about recent tax cuts that have been about 2 percent, that account for about 2 percent of GDP, I went back and I looked at how big the tax increases in 1990 and 1993 were. You may remember that.

Senator BUNNING. Yes, I remember that.

Mr. EDWARDS. George Bush I and President Clinton both increased income tax rates, particularly at the top end. The 1993 and 1990 tax hikes are essentially a wash with the 2001 and 2003 tax cuts. They are both about 2 percent of GDP. So one way to look at recent tax cuts is that it really is getting back to where we were in the late 1980's after the 1986 Tax Reform Act. In fact, our top income tax rate is still higher than it was in 1986.

So, you know, looking at this over the long term, we don't think recent tax cuts were large in the share of GDP.

Mr. ORSZAG. Senator, what I would say is that there are obviously two main factors to take into account when evaluating the impact of that kind of change on the economy. The first is how you raise the money, and the second is what you do with it. If we raise the money in an efficient way and we use it to invest either in reducing the deficit or in things like preschool education, for example, I think the net effect would be positive. It is just the flip side of the studies suggesting that the long-term impact of the tax cuts is negative. In other words, what you ask is the flip side of a tax cut, so consider a tax cut that reduces marginal rates. It may have some benefit on the economy because it strengthens incentives to work and invest, although my view is that evidence on that suggests those effects are relatively weak, but to the extent that it is financed by a deficit, there is a drag on the economy from that deficit, and most of the studies suggest that the net effect is, if anything, negative. So you could turn that on its head to answer your question.

Senator BUNNING. We all realize if we don't do something about automatic spending increases with our Medicare, Medicaid, and Social Security, that by the year 2030, we won't have any excess money to spend for Federal Government. We will have spent everything on entitlement programs, or at least we won't be able to defend our country. Do you have any suggestions what to do as far as entitlements are concerned?

Mr. HASSETT. I guess Peter has a plan on Social Security that I am sure he will be able to talk about.

Senator BUNNING. Well, I have a lot of plans, but I can't get anywhere with them.

Mr. HASSETT. I think that the key is that it is important—the first key is to recognize that it is important to start soon, because whatever you are going to do is going to involve reducing benefits, reducing net benefits to current recipients, and the longer we give individuals a chance to plan ahead for that, the more they can change their saving today and be prepared.

I think Senator Gregg's SOS bill has some ideas about how to fold the entitlements into the real budget process, and I am quite confident that in the end, if we don't double the size of government, that we are going to end up adopting a bill that looks something like his.

Mr. ORSZAG. Senator, I think the real key here is health care. That is the major driver of the long-term fiscal imbalance. There is both a sort of problem and an opportunity. The problem is that I don't think that you are going to be able to make a significant change in the health care obligations of the Federal Government without a significant change in the rate of growth in the private sector health care also. The systems are too linked. Costs per beneficiary in public programs have tracked cost per beneficiary in the private sector over long periods of time, and the patients are being treated at the same hospitals. You can't just rip the systems apart.

The opportunity is that there are significant possibilities for restraining cost growth in health care without impairing health outcomes. For example, costs vary across the United States, different regions of the United States, for reasons that don't have anything to do with outcomes. They are not correlated with how healthy people actually are or what their responsive to health care is. It seems like it comes down to things like doctor practice norms in different regions, that in some regions, doctors order all sorts of test that aren't actually necessary. In other regions, they don't do that.

Senator BUNNING. That is called covering your backside.

Mr. ORSZAG. It is, but there are major opportunities for—basically, we are at the flat part of the health expenditure, health outcome curve. So there are major possibilities to restrain cost growth without actually hurting people and perhaps actually even helping them, and that strikes me as the most important thing for the United States to tackle in terms of getting our long-term fiscal house in order.

Senator BUNNING. That is my time, but go right ahead.

Mr. EDWARDS. I think entitlements ought to be cut and we ought to have phase-in cuts to all the major entitlement programs. I think Social Security, a simple long-term valued-added there would be to switch from wage indexing to price indexing for initial benefits. That would slowly over decades reduce benefits, which I think is a very fair thing to do. We know we have got a big problem. If you let young people know now that benefits are going to be cut in one, two, three decades down the road, they can plan ahead and save more.

On Medicaid, I think we ought to do the same thing with Medicaid that we did for welfare reform in 1996, turn it into a Federal block grant. That way, we can control the Federal contribution to the program over time. Medicare, I think the CBO Budget Options book has a number of good ideas for increasing deductibles for Medicare.

I think all these changes could be made on a progressive basis if you want some sort of bipartisan compromise. You could have progressive price indexing for Social Security benefits.

Senator BUNNING. You also realize if we mean-tested all of these programs, the weeping and gnashing of teeth we would have at these seats that are sitting up here. That would be a very good solution in every instance if you give a warning out front that this is going to happen.

Thank you all very much.

Senator GREGG. Thank you, Senator.

Senate Conrad.

Senator CONRAD. You have heard presentations that I have made here about the unsustainable nature of our current fiscal policy. I think, basically, in different words, you have all basically agreed with it, that long term, we are on a unsustainable course. Let me ask you in order, Kevin, starting with you, if I could, if you could wave a magic wand to deal with the long-term imbalances, can you just give us a couple of sentences on what you would do?

Mr. HASSETT. Thank you for the opportunity, Senator. Yes. I would take Social Security and, as Chris suggested, index it, the prices, so that, again, people have a long time to see the reduction in benefits when they retire. On health care, I think that what we need to do is move toward a system where copays and so on by participants in the program depend their usage of health care in the previous year by participants in the program. I think we need to build a kind of sense of community that when they are seeking health care as an elderly person, they are asking something of their community, something that you want to provide to others so that you don't consume more than you need.

But I think that we need to move toward a system where the health system itself is more—that the fees of it are more related to what people do so people can see the effect they have on everybody else whether they consume a lot of health care. So I would like to tie those two over time, but again, I would not want to do it overnight. We would have to move gradually toward that system.

Senator CONRAD. Chris.

Mr. EDWARDS. One way to think about what the Federal Government does is, and there has been a few major studies on this in the past, is look at who gets the benefit of Federal spending. CBO did a nice study about a decade ago that looked at who gets all the benefits of Federal Government spending in terms of income distribution. It turns out that the Federal Government does not slant its spending toward the bottom end like a lot of people think it does. The distribution spending is actually right across the board from the wealthiest to the poorest.

So I think the only way to get a good bipartisan compromise on spending cuts is cut the corporate welfare, cut the business benefit, cut benefits of Medicare, Social Security, etc. for higher income people and give people warning that benefits will likely be phased down, but it seems to me that is the type of approach we need for the long run.

Senator CONRAD. OK. Peter.

Mr. ORSZAG. Senator, I would lock you all in a room and not let you out until you had come up with a solution.

Senator GREGG. That is my bill. That is my bill.

Mr. ORSZAG. And I can go through my litany of what I think you all should do, but I think the main problem at this point is one of political will and that if you all got in a room and were not allowed out until you actually had a solution, that would make far more movement toward an answer than my trotting out all by Brookings studies.

Senator CONRAD. Let me ask you, though, if we were locked in the room and you were the only advisor allowed in, what would you recommend to us be the focus?

Mr. ORSZAG. OK.

Senator CONRAD. Where would you start?

Mr. ORSZAG. I would start with health care, in order, health care, revenue, and then Social Security, and that reflects the relative importance of various factors in contributing to the long-term deficit.

So on health care, I would be looking at ways of changing those practice norms. I would be looking at more personal responsibility, because I think that is an important component of improving health outcomes and restraining cost growth. I would be looking at preventive care. I would be looking at a whole variety of things. We don't have all the answers there.

Senator CONRAD. Let me stop you and ask you how about the chronically ill. We know that about 5 percent of Medicare beneficiaries use half of the money. It seems to me, you know, in business school, I learned to focus like a laser on that kind of statistic. How about the notion of focusing on the chronically ill to better coordinate their care as a way of saving money and getting better health care outcomes?

Mr. ORSZAG. Certainly, you know, when looking to close a budget gap, it helps to look where the money is, and that is certainly an area that would be worthy of scrutiny along with, and relatedly, long-term care. I think there is a lot more that could be done, for example, with private long-term care insurance to make that market work better also. So health care is, obviously, a big component.

On revenues, I think that we could very easily reverse at least part of the tax cut and do some other steps on an individual income side. I would replace the estate tax with an inheritance tax so that Paris Hilton could not inherit hundreds of millions of dollars tax free, and I would also re-examine the base of the corporate income tax in a world in which capital is increasingly mobile. I think there are changes that could be made to the corporate tax that would also sure up that revenue for the Federal Government.

Finally, after you have solved all of that, I would be willing to let you out of the room, but if you wanted to keep going, there are changes that could be made with regard to Social Security also.

Senator CONRAD. Would everyone agree that the long-term shortfall—this is my last question, Mr. Chairman—the long-term shortfall in Medicare is far greater than the projected shortfall in Social Security? Isn't it really like seven times as much?

Mr. EDWARDS. It is more a variable too though. For Social Security, we know with much greater certainty what the future benefit burdens are. Health care, we might be lucky. Technology might save us. We don't know for sure.

Senator CONRAD. You know, you can also make an argument that technology may increase our costs. When I look at the breaking of the genetic code and the new technology that is flowing from that, it is incredibly exciting. It extends life. It improves quality of life. It also probably is going to increase costs, at least in the short run.

I want to thank the witnesses. I thank all of you. You really are thoughtful people, and it is valuable to the committee to have you here.

Senator GREGG. Thank you, Senator.

I thank the witnesses. The points that you have made, I pretty much agree, except for a couple of yours, Dr. Orszag.

Mr. ORSZAG. Right.

Senator GREGG. But, basically, the thematic, if I could try to define the thematic statement here, it is that we have got to get control over our entitlement accounts. Getting control over our entitlement accounts is going to take discipline and it is going to take political will and it is going to take the primary area of focus on health care and how we deliver health care in this country as we move into a generation which is going to double the size of retirees.

Social Security is a very definable world. It only has like six moving parts, and they are very correctable. All we need is the political will. We know how to correct it. We change the benefit. We adjust the COLA so it is an accurately accounting to COLA and you address the fact that people are working longer, and you have basically solved the problem of Social Security.

But the issue of health care is much more complex and it gets to the question which the Senator has made, the point the Senator has made, which is you have got a very small percentage of the beneficiaries using the vast majority of the resources. You have got the technology issues. You have got the matrix, which is so complex.

I have ideas on all these areas, and I appreciate you, Doctor, mentioning my SOS bill, which basically goes to what you suggested, Doctor, which is that we should have a system here where the procedure drives the policy, where you basically do put everybody in a room, give us some ideas, and basically the people in the room would be us, and then require us to act on those ideas. So I agree with that.

But to get to a couple of philosophical points which were made here on tax policy, we have some disagreements. I am sensing that some of you or maybe all of you—in fact, you, Dr. Orszag, if I understand your position correctly, there are some tax cuts which make more sense than other tax cuts, and certainly that was the point that was made by other witnesses, that there are some tax cuts that make sense from the standpoint of growing the country's economy and creating more incentive for savings that are better than other tax cuts, and so I would like to get your thoughts as if we are going to focus on tax cuts which produce more economic activity and, as a result, produce a better economy which means more jobs, and in my opinion, more revenue. What are the tax cuts that we should be focused on and are all tax cuts the same?

I have a prejudice here. I can give you my answer, but I would be interested in your answer. Why don't we start at this end and go this way this time.

Mr. ORSZAG. Not all tax cuts are the same. I would note, though, that the context in which tax changes occur is very important. Given the very low level of national saving and given the very large fiscal imbalance that we face, it is not at all clear to me that tax cuts should be anywhere near the top of the agenda at this point, but if you wanted to focus on tax changes, what I would actually do is come back to the idea that I mentioned before, which is we are spending $500 billion a year very inefficiently through the Tax Code in providing incentives for retirement and health, homeownership, and other things that we are trying to encourage. I would significantly re-examine that entire activity.

Senator GREGG. You said go from deductions to credits.

Mr. ORSZAG. I said go from deductions to credits.

Senator GREGG. Of course, the bottom quintile of the taxpayers in this country don't actually pay any taxes. They actually get a refund. The bottom 20 percent would not be affected by that either. Just as a distributional event, it would have no affect on the bottom 20 percent.

Mr. ORSZAG. Well, for example, let us take retirement savings. On a revenue neutral basis, you could take the tax preferences for 401Ks and IRAs and transform them into a 30 percent match that went into someone's account regardless of whether they owed personal income taxes or not, and that would raise the incentive to save for over 80 percent of households and would be much more effective at actually urging new savings.

Senator GREGG. And the cost would be the same, is what you are saying.

Mr. ORSZAG. Right.

Senator GREGG. That is interesting.

Mr. EDWARDS. I agree partly with Peter. In fact, the approach taken in the two plans under President Bush's tax commission, his report that came out, I guess, last November was converting a lot of the deductions, like the mortgage interest deduction, into credits. I think that is actually a pretty good idea, using the revenue that you save to lower the tax rate. That would make the Tax Code more efficient. It would target some of these deductions and credit that the Congress likes to put into the Tax Code at the bottom end to limit their cost, and that is reasonable.

I think looking forward, the big crunches in the revenue system in the coming years are the expiration in the Bush tax cuts, the gigantic AMP problem, of course; but the third one that will become more and more and more important in the coming years is the absurdly high corporate tax rate the United States has. The data from 2005 show that the average corporate tax rate across the 25 European Union countries was 27 percent. Our Federal rate is 35 percent. Our State and local rates go up to about 10 percent in New York City.

We have got a terrible problem here. We all know we have got problems with the competitiveness of the big corporations, the automobile companies, airlines, and others. I think the corporate tax rate is really something we really have to look at. In look at Senator Kerry, when he was running for President, he had a corporate tax reform plan. So I think that really is something we need to look at going ahead. Global capital will only get more mobile. So the problem will become greater and greater over time.

Senator GREGG. We have an answer that is call New Hampshire. There are no sales or income tax.

Mr. HASSETT. Thank you, Senator. I actually agree with both Chris and Peter on their main points. I think that if you want to think about what a good tax cut is, think a good tax cut is one that will help the economy. It is something that lowers the margin rate. It is something that moves us toward a consumption tax. Right now, the place the U.S. tax policy is most out of whack with the rest of the world is the corporate tax code. Senator Kerry did recognize that and suggested a reduction in the rate. I think that a reduction in the rate that is significant is really important, because right now, our firms have an incentive to locate their activity overseas to pay a lower tax, and you can spend a gazillion dollars in enforcement to try to stop that, or you can just lower the rate a little bit so we are in line with everyone else.

I think that the kind of tax reductions that don't have an affect on the economy very often are there for other reasons, and you might still want to do them. For example, the child credit might stimulate fertility, but it is not going to stimulate the economy.

With Peter's $500 billion point, I thought that I would finish with a point of, perhaps, rare consensus which I think is worthy of note for the committee, and that is that many of these base narrowing features of the Code, like the mortgage interest deduction, don't really have their intended consequence. The mortgage interest deduction really doesn't stimulate homeownership, because the people who are going to own a home anyway are the ones who take it. So if you think that you should have a subsidy in homeownership because you want to get people in homes to build communities and make them join the school committees and so on, then you need a different animal than what we have.

So I think if we look at our Code right now, it is a mess because we have a lot of things that narrow the base that don't do what we intend, and that is really an opportunity for significant reform.

Thanks.

Senator GREGG. Thank you.

Your testimony has been excellent and very valuable, and I hope somebody will take it beyond us, because I think we are in agreement with it, and we need to convince other folks of taking advantage of it. We are in general agreement with it.

There is a vote on. So we are going to have to end this hearing. Again, thank you for taking the time. Thank you for your input. It has been superb. I appreciate it.

The hearing is adjourned.

[Whereupon, at 11:56 a.m., the hearing was adjourned.]

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