S. HRG. 109–985

AMERICA'S PUBLIC DEBT: HOW DO WE KEEP IT FROM RISING?

HEARING

BEFORE THE

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

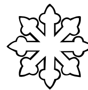
OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

SEPTEMBER 28, 2006



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

38–357—PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
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AMERICA'S PUBLIC DEBT: HOW DO WE KEEP IT FROM RISING?

THURSDAY, SEPTEMBER 28, 2006

U.S. SENATE,
SUBCOMMITTEE ON LONG-TERM
GROWTH AND DEBT REDUCTION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 3:35 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Gordon Smith (chairman of the subcommittee) presiding.

Present: Senator Bingaman.

OPENING STATEMENT OF HON. GORDON SMITH, A U.S. SENATOR FROM OREGON, CHAIRMAN, SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION, COMMITTEE ON FINANCE

Senator SMITH. Welcome, ladies and gentlemen. We appreciate your presence here today. We call to order the U.S. Senate Subcommittee on Long-Term Growth and Debt Reduction. This is the Committee on Finance.

Our topic is "America's Public Debt: How Do We Keep It From Rising?" I have found these hearings, over the last little while, always instructive, and they have helped me to produce some good legislation and good ideas that hopefully will add to our answering this question.

We are here today to discuss a topic of growing concern in America, how to solve our budget deficit problem in light of our government's long-term fiscal challenges. We have a balanced panel of experts with us today with differing views and backgrounds, and I look forward to this constructive dialogue on how best to address this looming fiscal crisis.

We recently received good news about this year's budget deficit. CBO now expects the 2006 deficit to total $260 billion. This is a $58 billion decline from last year's deficit, and $112 billion lower than CBO's March estimates.

The primary reason for this decline is increased tax revenues. Receipts from individual income and payroll taxes are projected to increase this year by $172 billion.

Furthermore, receipts from corporate income taxes are expected to grow strongly for the third consecutive year. These numbers once again demonstrate the success, I believe, of the President's tax cuts.

But by the end of 2006, we will have put back $1.2 trillion in Americans' pockets. This has resulted in a strengthened economy and increased tax revenues. The economy has created more than 1.7 million jobs over the last 12 months and more than 5.7 million jobs since August of 2003. In addition, over the first half of this year our economy grew at a 4.2 percent annual rate. This is faster than any other major industrialized nation.

However, despite recent improvements, our Nation faces a long-term fiscal—I would describe it as a structural challenge. We are about to experience a dramatic demographic shift as the baby boom generation begins to retire.

The aging of our population, combined with rapidly rising health care costs, is likely to create an ever-growing demand for resources to finance Federal spending for mandatory programs such as Social Security, Medicare, and Medicaid.

These programs, however, I think we all recognize, have had an enormously positive effect on so many Americans' lives. But we need to face the reality that they simply cannot be sustained in their current form for the long term.

Reforming our entitlement programs will become increasingly critical and must be done in a thoughtful manner so as not to hurt those Americans who rely most upon these benefits.

These reforms may require some politically difficult decisions, but I think most of my Senate colleagues realize that we must act soon to ensure that these vital retirement income and health care programs are around to serve the next generation as well.

I would like to thank our witnesses for joining us, and I look forward to your testimony. I have an opening statement from Senator Kerry that we will include in the record.

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

Senator SMITH. We welcome Senator Bingaman. Senator, your opening comments?

Senator BINGAMAN. Mr. Chairman, I will spare everybody any opening comments, and welcome the witnesses. Thank you for having the hearing.

Senator SMITH. Thank you very much.

Our witnesses today have a wealth of experience on Federal budget issues. We will hear, first, from Mr. Bob Bixby, who is the executive director of The Concord Coalition, a nonpartisan grassroots organization dedicated to educating the public about Federal budget issues and their consequence for the future. We will then hear from Peter Orszag, who is a Joseph A. Pechman senior fellow and deputy director of economic studies at The Brookings Institution. Then Chris Edwards is the director of tax policy studies at the Cato Institute. The Honorable Charles W. Stenholm is a former member of Congress who represented the 17th District of Texas in the U.S. House of Representatives. We welcome you, one and all.

Mr. Bixby, we will start with you.

STATEMENT OF ROBERT L. BIXBY, EXECUTIVE DIRECTOR, THE CONCORD COALITION, ARLINGTON, VA

Mr. BIXBY. Thank you very much, Senator Smith and Senator Bingaman. Thank you for inviting me.

My name is Bob Bixby. I am the executive director of The Concord Coalition. I am pleased to address the question of "America's Public Debt: How Do We Keep It From Rising?"

The short answer is, to keep the public debt from rising, we will need to reassert budget balance as our fiscal policy goal and make the necessary trade-offs to achieve that goal.

Budget rules can help in this regard, but they are not a substitute for political will. Moreover, no strategy for keeping the debt from rising will succeed over the long term unless we can find a way to reduce projected costs, particularly for health care.

A realistic strategy will likely require some mix of spending reductions and revenue increases, negotiated in a bipartisan process, aimed at preventing total spending, taxes, or debt from reaching levels that could reduce economic growth or harm future standards of living.

I will touch on the budget outlook, but I would also like to talk about some strategies for public engagement that I have been involved in this year, including something we call the Fiscal Wake-Up Tour, and some of the trade-offs of the broad options going forward.

In the short term, there is a budget problem. The CBO baseline has about $1.7 trillion in deficits over the next 10 years. The Concord Coalition looks at some different assumptions about war costs and extension of tax cuts and growth of discretionary spending.

Under what we think are a bit more realistic assumptions, you come out to a 10-year deficit of somewhere around $5 trillion. I have seen higher and lower estimates of that, but the basic scenario we see over the next 10 years is deficits about the size that we have now as a percentage of the economy, but drifting upward maybe to around 4 percent of GDP by the end of the 10-year period.

Then, of course, the real problems begin. As the Chairman mentioned, we have, over the long term, an unsustainable outlook. I think you can make all sorts of arguments and twists and turns over the short term, but most of us who look at the long-term budget think that we do have an unsustainable problem.

There are no easy ways to get around this. Basically we have a structural imbalance between what we are promising future generations and what we seem to be willing to pay for.

Generally speaking, taxes have been around 18 percent of GDP. If you look at spending over the long term, it is projected to drift up into the 20s, maybe even as high as 30 percent of GDP over the long term.

So we can have a debate about whether we should try to tax and spend at about 18 percent of GDP to keep the public debt from rising or whether we should tax and spend at about 25 percent of GDP to keep the public debt from rising. But we cannot tax at 18 percent of GDP and spend at 25 percent of GDP, and that is really the situation that you look at when you look over the long term.

So what we need to do is find some strategies that would reduce these spending promises, which are primarily for programs that are excellent social insurance programs for the elderly that have done so much over the years.

But when you look at the coming demographic bulge and then add on to that the fact that health care costs have been rising so much faster than the economy, and this has been a historic thing, you put these two factors together and it means that we are going to have to take some very politically difficult steps, I think, to change course.

Now, that is where the public comes in. Because these things are so difficult, because we are either going to have to reduce promised benefits, which would be politically very difficult, or raise taxes to pay for them, which would also be politically difficult, it is very important to bring the public into this discussion from day one.

So what we have been doing this year at The Concord Coalition is partnering with some people at The Brookings Institution, some people at The Heritage Foundation, the Committee for Economic Development (CED), and the Controller General, David Walker, people with diverse points of view, and going around the country doing what we call the Fiscal Wake-Up Tour. In fact, some of my colleagues are in Austin today at a Fiscal Wake-Up Tour event.

Briefly, what we try to do is explain that people from diverse perspectives understand the problem, agree on the dimension of the problem, think there are no easy options here, and we try to get the public to understand what the necessary trade-offs are. So it would help members of this committee, and others here in Congress, to make those hard choices with public understanding.

What we have found so far—and I will end with this because it is a bit of good news. I am used to spreading bad news, I am afraid, or at least warnings. The public can engage on this issue.

If you set aside the campaign-style rhetoric and just sort of look at some of these programs and understand their benefits, and then talk about how high taxes would have to go up for future generations, people are willing to look at those sort of trade-offs, but they are very distrustful, and getting over that is going to be one of the highest hurdles.

When I say "distrustful," I mean basically distrustful of government. So one of the questions that we all have to ask is, how can we win the trust of the American people so that they will make these hard choices?

But they are realistic, and I think they are grown up. The more public engagement we can do, the better. So, thank you for allowing me to testify. I look forward to your questions.

Senator SMITH. I am curious. Did they have a preferred solution? Means testing benefits, or raising taxes more?

Mr. BIXBY. They generally compromise, because that is what we try to get them to do. I mean, I have been surprised at the willingness of people, for example, to raise the eligibility age on Social Security.

They almost always want to raise the cap on the payroll tax. That is the sort of trade-off—I am just talking about Social Security here—I think they looked at as a little of one side, a little of the other side.

Now, if you just say to them, do you want the payroll tax to go up or do you want the eligibility age to go up, the immediate answer is going to be "no." But by the end of the day, they may reach a different point of view.

Senator SMITH. Thank you.

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

Senator SMITH. Dr. Orszag?

STATEMENT OF DR. PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW AND DEPUTY DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. ORSZAG. Thank you very much, Mr. Chairman and Senator Bingaman. Thank you for having me.

The Nation faces, in my view, two main problems. We are neither paying our way, nor investing adequately in our workers.

National saving is too low. In 2005, net national saving was about 1 percent of national income. It is now slightly higher, but there is no good outcome that comes from the world's leading economic power saving 1 percent of its income.

It means that we either are investing only that much in productive equipment, which robs workers in the future of the capital that they will need to be productive and earn higher wages, or it means that we borrow—and that is increasingly what we are doing—from foreigners to finance our investments at home. That, however, is not a free lunch. We are mortgaging our future income by borrowing such massive amounts from abroad.

We are already in a situation where almost half of the public debt of the United States is owned abroad. On current trends, that share will increase. It is not free money. We are increasingly indebted to the rest of the world.

The second problem that we face is that middle-class families have basically stagnant real incomes and increased income risk. The probability of a 50-percent decline in income over a 2-year period has more than doubled since the early 1970s.

The tax cuts, in my view, have made both of these problems worse. On the one hand, they have increased the budget deficit and they, over the long term, through 2015, will raise the public debt by $5 trillion, or 25 percent of GDP, thus contributing to the first problem.

The second thing is, once you take into account the fact that you need to finance the tax cuts, that is, ultimately they will have to be offset by either other revenue increases or spending reductions, they reduce income for more than 75 percent of households once that financing is taken into account, and they also reduce the effectiveness of the tax code in attenuating after-tax income fluctuations, so they actually also make that volatility or risk point worse also.

Senator SMITH. Could I ask you a question, Doctor?

Dr. ORSZAG. Sure.

Senator SMITH. And, please, I would like this to be a little bit informal so we can learn the most.

Dr. ORSZAG. That is great.

Senator SMITH. How have the tax cuts made it worse if it is increasing the revenues?

Dr. ORSZAG. I'm sorry?

Senator SMITH. How have the tax cuts made the deficit worse if we have increased revenues?

Dr. ORSZAG. Even this morning, Mr. Lazier and others from the Council of Economic Advisers indicated there is no credible evidence whatsoever that the tax cuts pay for themselves. So even under the most optimistic scenario, there is a net revenue cost to the tax cuts. They reduce revenue.

Senator SMITH. That assumes growth would be what it is without the tax cuts.

Dr. ORSZAG. Even if you take into account the most optimistic estimates of what the growth effect from the tax cuts are, they still significantly reduce revenue. The administration, for example, has said over the long run, at best, the tax cuts would raise the long-term size of the economy by 0.7 percent of GDP. The tax cuts cost a lot more than the revenue created by that extra growth. It reduces the net cost of the tax cut, even under their own numbers, by about 10 percent.

I would say most estimates suggest that over the long term, the net impact on long-term growth from the tax cuts, because they are deficit financed and that imposes a drag on the economy, will if anything be negative. So in other words, over the long term their costs might even be larger than not taking into account the impact on economic growth.

Senator SMITH. I see. All right.

Dr. ORSZAG. So if the tax cuts are not the way forward—and they are not, in my opinion—what is? There is an alternative way forward in which the goal is growth, broad-based participation in growth, and increased economic security.

That is the basis for a new project at Brookings that I direct called The Hamilton Project, where we are putting out a whole variety of ideas that are intended to promote investments in education, in economic security, and in national saving.

What, specifically, should we do? On national saving, there are two key steps. The first is, we need to increase private saving. I think the best approach there is to make saving more automatic.

I commend both you, Mr. Bingaman, and your colleagues for the legislation you introduced yesterday that would include an automatic IRA component. The evidence is overwhelming that this is by far the best thing we could do.

Inertia is a very powerful force in savings decisions, and making it easier for households to navigate the pension system is an overwhelmingly good thing. You should not need a Ph.D. in financial economics to navigate the pension system, and your legislation would go a long way towards eliminating that requirement.

Senator SMITH. We just have to get it passed now.

Dr. ORSZAG. It does need to get passed. That is the next step.

Senator SMITH. We will do that.

Dr. ORSZAG. That is your job, right?

Senator BINGAMAN. We are going to add it to the fence bill. [Laughter.]

Dr. ORSZAG. I am in favor of that.

The second thing we need to do is get our fiscal imbalance in order. There, I would make three points. The most important long-term thing that we could do is to tackle health care. Health care costs are the leading explanation for our long-term fiscal imbalance.

The second thing we need to do is shore up our revenue base. The third thing is Social Security, in that order. Health care is by far the most important, revenue second, Social Security third.

On health care, there is both a challenge and an opportunity. The challenge is that it is important to think about restraining cost growth not just for the Federal Government's programs by themselves. They are too integrated with the rest of the health care system.

Cost per beneficiary in the public programs and in the private sector have been growing at about the same rate, and it is impossible to think that you are going to solve one in isolation. So that is the challenge.

The opportunity is that the evidence suggests that there is a lot of health care spending that is not cost-effective. On average, health care spending is extraordinarily beneficial and leads to significant improvements in health. But there is a lot of health care spending that does not do that. If you think of a curve of health care spending and health care improvements, we are sort of at the flat part of that curve.

So there are significant opportunities for restraining cost growth in ways that either do not harm people or actually make them better off in terms of health outcomes. That is a very significant difference from Social Security reform.

In my view, it makes sense to try to tackle health care reform, both because it is a much bigger problem and because there is this opportunity for trying to restrain cost growth without directly harming households. That is impossible to do in Social Security, because basically it is a cash assistance/cash transfer program.

Senator SMITH. Can I explore that a little more with you?

Dr. ORSZAG. Sure.

Senator SMITH. I am from a State where we are very used to prioritizing what health care gives you the most health for the buck.

Dr. ORSZAG. Right.

Senator SMITH. I assume what you are meaning when you come to this flattening out of the benefit to health, it is usually at the end of life. Is that correct? Are you suggesting that we should assign certain numbers of kinds of health care or types of procedures that are available on Medicare and Medicaid and not get into the more expensive stuff at the end?

Dr. ORSZAG. I think the first step, before we get to that, although that may ultimately be required, is several-fold. I think we can significantly affect doctor norms and doctor practice norms in terms of what kind of tests they undertake, what kind of procedures they recommend.

There is overwhelming evidence, for example, that cost per beneficiary in Medicare and in Medicaid varies a lot across States, for reasons that have absolutely nothing to do with health outcomes.

The extra spending does not get you anything. The leading explanation is that the norm in one part of the country is just different from the norm in another part of the country for no underlying reason.

It is just, doctors talk to each other and they get into a certain practice style. Ways of trying to tackle that through practice guide-

lines, through the Institute of Medicine providing recommendations, would be a very good first step.

The other thing that I think we need to do, frankly, is ask more personal responsibility: you take care of yourself, and then we will take care of you. It does not make any sense to be providing very fancy health treatments to people who then go and do not take care of themselves at home after the treatment.

So I think those two main steps would be a significant step forward. It may not do everything that we need, and more rigorous intervention may be required.

Senator SMITH. And these ideas would be available from the Institute of Medicine and are generally accepted in the medical community and obviously would not be controversial because everybody agrees?

Dr. ORSZAG. There is significant movement towards evidence-based practices and recommendations, and the Institute of Medicine is just one body that can provide it. But I think we need easier access to professional guidelines for doctors so that they know: here is the evidence on what works and what does not.

When you are ordering Test A, Test B, and Test C that do not seem to actually yield any benefit for this kind of condition, you should be asking yourself why you are doing that.

Senator SMITH. It sounds like a really good idea. I am just trying to figure out how we would put it in legislation in ways that apply to Medicare and Medicaid that would result in the cost savings.

Those are the very kinds of ideas that have a real potential to save money and to preserve health. But obviously if you are the person who is in pain and wants something, and you do not want to be told what it costs, you want to be told how to feel better—I am anxious to learn more.

Dr. ORSZAG. If I could go on, Medicare, especially under Dr. McClellan's leadership, is starting to lean in this direction, and those are good first steps. But I think there is widespread agreement that much more could be done.

A key question is, who is reaching the decisions about what kind of information to be providing to doctors, and that is why the choice of that professional body would be very important.

The other thing I would note is that, as States move towards different types of health care reforms—for example, in Massachusetts, the Connector—that State government body that will be the backstop to the program is very likely to play this kind of role also.

It is going to be the basis for providing information about what works and what does not, and may help to set norms, at least in that State. As that model spreads to other States, that is another possibility.

While I am on the topic of health care, just briefly, I would say one other thing. This is a broader theme that I think that the Finance Committee, in particular, needs to reexamine.

We are currently spending $500 billion a year subsidizing—through the tax code, through tax incentives in the tax code—health care, retirement, home ownership, and a variety of other social goals that we want to promote.

We do it almost all in the form of deductions or exclusions—health care is in the form of exclusion, retirement is in the form

of a deduction or exclusion—which link the size of the tax break to one's marginal tax bracket.

In my view that is not only unfair, it does not make any economic sense. Unless you think that high-income households are more responsive or generate larger social benefits when they do respond than middle-income households or low-income households, it does not make any sense to provide a larger per-dollar break to one set of households than another.

So in a recent paper that was co-authored with Fred Goldberg, who was the IRS Commissioner under the first Bush administration, we argue that basically all of that should be reconsidered and redone in the form of a credit rather than a deduction or exclusion.

One could apply that to the roughly $200 billion incentive for employer-based health care, significantly raise the incentive to get health care for middle- and low-income households, while somewhat restraining it for high-income households that would probably purchase the health care anyway, and it could be done on a revenue-neutral basis.

Senator SMITH. That is it. That is good stuff.

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

Senator SMITH. Mr. Edwards?

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

Mr. EDWARDS. Thank you very much, Mr. Chairman, for inviting me to testify today, and to Senator Bingaman.

The Federal debt continues to rise, and spending growth keeps running ahead of fast-growing tax revenues in recent years.

Public debt today is about 37 percent of GDP. While the OMB and CBO baselines show a falling trend in public debt as a share of GDP, if you adjust for the Bush tax cuts, making the Bush tax cuts permanent and AMT relief permanent, which I support, public debt rises over the next 10 years to about 45 percent of GDP.

The debate over rising Federal debt usually splits between those who blame recent tax cuts and those who blame rising spending. I blame rising spending. However, those opposed to recent tax cuts argue that tax cuts that are financed by deficits do not do much for the economy. They are partly right. Recent tax cuts would have benefitted the economy even more if they had been matched by spending cuts.

But here is a crucial point: not all tax cuts are created equal. About 45 percent of recent tax cuts in 2001 and 2003 were what you can call social policy tax cuts, such as the expansion of the Child Tax Credit.

Such tax cuts do not reduce economic distortions, they do not do anything for economic growth, and all they really do is push tax burdens onto future generations if spending is unchanged.

But about 55 percent of recent tax cuts have been what you can call supply side tax cuts, including the individual rate cuts and the dividend and capital gains tax cuts.

These tax cuts do reduce distortions in the tax code. They increase the Nation's GDP. As you touched on earlier, Senator, they do not lose the Federal Government as much money as the basic static revenue estimates suggest.

So Congress should continue to pursue supply side tax reforms, in my view, targeting reforms at the worst parts of the tax code, but they should avoid further social policy tax cuts, particularly now because we have large and rising deficits.

Senator SMITH. Like child credits, and things like that.

Mr. EDWARDS. Right.

Senator SMITH. What are the other ones?

Mr. EDWARDS. Well, the other big one was the new bottom 10 percent tax bracket, which also does not generally affect the marginal incentives to work, or save, or other good things.

All it really did was, it gave a big break to a lot of folks who do not already pay taxes. It almost caused as much of a revenue loss as lowering the other rates, the 28 to 40 percent rates.

Senator SMITH. All right.

Mr. EDWARDS. Spending increases have been the real culprit, it seems to me, in rising deficits and debt. A couple of figures show how. Federal outlays have risen $800 billion in 5 years, 2001 to 2006. That is about four times greater than the revenues lost, even on a static basis, from the Bush 2001 and 2003 tax cuts of about $200 billion this year.

Also, if you compare the revenues lost in the 2001 and 2003 tax cuts, they actually just about equal the tax increases of 1990 and 1993 under Bush one and Clinton, so in a lot of ways we have just gone back to where we were in the late 1980s after the 1986 Tax Reform Act.

So regardless of whether or not you support recent tax cuts, though, it is clear, and everyone recognizes, that the government has a gigantic long-term spending problem.

The basic business as usual scenario by the GAO shows Federal outlays rising from 20 percent of GDP this year to about 45 percent by 2040. That European-sized government, it seems to me, would bring us low economic growth, lack of job opportunities, and all the other sort of pathologies we see in continental Europe.

Unfortunately, that is a bit of an optimistic scenario in a certain sense. That is because the GAO's estimates themselves are static. If Congress did try to raise taxes to match the rising entitlement spending, it would create sort of an economic death spiral where tax avoidance would increase, economic growth would fall, and Congress may try to respond and even raise tax rates higher.

So when you see some of those long-term, scary scenarios from the GAO or CBO, those are static scenarios. If we actually tried to raise taxes that much to match rising spending, we would be in big trouble.

Senator SMITH. Is that not what we see all over Europe right now?

Mr. EDWARDS. Yes. Absolutely. I mean, certainly over the last decade we have seen continental Europe grow much slower than the United States. The fast-growing countries in Asia and Eastern Europe now generally have smaller governments than in continental Europe.

Senator SMITH. And do the western European economies have a lot more tax avoidance, for example, than we do?

Mr. EDWARDS. Some, especially the southern countries in Europe, are infamous for tax avoidance, like Italy. There is no doubt that

there is a relationship between the marginal rates and tax avoidance.

Actually, to put another interesting number on that, if you look at the static sort of estimates from the Social Security Administration of the Federal payroll tax that funds Social Security and Medicare Part A, which currently is about 14 percent of taxable wages, that is expected to rise to 25 percent of taxable wages by 2040.

But estimates by Martin Feldstein at Harvard show that if you actually tried to raise the tax rate up to 25 percent, tax avoidance would increase and the government would actually have to raise the payroll tax up to 30 percent, not 25 percent, to get the revenue that it thinks it might get at 25 percent.

So, clearly, these numbers show a bleak fiscal future for young Americans. I do think we need new budgeting rules, among other changes, in Congress. I think we can look to the 50 States for guidance on changes in budget rules.

About half the States have some form of overall budget growth limitation or budget cap, which is what I proposed for the Federal budget. Colorado's constitution limits growth in the State budget to inflation plus population growth each year.

Similarly, I think Congress should put a statutory cap on the growth in total Federal outlays, discretionary and entitlement. I think the government should live within constraints that the rest of us do, and not consume any increasing share of the Nation's economy over time.

A real simple restraint, it seems to me—and it is so simple I think people have overlooked it, to an extent—is that you could put a cap on the overall Federal budget so that growth would not rise more than some fixed percentage, like 4 or 5 percent, and you could write that into law.

Senator SMITH. Is that not the Colorado model?

Mr. EDWARDS. Colorado varies by inflation and population, which may vary from year to year. What I am saying is, if you just said, look at the last 20 years. If inflation or personal income or some indicator rose by an average of, say, 5 percent a year, just say the total cannot rise more than 5 percent a year.

It would be a great planning tool for Congress. They would know exactly what they have to hit in future years. It would also be great for citizens, because it would be clear when Congress was cheating on the budget.

Some of the problem with prior budget rules, like Gramm-Rudman and some of those, is they are very complex. Average citizens do not understand them. So I think a real simple and clear cap would be a real step forward for budget transparency.

I would envision that Congress would have their annual budget resolution, the OMB and CBO could tell them where they are compared to the cap, they would include reconciliation bills to get spending under the cap, if needed. They would cap discretionary, if needed. If the session ends and we are still over the cap, the President would sequester, as has occurred under Gramm-Rudman and the Budget Enforcement Act of 1990.

Senator SMITH. Is it not true, though, that Colorado has had difficulty, even with their more flexible model?

Mr. EDWARDS. Right. The problem there was, they set their State cap on tax revenues, and tax revenues fell sharply with the recent recession. I am saying, put a cap on total Federal spending where you would not have that problem.

The problem with caps on both revenues and deficits, as under Gramm-Rudman, is they fluctuate widely and Congress has no real control over them. They depend, really, on how well the economy is doing. But Congress does directly control spending, so I think if you set a cap at 4 or 5 percent, Congress could clearly plan ahead.

So to wrap up, we obviously have huge problems here. I think we clearly need new budget rules, because the budget rules we have had recently have not worked. We have had deficits most years.

Spending is rising very rapidly. I think that Congress ought to experiment with new budget constraints. There may be new problems with new rules that they enact, but we can try again, just like we have tried with new rules in the past. So, I think we ought to experiment going forward to get the fiscal situation under control. Thanks a lot.

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

Senator SMITH. I would agree with you that not all tax cuts are created equal. The ones you identify, though, as not being equal, the child credits, the reduction of the tax credits for the bottom 10 percent, those obviously were designed to win votes, and all the things that you were talking about were only possible because we had to do some of those things. I am sure you recognize that.

Mr. EDWARDS. Absolutely.

Senator SMITH. But your budget rules idea and everything you said, I can agree with conceptually. But I have been around here for 10 years and I know how hard it is to do politically.

Would you not agree with that, Senator?

Senator BINGAMAN. I never found any difficulty. [Laughter.]

Senator SMITH. All right.

Well, thank you very much. Very informative.

Congressman Stenholm, you did not have any problems like this in the House, did you?

Representative STENHOLM. Never.

Senator SMITH. All right.

STATEMENT OF HON. CHARLES W. STENHOLM, FORMER MEMBER OF CONGRESS, WASHINGTON, DC

Representative STENHOLM. Mr. Chairman, Mr. Bingaman, it is an honor to be before you today. I am going to share with you a few ideas we gleaned over our 26 years in the House of Representatives.

In complete candor, many of the views you will hear from me contributed to me being here as a former member today rather than continuing to represent the 17th District.

I would summarize my testimony in three ways. The first thing we have to do is acknowledge we have a problem. As long as you have folks saying deficits do not really matter, which we have had now for several years, you are not going to solve the problem, be-

cause you cannot get there from here unless you agree that you have a problem.

Second, you have to stop digging the hole deeper. If you are going to start fixing the problem, the first thing you have to do is quit making it worse, which we have not been doing a good job of as of late.

Third, if you are going to get a solution, it has to be bipartisan. The only way to start that is to agree to put everything on the table and have everything be discussed, and then have some votes taken from time to time and settle it out, and go back to some of the previous suggestions you have already heard from my fellow panelists today.

The first part, as to whether we have a deficit problem or not, I was here when we went through the $1 trillion debt. I was here when we went through the $8 trillion debt. I will not be here, but you will, when we go through the $10 trillion debt. Back in the early 1980s, our debt was 25-percent owned by foreign interests.

Today our debt is 50-percent owned by foreign interests. By 2010 or 2011, foreign interests will be 60 percent of our banker. I am a farmer in real life, and I understand my banker has something to say about what we do or we do not do. That is why I think deficits do matter and why I would encourage you to begin dealing with the deficit, and dealing with it in a meaningful way.

The second recommendation is, quit digging. Here you go, a simple rule: pay-go. It worked very well in a bipartisan way in 1990, 1993, and 1997. Just agreeing that if you are going to increase spending for any worthwhile thing, you have to cut spending somewhere else or provide the revenue to pay for that which you are asking to be done.

It is very simple. If you are going to cut taxes, you have to cut spending or raise some additional revenues somewhere else. I totally agree, and most economists agree, that you do not increase revenue by cutting taxes. It just does not happen, when you take all of it.

At least, I am not smart enough to say that, but the economists that I believe in do say that. So, pay-go, and applying it to both spending and revenue, will work. It is a simple little gimmick, but it helps.

Put everything on the table. One of my clients is an organization called For Our Grandchildren, and we have been trying to work with you, in a bipartisan way, to fix Social Security for our grandchildren. We cannot get there because folks keep wanting to take everything off the table.

I remember the last debate I had in my last race, in which my opponent said at that time, “Contrary to Congressman Stenholm, I will never raise taxes on Social Security, as he did,” which was right—in 1983—“or cut benefits,” which I did.

You are not going to fix Social Security easily, in any way. There are only four things you can do: (1) raise revenue; (2) cut benefits; (3) borrow the money; and (4) grow the accounts. I happen to have come to a conclusion that you have to do all four. It is controversial. But again, it is seeing a way to get there. You have to put everything on the table.

My final point that I would like to leave, is a little idea for you. We increase the debt limit from time to time. I remember going through the $1 trillion limit, and it is always painful. But you have to do it.

Once you have spent the money, you have to increase the debt limit. But I have always objected to increasing the debt limit without doing anything to fix the problem that caused us to have to increase the debt limit. Little things like pay-go. Anything that you can do to help provoke a little bit of a discussion. I have always been in favor of doing a temporary debt ceiling.

Do it for a month or two, have a discussion in the interim, and then raise the debt limit. But at least you have had an honest debate, hopefully, of why it has to go up and why we think we have done something now in the interim that is going to keep it from going up as fast.

Then beginning to address the long-term problems, we have already had that. That is in my written testimony. But the entitlement problem, the challenge, is real. The baby boom generation is out there.

I remember first starting talking about the problems of Social Security and talking about 2008 when the baby boomers begin to turn 62. It was so far away, 26 years ago. But 2008? We are already talking about the next election in 2008.

Unless we find a way to begin dealing with the entitlement challenge—and it is a challenge, and commissions are a dime a dozen—but I strongly recommend that the 109th Congress, in the last few days, either get a commission, or the 110th Congress, that would begin to honestly put everything on the table.

It has to be truly bipartisan and it has to represent a broad range of ideas. The commission must be given a broad mandate to examine all aspects of fiscal policy, including entitlements and tax policy, and the commission should educate the public about the long-term fiscal challenges and engage the public—as Mr. Bixby has done, and is doing now, with David Walker, and others—in discussion of the potential problems to make those of you who still depend upon votes a little bit more comfortable with some of the suggestions that come out.

All policy options must be on the table. There should be no preconditions. Because if you have noticed the commissions that work, there are no pre-conditions. The ones that do not work are those that put on a pre-condition in saying you can talk about everything except X. That will never work.

The commission's recommendations should be given a broad up or down vote. The Base Closings Commission has worked very well because there is a vote on this. I would strongly recommend that you take a look at it, not as a silver bullet, but as you have already stated, Mr. Chairman, these are difficult questions.

Unless you are going to acknowledge up front that you have a problem and try to bring the public in, it is going to be very difficult to get to where you need to go.

Thank you, Mr. Chairman.

[The prepared statement of Representative Stenholm appears in the appendix.]

Senator SMITH. Charlie, I guess obviously I would defer to your many years here, but it seems to me, in my reading of history and my 10 years here, it seems like Congress only takes on these terribly difficult, politically hot issues when it has no other choice. Obviously I think we all recognize, we are not going to have a choice much longer. I was just wondering, in your calculation, when will we no longer have a choice? 2008? 2015?

Representative STENHOLM. I wish I was smart enough to tell you that, Senator.

Senator SMITH. Well, I really agree with you. Some commissions are better than others, but eventually we are going to have to have some structure to deal with these, obviously with the Congress reserving a vote, with some real smart group of people to figure out how to give us some light when we have no other choice.

Representative STENHOLM. Mr. Chairman, I would make this observation. I was known, and I guess proudly so, as a pretty bipartisan person through my 26 years, and that got me in trouble with my own party and ultimately started getting me in trouble with the other side.

But I find that all of the colleagues that I have served with, when you discuss it privately, admit we have a problem, but it is our political system that is causing more of the non-opportunity to solve the problem.

When we have the attacks every 2 years that we have had on the personal character of the members, it is difficult to sit down and then to start working on the difficult problems. I do not know what we are going to do about that.

But I do think that right after this year's election there is going to be an opportunity—and it is a small window of opportunity—that we will have. I know that I can speak for some on my side, and I can speak for some on your side of the aisle, that there are a lot of folks who are willing to do it, but we have to find the dynamics to put it together.

That is where there are some great ideas. Senator Voinovich and Congressman Frank Wolfe have a proposal. Senator Ben Nelson and Congressman John Tanner have been proposing some things.

So there are some bipartisan suggestions of how to get there in the over-simplified way that I have suggested today, but it just takes the dedication of members. Unless you have a Democrat and a Republican standing up together, you are not going to get there.

Senator SMITH. Exactly right.

Do you have some questions?

Senator BINGAMAN. Let me ask Peter Orszag to comment on any of the other testimony that he has been hearing here, but particularly, I guess, on this pay-go issue. As I understand Mr. Bixby's testimony, you favor pay-go and you think we ought to reinstate the pay-go rules that used to be in place. Certainly, Charlie Stenholm believes that.

Mr. Edwards's position is that we should not, we should have caps on spending, as I understand it.

Mr. EDWARDS. I do not support pay-go with including tax cuts because we are in a different position. In the 1990s, it was fine, but now we have tax cuts expiring in 2010 and this would tilt the playing field against extension of those tax cuts, which I do not think

is a reasonable position, because I think a lot of those tax cuts are doing very good things for the economy.

Senator BINGAMAN. Let me ask Dr. Orszag to give us his view on this discussion of pay-go.

Dr. ORSZAG. I think we should apply pay-go to both sides of the budget. There are lots of things on the spending side that do wonderful things for the economy, including investments in early education and a variety of other things.

I would say, though, that that is the least that we should do, because, of course, pay-go just basically sort of locks in the current imbalance and avoids making the hole deeper. So, unfortunately, that is just the first step. We also then need to actually start filling in the rest of the holes so we get back above ground. But I very firmly support pay-as-you-go rules on both sides of the budget.

I would say two other things with regard to some of the other questions that have already come up. First, Senator, with regard to when the crisis will hit, one can do a whole variety of projections about spending increases and deficit increases and when a critical point would be reached.

My concern is that that is a somewhat academic exercise in the following sense. We are currently in a quite dysfunctional relationship with the rest of the world. We are borrowing 7 percent of our income. I cannot guarantee you that it will fall apart, but we are running a fairly significant risk that it will fall apart.

It is a dysfunctional relationship. The thing about dysfunctional relationships is, they can go on longer than you think and then end faster than you think—-not that I have ever been in a dysfunctional relationship.

Senator SMITH. And how would it end?

Dr. ORSZAG. The way it would end, most likely, is by our foreign creditors deciding to reallocate their portfolios away from dollar-based assets. That could cause a very, very significant foreign exchange reaction, upward pressure on domestic interest rates, and basically you would then be forced to be making decisions about all these complicated questions in an environment that is fast-moving and not particularly amenable to sound choices.

I am not saying it will definitely happen, but insurance against that happening, I think, is a very strong motivation for acting sooner rather than later.

Senator SMITH. Can I ask you, because I am really trying to learn here, and I respect and value your opinion, in particular, and all of you as well; but when Charlie Stenholm began his Congressional career, the size of the American economy was roughly $4.6 trillion. In the time he served, our economy is now over $12 trillion. I do not know where they are going to go with their money if it is not here, because Europe is not going anywhere. Japan is stuck in neutral.

I guess I am really asking, how does it come to an end? We are the only game, it seems, in town at this point, with the rule of law, political stability, with an educated populace, with sort of a total mix of things. That is why I asked the question, when do we have no other choice? Because that seems to me when the stars align to do the kind of stuff Charlie is talking about.

Dr. ORSZAG. When the argument is that we might not be the ideal thing, but there is no better alternative, that is where I think we are really starting to run risk, because better alternatives spring up all the time. This actually brings me back to another question you had raised about continental Europe.

I think we need to really differentiate—and this is a direct question to where the investment portfolios can be diversified—and just in terms of economic performance, the Scandinavian countries, the northern European countries, are performing exceptionally well with a much different model.

Peter Lindert, who is an economic historian at U.C. Davis, has a new book out in which he basically shows that the reason that continental Europe has not done well is not their social insurance programs or their revenue systems, which by the way put higher emphasis on relatively efficient revenue sources like a value added tax, but rather that they have direct market interventions, hiring and firing restrictions, product market restrictions, and that is what is to be avoided.

In countries like Denmark, they have very flexible labor markets, a much different sort of attitude towards both government spending and revenue, and very strong economic performance. So I think we need to start differentiating the lessons that we learn from Europe. That was the other point I wanted to make about the earlier testimony.

With regard to a direct answer to your question, I think the most likely outcome, the most likely scenario in which this reallocation occurs, is most of those decisions are now being made by official bodies that are not motivated by relative rates of return in the sort of story that you were depicting, but rather, basically, central banks deciding where to hold their assets. They can make decisions for a whole variety of reasons that are not necessarily all market-based.

Senator SMITH. I am sorry to interrupt you.

Senator BINGAMAN. No. Let me just try to understand also. My impression is that there are attractive alternatives out there for a lot of capital, for people to put capital in.

This year is the first year, I believe, in history where China is the recipient of more direct foreign investment than the United States. I think there is a lot of money going elsewhere in the world, and there is no reason that that will not continue and accelerate in the future. I do not know if that is accurate or not.

Dr. ORSZAG. I think there are other alternatives that develop also, but the big story recently over the past 5 years is basically official entities, foreign governments and foreign central banks purchasing U.S. Government securities. That dynamic is much different. So your point just reinforces the concern, but that dynamic is a much different thing.

There is a very interesting analysis of the Suez Canal crisis from the 1950s in which, because we were a creditor to the rest of the world, we were able to put pressure on other of our allies—in particular, the UK government—in a way that we would not be able to have done if we were not basically lending them money. We are putting our Nation in the same position with regard to a whole va-

riety of forces that are not just relative attractiveness of our domestic markets.

Senator Bingaman, I would just say there are other markets that are attractive also, and especially if we do not tackle our fiscal imbalance and start investing in our workers, even the potential advantages that we do have in terms of private investors may be attenuated.

We saw yesterday a report from the World Economic Forum suggesting that our Nation was becoming much less, they used the word "competitive," mostly because of our fiscal imbalance.

Representative STENHOLM. Mr. Bingaman, on the question you asked, I want to make one point in a little disagreement with Mr. Edwards regarding the opposition to pay-go for revenue.

I have argued with my Republican friends who have taken that position in the last 5 or 6 years now, and others who have taken this position, that if you really believe in that concept, it should be very easy. You get a tax cut when you cut spending. That has been the argument about this.

It seems to be that if you really believe it and you really believe that the tax cuts had to be offset by spending cuts, get the spending cuts and have the tough vote on that. But we know the politics of that which has made that rather difficult, so we have just ignored that, and in so doing the deficits have increased alarmingly.

I know the Cato Institute has been very good at pointing out how the spending has gone up considerably in this, but it works. All I say is, when I find something that works, then I like to try it again. It is not working when you have pay-go only for spending.

Senator BINGAMAN. Let me just throw this idea out and see if this is right. It seems to me we have made it more difficult, as a practical matter, to adopt pay-go rules again because we have built into the law, both on the spending side and on the tax side, these multi-year assumptions and requirements, which we know are as phony as a 3-dollar bill.

One example is on the spending side. If you look at the projected expenditures in Medicare, the assumption built into the budget is that there is going to be a 5-percent cut, or 4.9-percent cut, or something in physician payments on the 1st of January.

I do not think that is going to happen. I do not think anybody in Congress thinks it is going to happen over the next 10 years or the next 5 years. I think we have built in something like a 40-percent cut in Medicare reimbursement as part of the baseline assumption. Now, that is a phony assumption. But if you reinstate pay-go, you would have to compensate in order to change that.

The same thing on the tax side. I mean, we write all these tax bills and they are all ready to expire because we do them a year at a time, because we know that it is irresponsible to do them long-term. So we do them a year at a time.

Like on the estate tax, you could get 95 votes here in the Senate for the idea of taking the $3.5 million exemption in the estate tax, which is going to occur, under current law, in 2009, and just keeping it there or increasing it by the cost of revenue, or something.

But to do that, under pay-go, it would cost you a lot of money because the assumption built into the law is that, in 2010, it is

going back to $650,000, or whatever the figure was, which is a totally ridiculous assumption. It is not going back to that.

Congress will not let it go back to that. But we have made it difficult, as a practical matter, for pay-go to work because of these phony assumptions we built in on the spending side and on the tax side.

I do not know. Peter, am I off base on that?

Dr. ORSZAG. Well, a couple things. One, of course pay-as-you-go rules could always be overridden. They just set a norm. So if you really had 95 votes, it would happen anyway.

But if this were the main objection to pay-as-you-go rules, you could define the baseline used for the pay-as-you-go rules in a slightly different way. I am not suggesting that, but if that were the only objection, one could at least do that so that you avoid making it worse relative to whatever you think the reasonable projection is.

Senator BINGAMAN. Right.

Dr. ORSZAG. That alone would be a significant step forward.

Senator BINGAMAN. Right. That is a good suggestion.

Yes, go ahead.

Mr. EDWARDS. Two quick points. One is the asymmetry. The tax cuts have only been enacted temporarily. Spending increases, such as the Medicare Modernization bill of a couple of years ago, of course, thrust these gigantic unfunded obligations many decades down the road into permanent law. So that is the asymmetry, it seems to me, on that.

To go back to the Chairman's question about how long can we go down the path we are going, unfortunately or fortunately, however you look at it, I think we can go a long time before there is any kind of big financial crash. The debt to GDP is 37 percent of GDP. A number of countries, Italy and Japan, have had debt-to-GDP ratios of over 100 percent in the past. That is not healthy, of course.

The United States is a much bigger economy, but the United States is becoming, slowly but surely, a relatively smaller and smaller economy in the world. The whole global pool of equities and debt is absolutely massive and growing constantly, tens of trillions of dollars.

The U.S. Government is borrowing out of a massive pool. So the problem with that is, of course, that Congress can go on being irresponsible as long as they want.

In the 1980s and 1990s, everyone, of course, up here on Capitol Hill and everywhere else was much more scared of large budget deficits, and that is why we had Ross Perot running for president, and folks like Mr. Stenholm proposing new kinds of budget rules, and the Gramm-Rudman-Hollings, and all those sorts of things.

So the problem now is, people are not scared. Members of Congress are not scared of the deficit any more because it does not seem to impact today's economic growth.

The problem with these rising deficits and debt is that it thrusts costs onto future taxpayers, and that is the cost of running these deficits now. It pushes costs onto the future, which I think we all think is unfair and immoral.

Senator SMITH. A question I have for all of you, and specifically to you, Mr. Edwards. In your book, "Downsizing the Federal Government," you talked about duplicative, wasteful, and fraudulent programs that ought to be eliminated.

I wonder if, for the record, you could name some of those. I will tell you if they are possible to cut.

Mr. EDWARDS. The interesting thing about the Federal budget, the $2.7 trillion in outlays, is a lot of folks think that the main thing the Federal Government does is sort of aid the poor and the less fortunate.

But if you look at the distribution of Federal spending, there is lots of corporate welfare. High-income people get Social Security, Medicare, and all kinds of other benefits. I think one way to move in a bipartisan fashion to cut and trim, is to cut benefits for higher-income folks.

I think putting price indexing for Social Security benefits, even in a progressive fashion, is a good idea. Congress should vote on that tomorrow. I think it could be a bipartisan agreement.

Cutting future Social Security benefits for middle- and higher-income people, phased in over decades, is very fair, I think. It gives people time to plan for the future, to save more.

Senator SMITH. Would that be better in terms of economic growth than raising their taxes now to keep them at the same level of benefit? In other words, they were promised a smaller benefit in the future but they still have the insurance policy. If they fall on hard times, they have the full benefit.

Mr. EDWARDS. Right. And if you look at Britain, what they have done is they have sort of gone to a two-tier system, where the first tier is the government-guaranteed benefit, but it is a flat benefit, which I think is fine. But on top of that, people have private accounts where they save.

So I think that sort of two-tier system where you have a flat, progressive, if you want, benefit is fine. But on top of that, give people the tax vehicle so that they can save for their own retirement and give them warning down the line. I think that would be very fair.

Senator SMITH. So you would make the benefit structures more progressive, reverse progressivity.

Mr. EDWARDS. Cut benefits, subsidies, corporate welfare, farm subsidies, and all the rest.

Senator SMITH. So those are the ones you are speaking of.

Mr. EDWARDS. Yes. I mean, there have been proposals up here, for example, to trim the amount of subsidies that some of the millionaire farmers can get. That is the type of progressive, populist spending cut I think that should gain wider support on the Hill.

Senator SMITH. I voted for that, by the way.

Representative STENHOLM. I feel compelled to defend the farmers. [Laughter.]

Senator SMITH. Well, there are not many farmers that get crop subsidies in Oregon currently. But one of the things that could be most helpful to me, and I suppose Senator Bingaman, is what do you see in other countries with similar structural deficit problems that we have? What is working? You have identified a couple of Britain's ideas.

Representative STENHOLM. Let me add, just a moment, to that. I do not disagree at all with Mr. Edwards on that, and, as he mentioned a moment ago, putting spending caps up. In fact, one time we recommended spending caps on mandatory spending.

Now, you cannot do that just with a simple budget. You have to do the policy. You have to have some discussion and you have to set meaningful caps. When you set discretionary spending below what is doable, then you do not get there, but if you have a good debate as to what is doable, then you can come out with a consensus that that should be the steps. We did a pretty good job at staying at that. When you look at discretionary spending in the budget today, you guys have not done badly.

Senator SMITH. No.

Representative STENHOLM. Now, when you start asking, what do you start cutting, do not exempt anything. I have always said, and I have served on the Agriculture Committee, start with agriculture.

But do not do just agriculture. Then have the honest debate. Which we do. Every 5, 6 years we have a big omnibus farm bill. We have these discussions. Congress decides whether or not they are worthwhile expenditures or not, and then we go on. But so much of government does not have any oversight.

Sunset legislation—there should be no government program—none—that does not have, at least every 10 years, oversight by the appropriate committees to determine whether or not it should continue; if it should, should it be changed, or is it doing perfectly.

Mr. BIXBY. I would say on that also, we find support for that in the events we do around the country, on the Fiscal Wake-Up Tour. You have all seen David Walker's presentations, and The Concord Coalition's are pretty similar; so are Belle Sawhill's from Brookings, and Stuart Butler's from Heritage.

We are trying to get people focused on these big, long-term issues such as health care costs. What do we do about Social Security? How do we keep the debt from rising? It always comes back in the Q&A to waste, fraud, and abuse.

People will say, no, we understand what you are saying. But they do not trust. One of the problems is, they say, well, I would not mind paying higher taxes, but I just heard about this bridge to nowhere. Why should my taxes go up?

You can get into the proportions of these things, that a lot of the waste, fraud, and abuse that makes the headlines, it should not happen, but it is pretty small when you are talking about the things that are going to drive fiscal policy over a cliff. But consider the outrage factor—they like Medicare, they like Social Security, and they do not want to pay higher taxes.

They do not like hearing about some wasteful project. Urban people do not want to hear about farm subsidies and rural people do not want to hear about Amtrak subsidies. So you get into this waste, fraud, and abuse thing.

But I think that in order to deal with some of these really big issues that we would like to get into and that we know we need to get into, some very strong signal would help, from Congress and the White House, about cutting waste, fraud, and abuse.

I say that as one who has sort of never spent a lot of time talking about waste, fraud, and abuse in the government because to me it

seems like the big savings are elsewhere and that is not really what is driving the problem.

But when you look at public attitudes, when people have a bee in their bonnet, something that is of real concern to them, that at least has to be addressed in some way before you can get them to look seriously at some of the other things. So, more than the budgetary savings, the signal it sends is important.

Dr. ORSZAG. Senator, I would strongly agree with what Mr. Bixby just said. I think, frankly, progressives, or people who believe that government can play an effective role in the economy, need to be paying more attention to the symbolism of efficiency within government.

I mean, Cato and other places are always putting out ideas about how to make the government more efficient. In a sense, actually, progressives should be the one doing that, because if you believe government can be effective, you need to demonstrate to people that it is not waste, fraud, and abuse. I also agree with Mr. Bixby that the reality is that it does not seem like that is the major contributor to the problem here.

Let me put on the table three things. One, we released a paper by McKinsey & Company about setting productivity goals or efficiency goals for the Federal Government, drawing on experiences abroad, including from the United Kingdom, that suggest that there may well be some benefits there.

A third of Federal civilian employment is in the Postal Service. Other countries have moved to introduce a lot more competition into their postal systems than we have, and I think that is an area we could do even more on.

Then, finally, the Federal Government owns several hundred billion dollars of buildings all across the country, much of which is a legacy of old missions or outdated agencies and could be reexamined. So there is sort of an asset portfolio management task that we could do a lot better at.

Senator SMITH. I am with you 100 percent on all that.

Representative STENHOLM. Mr. Chairman?

Senator SMITH. Yes, Charlie?

Representative STENHOLM. One other suggestion. When you start talking about waste, fraud, and abuse, in the House Agriculture Committee, from time to time, and I know it is true on the Senate side, there are certain suggestions that there is waste, fraud, and abuse in certain areas, and we did a pretty good job with some oversight, particularly in the area of crop insurance.

Then there is a little technology thing there that is commonly called data mining. It is amazing what you can do, finding out if there are any anomalies or if there is anything going wrong, when you take the data that you have available and mine it and see.

Now the Department of Agriculture uses as their poster child the data mining project that was done on crop insurance, and we are hoping now that this will be expanded into some other areas, not the least of which are Medicare and Medicaid.

Now, when you look at a chart and you see the cost per enrollee State by State, there is a question that just pops out into my mind as to why the State of Iowa, for example, gets $3,100 per enrollee

and the State of Texas gets $6,300, and other States involved in this.

I am not saying that anything is wrong, but wouldn't we like to know, if we are going to put a cap on mandatory spending, what Iowa was doing right, Texas is doing wrong, or New York, or California? Would you not, as the policy makers, like to know that?

There is a good suggestion running around now that by applying the principle of data mining to this concept, that you can find out. We know it has worked in the VA beautifully right now in saving money and providing better service. So these are some of the tools that can be used.

A final point you asked. When you say, when is this all going to end? I am not a pessimist. I am an optimist. But I also spent my whole life on the farm. That is my life. I can remember, when you say, yes, the Gross Domestic Product was $4 trillion in 1978 when I was elected, and it is now $12 trillion, and I can remember some of my fellow farmers going to a net worth of $100,000 to several million, and then it collapses.

Why does it collapse? Because things change. The economy changes, the demand. The most concerning deficit, I think, to most of us today is the current accounts deficit. That is the one that is way out of kilter.

You could look at the fiscal deficit as a percent of GDP and make the argument that that is not a major problem, but then you look at the current accounts deficit, or as I like to put it, how long can America keep exporting $700, $800 billion of our jobs every year, and the money keeps going out, and foreigners keep subsidizing the interest rates on what we are borrowing back.

Senator SMITH. I do not know either, Charlie. It is an interesting thing. In my other life, I am a frozen vegetable processor. When you were serving in Congress and I was picking peas, I did not sell anything to China. But today, they come in and they buy 10, 20 million pounds of frozen vegetables.

What does that tell me? They tell me they have refrigerators and their middle class is growing. All of a sudden they are buying American food and American products. I do not know when it reverses.

I honestly do not know. But I do know that, as India, China, and the world gets flatter and they grow middle classes, America is an enormously productive Nation. I also know that half the current accounts deficit is just due to foreign energy, which is pretty pathetic.

So if you take energy out of it, we can produce more, we can conserve more. We are going to be shipping more, too. Not just high-tech, but low-tech, like corn. I have just seen it in my lifetime. So I do not know whether it is the worst deficit we have had, or when it will reverse course. It has not yet, because everybody keeps enjoying Wal-Mart.

Mr. BIXBY. Can I make a point on the crisis thing, just before you wrap up? Nobody here can say when a crisis will hit, but we know we have a terrible vulnerability. I mean, there is a lot of risk there. You can look ahead 20 or 30 years, to 2030, or something, look at CBO or GAO, and you see a scenario that cannot happen. I mean, debt is at 200 percent of GDP and the deficit is about 20 percent of GDP. It is as big as the entire government is today.

So you can give at least a range and say, if you plan to be alive in 2030, or know somebody who will be, we cannot get there on the course that we are on. That is the vulnerability. It is really an unprecedented challenge. We have never had this combination of demographic factors and entitlement programs, so it is not the usual deficit challenge.

I mean, I guess I can say, if we wait for a crisis, we are in big trouble, because at the time the crisis hits it will be too late to do anything rational about it. That is really the challenge for all of us, for you particularly as elected officials, and for us who talk about it, and for the American public. It is something we need to go through together.

Senator SMITH. Yes.

Senator BINGAMAN. Mr. Chairman, this was a very useful hearing. I think if we had additional time before the end of the Congress and you have an interest, we ought to try to do one on the current account deficit and try to identify what the problems are there that are subject to some kind of resolution.

Senator SMITH. At your recommendation, we will get the hearing organized.

Senator BINGAMAN. That would be great.

Senator SMITH. Well, gentlemen, this has been very helpful to me. I hope it has been for you. I want to say for the record of the U.S. Senate, we congratulate Congressman Stenholm for doubling the size of the American economy during his Congressional tour. [Laughter.] Good work.

Representative STENHOLM. I am glad you mentioned that, not the deficit.

Senator SMITH. Yes. [Laughter.] But anyway, there are a lot of people of good will whom I serve with on both sides of the aisle who understand this and who frankly struggle with the political realities of how to get from here to there. It is hard. It is really, really hard.

Election seasons, as important as they are, get pretty darned silly, with the character assassination. Then you have to go cut a deal with a guy who just took your head off. It is just really, really difficult.

But the whole point of my asking the question, when do we hit the wall—because I am a student of history; I cannot read enough of it—tells me that Congress ultimately acts on hard political things when it has no other choice. That is too darned bad. I think there are some people here—I know Senator Bingaman is one of them—who would like to act sooner rather than later. We will keep working until we get there.

This is a great country that has produced a pretty great civilization, and each of you has added immeasurably to our understanding, to the Senate record, and we are thankful to you for your time and your expertise.

With that, we are adjourned.

[Whereupon, at 3:47 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of Robert L. Bixby

Executive Director, The Concord Coalition

America's Public Debt: How Do We Keep It From Rising?

Senate Finance Committee Subcommittee on Long-Term Growth and Debt Reduction

September 28, 2006

Chairman Smith, Senator Kerry, and members of the Committee, thank you for inviting me to discuss the nation's public debt and how we can keep it from rising. It is an important question to ask in assessing our nation's long-term fiscal and economic outlook. The short answer is that to keep the public debt from rising we will need to reassert budget balance as our fiscal policy goal and make the necessary trade-offs to achieve that goal. Budget rules can help in this regard, but they are not a substitute for political will. Moreover, no strategy for keeping the debt from rising will succeed over the long-term unless we find a way to reduce projected costs, particularly for health care. A realistic strategy will likely require some mix of spending reductions, and revenue increases — negotiated in a bipartisan process — aimed at preventing total spending, taxes or debt from reaching levels that could reduce economic growth and future standards of living.

I am here representing The Concord Coalition, a nonpartisan organization dedicated to strengthening the nation's long-term economic prospects through sound and sustainable fiscal policy. Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to produce a credible plan for long-term fiscal sustainability.

My testimony today will address:

- The overall budget outlook; short-term and long-term
- The importance of public engagement in addressing fiscal challenges, and
- Broad options for change and the necessary trade-offs

I. Overview of the Budget Outlook

It is often said that our political system only responds to a crisis. If that turns out to be true, our children and grandchildren are in big trouble.

Our nation is about to undergo an unprecedented demographic transformation — with no plan to pay for it other than running up the public debt. The coming age wave is not a temporary challenge that will recede once the baby boom generation passes away. The baby boomers' retirement is ushering in a permanent transformation to an older population—and a permanent rise in the cost of programs such as Social Security, Medicare and Medicaid, which already comprise 40 percent of the federal budget.

It may seem that there is no immediate crisis, yet a broad bipartisan consensus exits that current fiscal policy is on an unsustainable path. No one can say when a crisis will hit, but by the time it does the economy will likely be burdened with a debilitating amount of debt; leaving painful benefit cuts and steep tax increases as the only options. Doing nothing to avoid such a gut-wrenching outcome would be an act of fiscal and generational irresponsibility.

The basic facts are a matter of arithmetic, not ideology. Over the next 25 years the percentage of the population aged 65 and up will grow by 50 percent while the number of workers is estimated to rise by only 13 percent. The imminent retirement of the baby boom generation will set off an era of extraordinary demands on the nation's workers. At the same time, one of the major engines of economic growth — an expanding workforce — will slow substantially due to the large exodus of older workers from the labor force and lower birth rates following the baby boom. This combination of factors presents a distinct challenge for the economy in the future, which will be called upon to transfer a large and rising share of real resources from workers to retirees.

Demographic change, however, is only part of the problem. Health care prices continue to outpace economic growth and this phenomenon greatly compounds the growing costs attributable to the rising number of aged. If historic growth rates persist, by 2050 Medicare and Medicaid will grow by nearly 5 times as a share of the economy (GDP).[1] They will absorb as much of our nation's economy by the late 2040's, as the entire federal budget does today.

Without a change in policy, by the time today's 20-year olds reach retirement age the cost of government as a share of the economy is on track to reach levels not seen since the nation was fighting World War II — the big difference being that instead of spending the

[1] Outlays for the two programs equal 4.6 percent of GDP in 2006. Under an historic growth rate scenario, CBO projects that they would reach 21.9 percent of GDP by 2050. By comparison, Social Security is projected to grow by about 60 percent as a share of GDP by 2050, from 4.2 percent to 6.6 percent.

money on a life and death struggle against totalitarian aggression we would be spending it on an ever-rising stream of benefit payments.

Today, governmental expenditures absorb 20.3 percent of the economy (GDP). At the high end of what the Congressional Budget Office (CBO) sees as a possible range, federal spending could rise to 56 percent of GDP in 2050. In contrast, federal spending never went above 44 percent of GDP throughout World War II.

While it may be unrealistic to assume that half the nation's economic output could be consumed by government programs, even if the cost of government rose to 30 percent of GDP, the share of the economy needed would be 50 percent greater than it is today.

This raises an obvious question: how will we pay for it?

Federal tax receipts have hovered in the range of 18 percent of GDP over the past half century.[2] If retirement and health care entitlements are allowed to grow on autopilot pushing total federal spending to 30 percent of the economy, and Americans' intolerance for taxes above 20 percent of GDP holds true, the resulting deficits will rapidly escalate to dangerous levels. A deficit equaling 10 percent of GDP in today's terms is the equivalent of $1.3 trillion. That amount is roughly half of today's total government expenditures. The prospects of being able to carry that amount of new debt, year after year, without stifling the economy are nil.

Borrowing our way through this is not a viable option because the rising cost of entitlements is not a temporary blip. It gets bigger with time. Incurring ever-rising levels of debt would result in staggering interest costs and ultimately a level of debt that would crush the economy.

The real choices require scaling back future benefit promises, raising taxes to pay for them or some combination of both. Economic growth alone will not be enough, nor will trimming everyone's favorite target — waste fraud and abuse.

The choices we make now will determine what kind of society our children and grandchildren inherit 20 and 30 years from now. There is little time for political gridlock. With the first of the 77 million baby boomers on the verge of retirement, the window of opportunity to act is rapidly closing.[3] Inaction now increases the prospects of severe changes later. Every year that change is postponed greatly raises the risk of large tax increases or sudden benefit reductions in the future.

The question is whether we will face up to the challenge and fulfill our generational stewardship or put the future at risk by waiting for a crisis.

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[2] They reached 20.9 percent of GDP in 2000, but as a result of tax reductions and economic factors fell below 17 percent in 2003 and 2004 before rising back to a projected 18.3 percent this year.

[3] The oldest segment of the 77-million baby boom generation, now turning 60, will begin drawing on their Social Security benefits in two years. In five years they will be eligible for Medicare.

Short-term outlook

There is at least one positive thing to report on the budget front: at a projected $260 billion, the deficit in 2006 will be lower than the $318 billion deficit in 2005. This is the second year in a row of declining deficits.

Does this mean that we are on a smooth and easy road back to balanced budgets? Not at all. Both CBO and the President's Office of Management and Budget (OMB) project an increase in the deficit next year.[4] More significantly, in an ominous sign of things to come, CBO projects that the cost of Social Security, Medicare, and Medicaid will grow from 8 percent to 10.2 percent of GDP over the 10-year outlook — a 27 percent increase.[5] As a result, these three programs, which consumed 40 percent of the budget in 2006, will consume 51 percent by 2016 — and that is just the tip of the demographic iceberg.

Budget projections over the 10 years covered by the CBO baseline (FY 2007-2016) are unusually complicated by a number of factors — some on the spending side and some on the revenue side.

On the spending side, projections are complicated by the treatment of operations in Iraq and Afghanistan. The Bush Administration has chosen to treat each year's expense as a one-time event on the theory that future costs are unknowable. This has the effect of understating outlays in the President's budget projections because it assumes no new funding for operations in Iraq and Afghanistan beyond 2008 even though, as the Administration acknowledges, that will not be the case.

On the other hand, the CBO's latest budget projections probably overstate likely costs for these operations because, in keeping with the scoring conventions of budget laws, it assumes that this year's level of appropriations (including the war costs) will continue each year adjusted for inflation. The effect of this is to assume that operations in Iraq and Afghanistan (along with Hurricane Katrina relief efforts) will continue at their current level for the next 10 years. While this outcome is not impossible, a more probable projection would fall somewhere between 10-year costs at the current level and the Administration's official assumption that there will be no further costs beyond those requested in this year's budget.

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[4] CBO, *The Budget and Economic Outlook, An Update*, August 2006. OMB, *Mid Session Review*, July 2006. While the President's budget shows a steep decline in the deficit after 2007, this assumes no continuing war costs beyond 2008 and an implicit revenue windfall from the Alternative Minimum Tax (AMT). Neither of these assumptions is consistent with administration policy, which diminishes the usefulness of the projections.

[5] Medicare numbers in this calculation include offsetting receipts.

Projections on the revenue side of the budget are complicated by two factors; the scheduled expiration by 2011 of the tax cuts enacted since 2001 and the growing toll of the Alternative Minimum Tax (AMT), which if not adjusted will apply to roughly eight times as many taxpayers by 2010 as it does today. In preparing its baseline, CBO must assume that current law is carried out. Thus, however politically improbable, the baseline assumes a revenue windfall from expiring tax cuts in 2011 and rapidly growing receipts from the AMT.

Taking all these factors together, CBO's baseline is too optimistic. A more plausible deficit path based on recent experience would:

- Assume a phase-down of supplemental funding for Iraq and Afghanistan and assume that regular appropriations grow with the economy instead of at the rate of inflation as assumed in the projections.
- Assume that all expiring tax cuts are extended.
- Assume continuing relief from the AMT by adjusting it for inflation.
- Assume scheduled cuts in Medicare payments to doctors will not take effect.
- Deduct debt service cost on the above changes.

Under that scenario, deficits would total $5.2 trillion over the 2007 to 2016 period rather than $1.7 trillion as in the CBO August baseline. As a percentage of the economy, deficits in this plausible baseline steadily rise to 4 percent by 2016 and average 3 percent over the 10-year period. Deficits of that size would drain national savings, raise the debt to GDP ratio and increase interest costs. This would be a very untimely mix because it would come at a time when we should be doing the opposite: increasing national savings, lowering the debt to GDP ratio, and reducing interest costs in preparation for the fiscal challenges that come in the following decade.

As the government's debt increases, its interest costs grow as well. Those costs use up precious resources that could be directed to other purposes. Comparing CBO's official baseline and the more plausible scenario outlined above demonstrates the difference in how the public debt could grow and the importance of acting in the short-term to strengthen our fiscal position for the tougher challenges ahead.

Under CBO's official projections, debt held by the public shrinks from 37.3 percent of GDP in 2007 to 32.2 percent by 2016, primarily because of the assumed revenue windfall from expiring tax cuts and the AMT. However, under the more plausible scenario outlined above, debt held by the public would reach 48 percent of GDP by 2016. The last time that debt held by the public was over 50 percent of GDP was in the 1950s. At that time, however, debt was coming *down* from the heights it achieved to pay for World War II.

Meanwhile, according to CBO's latest projections, the federal government's interest costs will total $220 billion in 2006 — more than the combined cost of all mandatory programs for income support such as Supplemental Security Income (SSI), unemployment compensation, food stamps, child nutrition, the earned income tax credit and child tax

credits. It is more than either the federal government's share of Medicaid or the costs of military operations in Iraq and Afghanistan.

In 2016, net interest costs will rise to $333 billion, according to the official baseline Under the plausible scenario outlined above, however, interest costs by 2016 would approach $500 billion.

The fact that we've had high deficits before and managed to get out of them offers no reason to ignore them now. For one thing, Congress and Presidents George H. W. Bush and Bill Clinton engaged in a series of legislative actions, many of them bipartisan, designed to bring the deficit under control. Moreover, the end of the cold war allowed us to shrink defense expenditures from 6 percent of GDP in 1985 to 3 percent by 2000. That was a big help in keeping total spending under control. Today's situation is far different. While defense spending has not gone back to anything approaching Cold War proportions, it has risen back to about 4 percent of GDP.

More fundamentally, however, the boomers' retirement in those days was a generation away. Now, the first boomers will begin retiring in just two years, so we face a much more urgent, and difficult, situation than we did 20 years ago.

Moreover, the plausible baseline outlined above is not a worse case scenario. It assumes a healthy economy over the next decade. The return to deficits and the projection of continuing deficits, even at the levels in the CBO baseline, is not the result of cyclical economic factors. We have a structural deficit and it is likely to get worse in the absence of legislative actions to correct it.

Unfortunately, the deficit reduction reflected in CBO's new projections is the result of technical and economic re-estimates, things over which Congress has no control. Legislative actions, which Congress does control, have actually increased the deficit. According to CBO, the net impact of legislation enacted by Congress this year would increase the deficit by $132 billion over the next five years (measured against earlier projections). The modest savings on the entitlement side from the Deficit Reduction Act were more than canceled out by the impact that tax cut extensions, additional spending for military operations and other increases had on the deficit. These may all be worthy initiatives in the abstract, but taken together they don't add up to a strategy that will keep the debt from rising.

To add insult to injury, the savings from the Deficit Reduction Act barely register. Last year, CBO projected that entitlements (mandatory spending) would grow from 10.7 percent of GDP in 2006 to 11.7 percent in 2015. This year, after passage of the spending cut bill, CBO is projecting that mandatory spending will reach 11.8 percent of GDP in 2015 — a small *increase*. In other words, for all the political pain involved in passing this bill, it didn't have any real impact on the long-term budget outlook

In sum, we are risking a decade of large sustained deficits at a particularly bad time because as CBO warns, "growing resource demands for [Social Security, Medicare and

Medicaid] will exert pressure on the budget that economic growth alone is unlikely to eliminate." As a result, CBO concludes, "A substantial reduction in the growth of spending and perhaps a sizable increase in taxes as a share of the economy will be necessary for fiscal stability to be at all likely in the coming decades."[6]

The real question is whether we will face up to this challenge or be content to let these developing problems fester in hopes that future lawmakers — with fewer choices and perhaps acting under crisis circumstances — can find solutions.

Long-term outlook

For all the twists and turns in the 10-year outlook, the basic story over the long-term is pretty clear: current policy is unsustainable and the sooner we begin to take corrective actions the better.

The Government Accountability Office (GAO) and the CBO have each published long-term scenarios under alternative sets of assumptions. In GAO's view, "Under any reasonable set of expectations about future spending and revenues, the risks posed to the nation's future financial condition are too high to be acceptable."[7]

To illustrate the point, one GAO scenario uses assumptions very similar to those outlined in the Concord Coalition's 10-year plausible outlook described in the prior section. Discretionary spending grows with GDP and expiring tax provisions are extended. Here are some notable signposts on that unsustainable path:

2024 — Social Security, Medicare, Medicaid and net interest consume all revenues; the deficit hits 10 percent of GDP.

2025 — Net interest costs more than Medicare; debt held by the public exceeds 100 percent of GDP.

2035 — Net interest exceeds Medicare and Medicaid; debt held by the public equals 200 percent of GDP.

2037 — The deficit reaches 20.5 percent of GDP, exceeding the size of today's entire federal budget

2039 — Social Security, Medicare and Medicaid consume all revenues

2041 — Debt held by the public equals 300 percent of GDP.

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[6] CBO, *The Budget and Economic Outlook: Fiscal Years 2007-2016*, January 2006, Summary p.XIV.

[7] GAO, The Nation's Long-Term Fiscal Outlook, September 2006 Update p.1. GAO-06-1077R.

2045 — Debt held by the public equals 400 percent of GDP.

2046 — Interest costs, at 21.6 percent of GDP, exceed the size of today's entire federal budget.

2047 — Debt held by the public equals 500 percent of GDP.

2049 — GAO model blows up

The CBO scenarios include variations on health care cost assumptions, revenues and discretionary spending. The most significant difference between the high cost and intermediate cost assumptions is whether health care costs go up at the historic rate or come down to roughly the level assumed in the Medicare Trustees Report.

The lower revenue scenario assumes that revenues permanently lock-in at 18.3 percent of GDP (by coincidence, where revenues stand this year). The higher revenues scenario assumes that the tax cuts sunset and that revenues grow from 17.8 percent of GDP in 2010 to 23.7 percent by 2050.

Combining the revenue and spending assumptions of the CBO scenarios adds further support to the conclusion that current policy is unsustainable.

- If revenues level off at 18.3 percent of GDP and entitlements grow on their current course, CBO projects a deficit of 14 percent of GDP by 2030 with debt rising to 137 percent of GDP. By 2040, the deficit is 24 percent of GDP and debt is at 261 percent of GDP.

- Even if the tax cuts sunset, CBO projects that the deficit would reach 8.3 percent of GDP by 2030 and the debt would reach 91 percent of GDP without a slowing of entitlement costs. By 2040, the deficit would reach 15 percent of GDP and debt would be 165 percent of GDP under this scenario. Keep in mind that this assumes revenues go up to 21.7 percent of GDP in 2030 and 22.8 percent of GDP in 2040.

The GAO and CBO scenarios are valuable tools for policymakers in outlining the dimensions of the fiscal challenge we are facing and why spending cuts and revenue increases will likely be needed to bring about a sustainable fiscal policy.

Beyond fiscal imbalance, however, the policies embedded in today's budget threaten to place ever-tighter constraints on the ability of future citizens and policy makers to determine their own fiscal priorities. The share of federal resources pledged to aging baby boomers and the generations immediately preceding them is growing, leaving shrinking amounts for all other purposes.

What if nothing changes? Future taxpayers will be forced to pay far higher taxes than we pay today, or they will either have to accept much lower spending for all other public

purposes—including national defense, homeland security, and education—or face rapidly escalating deficits and the resulting negative consequences for the economy and future standards of living.

Conventional economic wisdom holds that persistent deficits should result in higher interest rates, lower investment and slower growth. However, despite the sharp reversal in fiscal fortunes and despite rising short-term rates, long-term interest rates have remained relatively low. That circumstance has allowed some pundits to claim that deficits don't matter. In the absence of "pain" or a clear crisis, elected officials seem unwilling to take the actions necessary to reduce the budget's red ink. And yet, postponing action while deficits rise is not a generationally equitable or economically sustainable policy. It mortgages the future to pay for the unwillingness of today's policymakers to require trade-offs.

Interest rates have remained low in part because foreign sources of capital have been willing to finance our federal deficits (as well as make up for our low private savings rates). The level of our public debt held by foreign investors has increased substantially in recent years from 36 percent in 2001 to 51 percent now. That foreign investment, however, has distinct downsides. For example, through the interest rate function, it increases the budget's exposure to international capital markets and decisions made by foreign interests. The current favorable environment could change quickly — driving down the value of the dollar and driving up domestic interest costs for the federal government and everyone else. In addition, debt service payments go to bond holders from abroad and drain financial resources away from the U.S economy and taxpayers.

We could cross our fingers and hope that the U.S. economy is sufficiently resilient to overcome anticipated fiscal challenges without any change to current policies. However, this outcome is highly unlikely. No plausible rate of economic growth would be enough and wishful thinking is not a sound fiscal strategy. A far more prudent and secure path to bettering the fiscal outlook would be to once again undertake constructive action to reassert control over fiscal policy and to restore budget discipline. There is no shortage of warning signs:

- Economic growth, while strong today, will slow as the proportion of retirees to active workers increases. CBO projects that real economic growth will decline from an annual rate of 3.5 percent to 2.5 percent between 2006 and 2016. As the economy expands more slowly, it will be harder to fulfill the needs of a growing and aging population.

- CBO projects that real growth in Medicare and Medicaid will outpace the annual growth in the economy. Those estimates don't anticipate costly advances in treatment and technology that could drive costs even higher and place greater pressure on the budget.

- Private employers also face pressures as a result of the aging population. Many private defined benefit pension plans are underfunded and require additional

employer contributions to bring plan assets more into line with liabilities. In addition, rising health insurance costs make it harder for employers to maintain benefit levels for their retirees. If the private sector cuts back its support for retirement income and health insurance, there will be greater pressure to increase public programs.

- The economy faces many uncertainties. Oil and energy prices are unpredictable. World events may affect the international economy and place additional demands on U.S. resources. The United States would be in a stronger position to weather difficult times if it had greater flexibility and strength in its fiscal position.

- The strength of the future economy depends on an educated workforce, productive capacity, sources of energy and solid infrastructure. If there is no financial slack in public budgets because available resources are already committed to supporting the standards of living of older people and paying debt service, it will be harder to find the funding to invest in children, research and development, transportation and communication, and other factors that will promote future growth.

We could credibly claim that the budget outlook is improving if we were taking actions to close the gap between spending and revenues. As long as we are content to ignore the unsustainable long-term trend and to keep near-term revenues at 18 percent of GDP while allowing spending to grow far above 20 percent of GDP, as projected, we are a long way from being able to declare victory.

II. The importance of public engagement and the Fiscal Wake-Up Tour

Daunting as the long-term projections are, there is nothing inevitable about a fiscal crisis. The problems we face — essentially a structural imbalance between what government promises and what it collects in taxes to pay for those promises — is one that can be cured in a timely way if we begin to address it now. In other words, the solution is in our own hands. As Concord Coalition President and former Commerce Secretary Peter G. Peterson has written:

> If America chooses the right future, it will be because we learn again to cooperate politically and embrace a positive vision of what our nation can become. Yes, we have to make some tough choices. But instead of obsessing over the tax hike that outrages us, or the benefit cut that shocks us, we need to focus on everything our nation can achieve if we all made an effort to come to terms with our future [8]

There is no better time to begin such an effort than now. The lessons of Hurricane Katrina have important implications for our long-term fiscal challenge. Known dangers

[8] *Running on Empty*, Peter G. Peterson, Farrar, Straus and Giroux, 2004 p.224.

should be acknowledged in advance of a crisis and dealt with in a straightforward manner. By all means, we should debate the options and trade-offs. But we must act. Whether through increased taxes or constrained spending (or some combination thereof), action by lawmakers will be necessary to restore balance between future governmental receipts and expenditures. Economic growth alone will not be enough to close the gap. Moreover, the sooner action is taken, the more gradual the remedies can be. The political system can adjust to unexpected good news. More problematic are the potentially harsh adjustments of deferring action on bad news projections that prove correct.

Because these options are politically difficult, the active involvement of the American people is critical. That is what the Fiscal Wake-Up Tour is all about. Without greater understanding of the problem among the public, community leaders, business leaders and home state media, elected leaders are unlikely to break out of their comfortable partisan talking points — and unlikely to find solutions.

The Fiscal Wake-Up Tour is a joint public awareness initiative by The Concord Coalition, the Budgeting for National Priorities Project at The Brookings Institution, and The Heritage Foundation. U. S. Comptroller General David Walker is an advisor and has participated in each of the Tour's public events.

For the past year we have visited many cities including Portland (OR), Kansas City, Durham, Omaha, Philadelphia, Wilmington and San Diego. We have also spoken to various organizations such as the National Conference of State Legislatures and the National Conference of Editorial Writers. Many other events are being planned for the fall and into next year. In fact, today some of my Fiscal Wake-Up Tour colleagues are in Austin Texas for a series of forums.

The purpose of this Tour is to explain in plain terms why budget analysts of diverse perspectives are increasingly alarmed by the nation's long-term fiscal outlook. Our emphasis is on the key areas in which we have found consensus, such as:

- The overall dimensions of the problem
- The nature of the realistic trade-offs that must be confronted in finding solutions
- The adverse and inequitable consequences for future generations if we fail to make serious changes, sooner rather than later.

Our mission is to cut through the usual partisan rhetoric and stimulate a more realistic public dialogue on what we want our nation's future to look like, along with the required trade-offs. We believe that elected leaders in Washington know there is a problem, but they are unlikely to act unless their constituents better understand the need for action, and indeed, demand it.

Members of the Fiscal Wake-Up Tour do not necessarily agree on the ideal levels of spending, taxes and debt, but we do agree on the following key points:

- Current fiscal policy is unsustainable
- There are no free lunch solutions, such as cutting waste fraud and abuse or growing our way out of the problem.
- The best way to make the hard choices is through a bipartisan process with all options on the table.
- Public engagement and understanding is vital in finding solutions.
- This is not about numbers. It is a moral issue.

A typical stop on the Fiscal Wake-Up Tour will include a public forum, a breakfast meeting with community/business leaders and an editorial board meeting with the local newspaper. In most cases, the venue for the public forum is a college or university.

The program generally consists of presentations by four or five panelists and an extended Q&A session with the audience. Panelists use PowerPoint presentations to show:

- The current budget numbers in historic context as a percentage of GDP
- Where the budget is headed on autopilot
- The driving forces behind the long-term projections
- The magnitude of the changes in either spending or tax policies that are needed to bring about a more sustainable and generationally equitable outcome
- Potential consequences of failure to change course

We do not recommend specific policy solutions. Indeed, we are upfront about the fact that we do not necessarily agree on solutions. However, we remind audiences that each of the realistic options comes with economic and political consequences that must be carefully weighed, and that there must be tradeoffs. Those who want to raise taxes are asked to explain what level of taxation they are willing to support and the manner in which the new revenue should be raised. Those who argue that spending must come down from projected levels are asked which programs they would target and how the savings would be achieved. Those who are unwilling to do either are asked how much debt they are willing to impose on future generations.

Our experience is that when audiences are told the facts, and shown that if they demand their "rights" to programs or policies it will have damaging economic effects to other groups or generations represented in the audience, they begin to accept the need for

tradeoffs.The Fiscal Wake-Up Tour does not presume to know the "correct" answers, but we are trying to make sure that the American people and their elected leaders are asking the correct questions.

In addition to the Fiscal Wake-Up Tour, the same group of analysts from Concord, Heritage and Brookings have been working with Public Agenda and ViewPoint Learning, (both chaired by Dan Yankelovich) on a project designed to provide insight into how attitudes evolve as people discuss difficult trade-offs with regard to long-term fiscal policy.

Three intensive day-long "Choice Dialogues" were conducted earlier this year in San Diego, Kansas City and Philadelphia. Public Agenda and ViewPoint Learning are in the process of reviewing the results. A report will be released sometime late in the year. As a preliminary matter, however, the following observations stand out:

- The public is strongly averse to big increases in the size of the national debt and, with the right kind of leadership, is prepared to accept sacrifices to avoid it.
- For most people, the overriding concern is not resistance to taxes but a profound lack of trust in government. People are willing to pay for what they want so long as they can be satisfied that government will spend the money wisely and for the purposes intended.
- Americans are willing to make changes in entitlements, but again on condition that trust and accountability exist.
- While there is continued strong support for defense spending, it is accompanied by the widespread perception that funds are misallocated and often wasted.
- Americans want to be engaged in addressing these issues and are frustrated by the lack of engagement that contributes to their mistrust of government

III. Broad strategies for Change and necessary trade-offs

While there is no quick fix, there are things we can begin doing now that will result in a much brighter picture for future generations. These do not include "slashing" entitlements or "killing the economy with tax increases." They do require that everything be on the table. The following are some recommendations and entitlement reform criteria that The Concord Coalition has long supported and continues to support:

1. Set a goal of balancing the budget

Fiscal policy must have a firm and responsible goal to guide decision making. Having such a goal underscores the need to make trade-offs between competing desires — distinguishing wants from needs. Without a fiscal policy goal, budget deficits are more

likely to reach harmful levels because there is nothing to force hard choices between politically popular spending increases and tax cuts.

The most responsible goal is a balanced budget. Aside from being fiscally responsible, balancing the budget is the goal most likely to be broadly understood, supported and enforced. It is also the most generationally responsible goal. Americans understand that it is wrong to provide ourselves with more government services than we are willing to pay for and then send the bill to our children. The best way to avoid such unjust burden shifting while laying a solid long-term foundation for a strong economy is to adhere as much as possible to the balanced budget goal. Policymakers should put everything on the table—including entitlement cuts and tax increases—and negotiate the necessary tradeoffs.

2. Reinstate caps on annual appropriations and pay-as-you-go rules for taxes and entitlement spending

Although budget rules alone will never be able to solve the nation's fiscal problems, enforcement mechanisms can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make the tough choices necessary to reduce the deficit. Pay-as-you-go rules (PAYGO) for all tax and entitlement legislation and spending caps for appropriations are proven tools for fiscal discipline. These enforcement rules, enacted in 1990 and extended in 1997 with bipartisan support, were an important part of getting a handle on the deficits in the early 1990s and getting the budget back into balance.

Reinstating PAYGO rules and spending limits on appropriations alone would not balance the budget, but doing so would represent an important first step in bringing discipline to the budget process. Statutory caps on appropriations helped hold such spending flat from 1991 to 1996 and restrained its growth to 3.7 percent a year between 1996 and 2000. The PAYGO rules required anyone proposing tax cuts or entitlement expansions to answer the question: "How do you pay for it?" Renewing the discipline imposed by an answer to this question is perhaps the most important thing politicians can do in the short-term to restore fiscal discipline in Washington.

3. Don't put Social Security reform on the back burner.

There is no good reason why this issue should be kept off the 2007 legislative agenda. The demographic and fiscal challenges facing Social Security in the years ahead are well known. Failure to change current law amounts to complacency with the prospect of deep benefit cuts for today's young workers, or steep payroll tax increases. It is understandable that political leaders will disagree on the details of any reform plan. But what's needed now is rejection of the "Do Nothing Plan."

Any Social Security reform plan should be designed to meet three fundamental objectives — ensuring Social Security's long-term fiscal sustainability, raising national savings, and improving the system's generational equity:

- **Reform should ensure Social Security's long-term fiscal sustainability.** The first goal of reform should be to close Social Security's financing gap over the lifetimes of our children and beyond. The only way to do so without burdening tomorrow's workers and taxpayers is to reduce Social Security's long-term cost.

- **Reform should raise national savings.** As America ages, the economy will inevitably have to transfer a rising share of real resources from workers to retirees. This burden can be made more bearable by increasing the size of tomorrow's economy. The surest way to do this is to raise national savings, and hence ultimately productivity growth. Without new savings reform is a zero-sum game.

- **Reform should improve Social Security's generational equity.** As currently structured, Social Security contributions offer each new generation of workers a declining value ("moneysworth"). Reform must not exacerbate--and ideally it should improve--the generational inequity underlying the current system.

Meeting these objectives will require hard choices and trade-offs. There is no free lunch. Policymakers and the public need to ask the following questions to assess whether reforms honestly face up to the Social Security challenge--or merely shift and conceal the cost:

- **Does reform rely on trust-fund accounting?** Trust-fund accounting obscures the magnitude of Social Security's financing gap by assuming that trust-fund surpluses accumulated in prior years can be drawn down to defray deficits incurred in future years. However, the trust funds are bookkeeping devices, not a mechanism for savings. The special issue U.S. Treasury bonds they contain simply represent a promise from one arm of government (Treasury) to satisfy claims held by another arm of government (Social Security.) They do not indicate how these claims will be satisfied or whether real resources are being set aside to match future obligations. Thus, their existence does not, alone, ease the burden of paying future benefits. The real test of fiscal sustainability is whether reform closes Social Security's long-term annual gap between its outlays and its dedicated tax revenues.

- **Does reform rely on hiking FICA taxes?** Hiking payroll taxes to meet benefit obligations is neither an economically sound nor a generationally equitable option. The burden will fall most heavily on lower and middle-income workers and on future generations. Younger Americans in particular will be skeptical of any plan that purports to improve their retirement security by increasing their tax burden and by further lowering the return on their contributions.

- **Does reform rely on new debt?** Paying for promised benefits--or financing the transition to a more funded Social Security system--by issuing new debt defeats a fundamental purpose of reform. To the extent that reform relies on debt financing, it will not boost net savings and may result in a decline. Without new savings, any gain for the Social Security system must come at the expense of the

rest of the budget, the economy, and future generations. Resort to borrowing is ultimately a tax increase for our kids.

- **Does reform rely on outside financing?** Ideally, reform should achieve all necessary fiscal savings within the Social Security system itself. Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures, now or in the future. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

- **Does reform use prudent assumptions?** There must be no fiscal alchemy. The success of reform should not depend upon rosy projections of future economic growth, presumed budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on realistic assumptions, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

While fixing Social Security's problems, reform must be careful to preserve what works. Social Security now fulfills a number of vital social objectives. Policymakers and the public need to ask the following questions to assess whether reform plans would continue to fulfill them:

- **Does reform keep Social Security mandatory?** The government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on the safety net in retirement. Moving toward personal ownership need not and should not mean "privatizing" Social Security. Any new personal accounts should be a mandatory part of the Social Security system. Choice is not important in a compulsory social insurance program whose primary function is to protect people against poor choices.

- **Does reform preserve Social Security's full range of insurance protection?** Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system should continue to provide insurance protection that is at least equal to what the current system offers.

- **Does reform maintain Social Security's progressivity?** While individual equity ("moneysworth") is important, so too is social adequacy. Social Security's current benefit formula is designed so that benefits replace a higher share of wages for low-earning workers than for high-earning ones. Under any reform plan, total benefits, including benefits from personal accounts, should remain as progressive as they are today.

- **Does reform protect participants against undue risk?** Under the current system, workers face the risk that future Congresses will default on today's unfunded pay-as-you-go benefit promises. While reducing this "political risk," personal account reforms should be careful to minimize other kinds of risk, such

> as investment risk, inflation risk, and longevity risk--that is, the risk of outliving ones assets.

If we reform Social Security today, the changes can be gradual and give everybody plenty of time to adjust and prepare. If we wait much longer, change will come anyway--but it is more likely to be sudden and arrive in the midst of economic and political crisis.

We have a crisis today only because of the threat of political gridlock. Inaction now increases the prospects of severe changes later. Every year that alterations are put off greatly raises the risk of large tax increases or sudden benefit reductions in the future. Reforming Social Security today would not free society from that future stress, but it would be a good start.

It is worth recalling that President Bush is not the first president in recent years to put Social Security on the political agenda. In 1998, President Clinton made Social Security reform one of his top domestic priorities. Here is how President Clinton summarized the situation at a forum hosted by The Concord Coalition and AARP in July 1998:

> We dare not let this disintegrate into a partisan rhetorical battle. Senior citizens are going to be Republicans and Democrats and independents. They're going to come from all walks of life, from all income backgrounds, from every region of this country, and therefore, so will their children and their grandchildren. This is an American challenge and we have to meet it together.

4. Medicare is in worse shape than Social Security. We must engage on a bipartisan basis to make Medicare both effective and affordable over the long-term.

As currently structured, Medicare is financially unsustainable. Costs are growing faster than the payroll taxes and premiums that finance the program. Costs are also growing faster than the overall economy, and faster than can be reasonably supported by the federal budget unless spending priorities change dramatically.

Health care costs are rising faster than wages. Consequently, the payroll taxes that fund Medicare are falling short of program costs. At the same time, the number of beneficiaries will climb steeply when the baby boom generation begins receiving benefits in 2011. Moreover, people who reach age 65 are living longer. People aged 85 and older are the fastest growing segment of our population. Medicare spending averages more than twice as much for people over 85 as it does for those age 65.

The addition of Medicare's prescription drug benefit merely compounded the program's shaky financial foundation. According to the President's Office of Management and Budget, the new prescription drug benefit will add $45 billion to the FY2006 deficit and $361 billion over the next five years. Indeed, estimates by the administration indicate that the unfunded obligations of the Medicare Part D drug benefit are roughly 50 percent more than those of the entire Social Security program. Congress and the President must look for ways to make the benefit more efficient, better targeted and less expensive.

Putting the Medicare program on a financially sustainable path will require some combination of reductions in services, increased cost-sharing by beneficiaries, increasing the eligibility age, bringing more revenues into the system and improving the cost effectiveness of Medicare and the health care system overall. We cannot pretend that there are simple fixes that don't require anyone to give anything up such as clamping down on fraud, or cutting back on excessive paperwork, or eliminating all the unnecessary tests and procedures. Pure "waste" is no easier to pinpoint in the health system than it is in the federal budget. And even if we could identify and eliminate all of it, the underlying cost drivers — from technology to expectations to aging — would soon cause spending to grow again as fast or faster than before.

Health care spending on the elderly will continue to grow faster than the economy so long as we pretend that costs can be controlled without any sacrifice. Costs aren't rising because of the proliferation of useless medical services. They're rising because medical science can do more for more people--and because what it can do is often very expensive.

Setting limits in Medicare will mean moving toward a whole new paradigm--one in which prospective budgets at the program level and capitation at the beneficiary level finally compel us to make tradeoffs between health care and other national priorities.

Before thinking about specific ways to address the Medicare problem, it is important to establish a set of criteria against which various proposals can be evaluated. Listed below are the criteria that the Concord Coalition believes should guide decision makers in reforming Medicare.

- Quality care: Medicare insurance should cover a level of care that is commensurate with the care available to working age people. This does not mean that taxpayers must be expected to finance a "high option" insurance plan for all seniors. If individuals wish to purchase supplementary insurance to augment their Medicare benefits, they should be permitted to do so. However, there must be an affordable insurance plan to provide a reasonable level of medical care available to the elderly, regardless of their ability to pay.

- Fiscally responsible and generationally sustainable: Concord believes that each generation should pay as much as possible of the cost of its own retirement package, including Medicare, Social Security and long-term care. No generation should have an automatic claim on taxpayer resources simply because of its chronological age. People of all ages have problems that the government could address, ranging from prenatal care, to child development and education, to job training, to old age assistance. A fiscally responsible program is one that can reasonably be expected to operate within the resources available to finance it. A program that assumes a perpetually open spigot from the Treasury gushing an ever-increasing flow of spending is not fiscally responsible. If it is decided that program costs should be permitted to increase, (i.e., filling the "donut hole" or

adding long-term care) then fiscal responsibility demands that a commensurate stream of revenue be identified to pay for the program.

- Income-related cost sharing: As a group, seniors enjoy a better income and less poverty than other age groups, particularly children. Therefore, Medicare's medical insurance premiums should be geared to income levels.

- Efficient provision of medical care: Whatever new system of medical insurance for the elderly is devised, it should contain incentives for both providers and patients to use resources in a cost-effective manner. Treatments that have little or no promise of achieving any appreciable improvement in a patient's well-being should not be financed with taxpayer dollars. A distinction must be drawn between wants and needs.

- Prompt action: Changes in Medicare should be enacted promptly. Entitlement programs for the elderly are long-term commitments between the government and the citizenry. People base their behavior and make their plans based on current provisions. Therefore changes in the Medicare health insurance commitment should be undertaken in time to permit gradual changes and give people time to plan and adjust.

- Medicare changes should not be made in a vacuum: Medicare is only one of the long-term commitments citizens have made to support seniors, along with Social Security and, in the case of long-term care, Medicaid. When program reforms are considered one at a time, it is possible to ignore the ripple effect of changes in the cost or financing for other programs serving the elderly. And once a stream of revenues has been committed to pay for one of the programs on which elderly people rely, it can no longer be used to shore up other programs. Both Social Security and Medicare tax the same people (mostly workers) to pay benefits to the same people (mostly retirees). What matters fiscally and economically is the total burden of senior benefits. Because controlling health benefit spending will be so difficult, it is all the more urgent to save what we can in Social Security.

5. Tax cuts scheduled to expire should not be permanently extended absent a plan for long-term fiscal sustainability.

Circumstances have changed dramatically since the bulk of the tax cuts were enacted in 2001. The surplus era in which the tax cuts were enacted has been replaced by deficits and the budget faces new demands for the war on terrorism and homeland security. Moreover, no action has been taken to prepare for the costs of the baby boomers' retirement and health care needs that will begin to place a growing strain on the budget in the years ahead. In fact, the burden has been dramatically increased with the addition of a Medicare prescription drug benefit.

In light of all of this, it makes sense to reassess whether we should continue all of the tax cuts enacted in the surplus era. In has been suggested by some that the recent high increase in the growth rate of federal taxes proves that tax cuts have not increased the deficit because they "pay for themselves" through greater economic growth. While revenue growth has indeed been very impressive over the past two years, we should not leap to the conclusion that tax cuts lead to "higher" revenue. Keep in mind:

- While this year's revenues (estimated to be $2.4 trillion) will set a record in dollar terms, it represents a much lower percentage of the economy (GDP) than in 2000 — 18.3 percent of GDP as opposed to 20.9 percent.

- Revenues this year will be almost identical to 2000 revenues adjusted for inflation. In 2000, revenues were 2.025 trillion. In 2006, CBO projects revenues to be $2.40 trillion, which translates to $2.029 trillion in 2000 dollars adjusted by CPI. Done in reverse, 2000 revenues would be $2.397 trillion adjusted for inflation.

- Individual income taxes are still *below* 2000 levels, adjusted for inflation. CBO projects individual income taxes of $1.059 trillion in 2006, which translates to $894 billion in 2000 dollars, well below the $1.004 billion in individual income taxes collected in 2000. If individual income taxes had kept pace with inflation since 2000, they would be $1.189 trillion.

- Setting a record for revenues in nominal dollars is not remarkable; revenues almost always set a record in nominal dollars every year as revenues naturally increase with inflation, economic growth and other factors. What is remarkable is that the revenue record set in 2000 ($2 trillion) was not broken until 2005. Between 2001 and 2003 revenues actually declined for three years in a row for the first time since the 1920's.

There is not an inevitable connection between tax cuts, economic growth and higher revenues. For example, in the five years following the tax increases of 1993, annual real economic growth averaged 3.8 percent. In the five years since the tax cut policies began in 2001, annual real economic growth has averaged 3.1 percent. Certainly, this does not establish that tax increases are better for the economy than tax cuts, but it does establish that tax cuts enacted over the past few years are not necessarily needed beyond their expiration date to ensure economic growth.

It is also worthy of note that the $2.66 trillion of *spending* in 2006 will also be a record in dollar terms. Spending restraint is, of course, the key to maintaining a sustainable fiscal policy and allowing future generations more of a choice in setting their own priorities. But experience has demonstrated that attempting to reduce spending simply by cutting taxes, or "starving the beast," is a failed strategy. The tax burden is ultimately determined by the government's spending commitments and not the other way around. Unless we reduce spending over the long-term we are not really cutting taxes over the long-term but

merely shifting the tax burden from ourselves to our children. The best fiscal policy is one that balances spending and revenues at a sustainable level over the long-term.

6. Establish a bipartisan fiscal commission

The Dean of my law school had a saying that seems apt to the political task ahead. When referring to unlikely solutions to tough problems he would remind us that, "Water doesn't run uphill without a pump."

Reducing promised benefits or raising taxes to pay for them strikes me as the political equivalent of expecting water to run uphill. It goes against nature and is unlikely to happen without some intervening force. One such force would be a crisis. A far better one would be a bipartisan commission — provided that it is organized and selected in a way that recognizes fiscal and political realities. As Concord Co-Chairs former Senators Warren Rudman (R-NH) and Bob Kerrey (D-NE) wrote in a recent *Washington Post* op-ed, the commission would need five elements to succeed:

- First, it must be truly bipartisan. Any perception that the commission's purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

- Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.

- Third, all options must be on the table. If either side sets preconditions, the other side will not participate. This means that Republicans cannot take tax increases off the table and Democrats cannot take benefit reductions off the table.

- Fourth, the commission must engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. In our experience, when people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices.

- Fifth, the commission's recommendations should be given an up or down vote in Congress, allowing for amendments that would not reduce the total savings. Absent that, the report would likely join many others on a shelf.

The full text of the op-ed is attached.

washingtonpost.com

Securing Future Fiscal Health

By Bob Kerrey and Warren Rudman
Monday, August 28, 2006; A15

The economic and moral case for long-term reform of fiscal policy is clear. Yet politicians refuse to act. If this stalemate persists, it could end in catastrophe.

Over the next 30 years, spending on federal programs is on track to go up by 50 percent as a share of the economy. If revenue remain at their historical level, the resulting deficits will approach 20 percent of gross domestic product by 2036 -- almost 10 times the current size. The debt will surge to 200 percent of GDP -- twice what it was at the end of World War II.

Political realities explain why nothing has been done about this. Changing course would require substantial spending cuts from projected levels or equivalent tax increases. Neither party wants to be the first to propose these tough choices out of fear that the other side would attack it. Similarly, neither side wants to discuss possible compromises of its own priorities, out of fear that the other side will take the concessions and run. Unfortunately, these fears are justified.

Since the regular legislative process seems incapable of dealing with the impending crisis, some alternative has to be found. President Bush has suggested a commission. Having served on many commissions, we understand their potential value. We also understand how they can go wrong. In our view, a new commission could be very useful, but only if it recognizes fiscal and political realities. It needs five elements to succeed.

First, it has to be truly bipartisan. Any perception that the commission's purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.

Third, all options must be on the table. If either side sets conditions, the other won't participate. Republicans cannot take tax increases off the table, and Democrats cannot take benefit reductions off the table.

Fourth, the commission needs to engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. When people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices.

Fifth, the commission's recommendations should be given an up-or-down vote in Congress, allowing for amendments that would not reduce the total savings. Absent that, the report would likely join many others on a shelf.

Rep. Frank Wolf (R-Va.) and Sen. George Voinovich (R-Ohio) have put forward a proposal that satisfies most of these elements. They would create a bipartisan commission with a broad mandate to examine long-term fiscal challenges. All policy options would be on the table. The commission would solicit input from the public and develop legislation that Congress and the president would be required to act on. Its work would address four key concerns: the unsustainable gap between projected spending and revenue, the need to increase national savings, the implications of foreign ownership of U.S. government debt and the lack of emphasis on long-term planning in the budget process.

A commission with these attributes could give all parties the political cover they need to tackle the tough choices and develop a bipartisan consensus for solutions. This would be invaluable regardless of who controls Congress or the White House.

In the end, of course, elected representatives, not a commission, will have to make the hard decisions. But a commission that produced solutions with meaningful bipartisan support would provide a catalyst for action. If Congress were required to vote on the commission's recommendations, opponents would be challenged to produce solutions of their own.

Advocates of extending tax cuts would be challenged to say how they would restrain spending enough to avoid cascading debt once the baby boomers begin to retire in large numbers. Those who oppose reductions in current entitlement promises would be challenged to say how they would fund those promises without squeezing out other priorities or raising taxes to unacceptable levels that could damage the economy.

The Wolf-Voinovich proposal has been greeted with silence or outright hostility. It deserves better. This is a serious proposal by two leaders who regard the debt burden and draconian policy options we are leaving to future generations as a moral stain on our nation's character.

To be sure, their proposal has shortcomings that must be corrected. Two improvements that are critical to the success of a commission are providing for bipartisan co-chairs and dividing the membership more evenly between parties than the current 9-6 split in favor of Republican appointments. These problems are not minor technicalities, but they could be fixed in negotiations with potential Democratic co-sponsors.

Time is running out to enact reforms. Wolf and Voinovich have come up with a credible way to get the process started. Any takers?

Statement of

Chris Edwards
Director of Tax Policy Studies, Cato Institute

before the
Senate Committee on Finance,
Subcommittee on Long-Term Growth and Debt Reduction

regarding
America's Public Debt: How Do We Keep It From Rising?

September 28, 2006

Mr. Chairman and members of the committee, thank you for inviting me to testify today on the topic of controlling growth in the federal public debt. Federal debt continues to rise as spending growth keeps running ahead of the increased tax revenues the government is enjoying as a result of the strong economy. I will discuss some of the relationships between federal debt, spending, and taxation in light of recent 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] That is true regardless of whether higher spending is financed by increased taxes or higher deficits, which can be considered deferred taxes on future generations.

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 current and future 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.

Deficits and Tax Cuts

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***. "Supply-side" tax cuts that reduce distortions in the tax code will spur economic growth and will not create as large a revenue loss as static calculations suggest. Any added debt from such tax cuts can be compared against the larger gross domestic product that will be generated. Supply-side tax cuts that represent long-term reforms of the federal fiscal system should be implemented regardless of the current budget balance. By contrast, further "social policy" tax cuts 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.

Numerous studies have found that supply-side 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.[7] 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. The JCT also found that there are much larger positive growth effects when tax cuts are offset by spending cuts to prevent the deficit from increasing.

Federal tax legislation since 2001 has been a mix of supply-side and social policy cuts. 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.[8] 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.

The economic impact of 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.[9] 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.

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.[10] Thus, recent spending increases are four times more important in explaining the current budget deficit than are recent tax cuts.[11]

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.[12]

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.[13] 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.[14] 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.[15] 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.[16]

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 budget reform proposals, such Senator Gregg's "Stop Over Spending Act of 2006" (S. 3521) are important.[17] 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.

Some people argue that such 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.

Consider also that the 50 states generally have much tighter budget rules than does the federal government.[18] 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. More than half the states have some form of overall tax and expenditure limitation (TEL).[19] 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 a good 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.[20] 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.[21] 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.

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, but a sequester on the overall budget 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 and rising debt as entitlement costs soar in future years. Policymakers need to scour the budget for programs and agencies to cut.[22] A cap on total federal 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.

Chris Edwards
Director of Tax Policy Studies
Cato Institute
cedwards@cato.org
www.cato.org/people/edwards.html

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

[8] 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.

[9] 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.

[10] 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.

[11] 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.

[12] Chris Edwards, "Social Policy, Supply-Side, and Fundamental Reform: Republican Tax Policy, 1994 to 2004," *Tax Notes*, November 1, 2004, p. 691.

[13] Government Accountability Office, "21st Century Challenges: Reexamining the Base of the Federal Government," GAO-05-325SP, February 2005, Figure 2, p. 8.

[14] *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.

[15] Estimate based on Martin Feldstein, "Prefunding Medicare," National Bureau of Economic Research, Working Paper no. 6917, January 1999, p. 4.

[16] Chris Edwards and Jagadeesh Gokhale, "Unfunded State and Local Health Costs: $1.4 Trillion," Cato Institute Tax & Budget Bulletin, September 2006.
[17] U.S. Senate, Committee on the Budget, "The Stop Over Spending Act of 2006," Senate Report 109-283, July 14, 2006.
[18] For background on state budget processes, see National Association of State Budget Officers, "Budget Processes in the States," January 2002.
[19] Michael New, "Limiting Government through Direct Democracy," Cato Institute Policy Analysis no. 420, December 13, 2001.
[20] 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.
[21] The commission was sponsored by the Center for Strategic and International Studies.
[22] For detailed discussion of federal programs that should be cut, see Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, 2005), www.downsizinggovernment.com.

Statement of Senator John Kerry
Senate Finance Subcommittee on Long-term Growth and Debt Reduction
Hearing: "America's Public Debt: How Do We Keep It From Rising?"
September 28, 2006

Mr. Chairman, thank you for holding this hearing today on the extremely important topic of addressing the public debt. This is an excellent forum to discuss a topic that we should be paying more attention to – how to reduce the rising federal debt. When you take a good hard look at the nation's current fiscal situation, there is cause for alarm. I look forward to hearing the solutions offered by our panel of experts.

The projection for the deficit for 2006 is expected to be lower than original projections, but it will still be around $260 billion. Back in 2001, a substantial surplus of $506 billion for 2006 was predicted by the Congressional Budget Office. Not only has that surplus never materialized, but the deficit for 2006 is expected to be the sixth largest in our history.

It is almost hard to believe that back in 2000 we were having conversations about how to pay down the debt, and today we are talking about debt projections over $10 trillion within a few years. Not too long ago, David Walker, Comptroller General of the United States testified before the Senate Budget Committee and commented that "our nation's fiscal policy is on an imprudent and unsustainable course." He further indicated that "we face a large and growing structural deficit due primarily to known demographic trends, rising health care costs, and lower revenues as a percentage of the economy." He believes major policies and priorities need to be looked at in order "to recapture our future fiscal flexibility." I completely agree with him and I expect that during this hearing we will delve into the details on why changes are needed.

A look at our fiscal situation shows how unsustainable our current course is. Congress has increased the debt limit for the fourth time in five years for a total of $3 trillion. An individual's share of the debt is $28,300.

Not only is the amount of debt a problem, I am also concerned about the amount of debt that is foreign-held – almost $2.2 trillion. Japan holds the most, $685 billion. China holds $258 billion. Even the Caribbean Banking Centers hold $111 billion. Over 54 percent of the public debt is held by foreign investors.

Over sixty percent of the foreign debt is held by official foreign investors. This is extremely dangerous: being dependent on foreign capital threatens our national security and our way of life. If foreign investors decided to stop financing our borrowing habits, our economy could spiral downward. If those investors began to withdraw their capital, our financial markets would plummet and interest rates would climb. This would filter down to American families. Homes, education, and cars would become more expensive. Their entire way of life would change.

I am concerned that not enough attention is being given to our rising debt. With a lower deficit than originally projected for this year, some might believe that our fiscal house is getting in order. This would be an incorrect assumption. The annual deficit cannot be looked at in isolation. Each year that there is a deficit we are substantially increasing the public debt. The federal government's interest payments on the debt are the fastest growing category of federal spending over the next five years. Each dollar we spend on interest payments is a dollar not used on investing in our future. I would rather use this revenue to help with the cost of college education or to improve the solvency of Social Security.

Our increasing debt is impacting our global competitiveness. Earlier this week, the World Economic Forum ranked the economic competitiveness of countries. The United States dropped from first to sixth. The reason given was the increasing public debt. Simply put, the more money that is spent on servicing the debt is less money available for spending on school infrastructure or other investments that could boost productivity.

A deficit projection of $260 billion for 2006 is misleading because it includes the Social Security trust fund surplus. The long-term budget outlook is even bleaker if it is adjusted to include priorities of the Administration such as making the tax cuts permanent and Social Security privatization. Budget projections also do not reflect the full costs of the wars in Iraq and Afghanistan and addressing the individual alternative minimum tax. I commend the Concord Coalition for their effort in educating Americans about our fiscal situation and explaining the true budget picture. I am interested hearing the reaction that they have received across America to their Fiscal Wake Up Tour.

I look forward to hearing the testimony of our distinguished panel. We have to understand the reasons why our budget is on an unsustainable path and what can be done to change course. Our dialogue should address all aspects of this issue not just spending. This issue cannot be resolved by just cutting spending. We need to look at tax receipts and determine the impact recent tax cuts have had on the debt. We need to work together to put the budget back on a sustainable path.

"Long-term Growth, Government Debt, and Family Incomes"

Testimony before the Senate Finance Committee
Subcommittee on Long-term Growth and Debt Reduction
Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow, The Brookings Institution
Director, The Hamilton Project

September 28, 2006

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

[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.

result in broad-based participation in that growth. It is the basis of a new project, The Hamilton Project, at Brookings.[2]

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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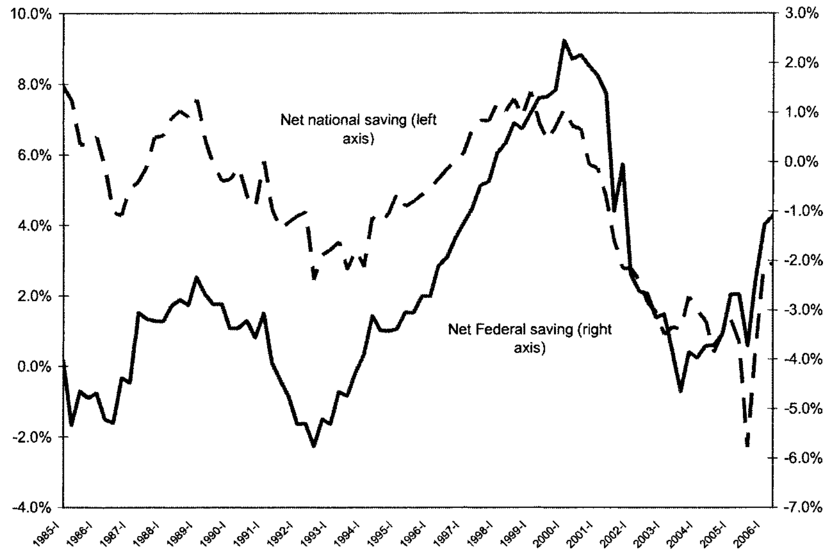
[2] For more information on The Hamilton Project, see www.hamiltonproject.org.

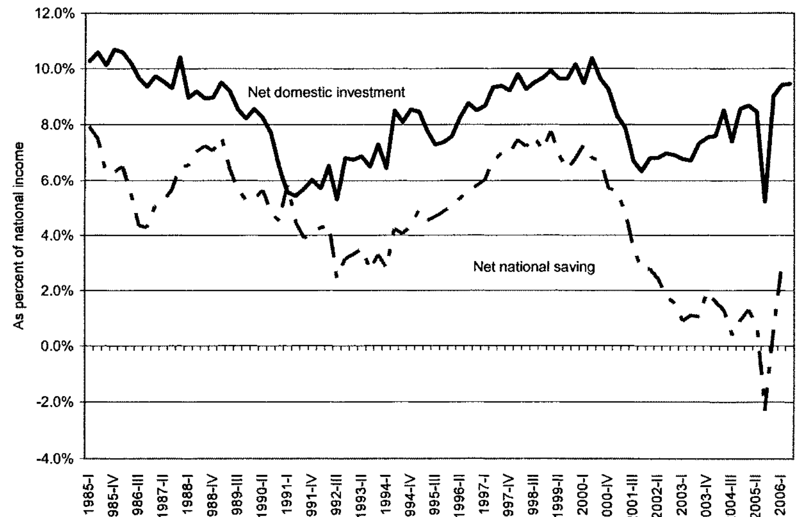
[3] William G. Gale and Peter R. Orszag, "Budget Deficits, National Saving, and Interest Rates" *Brookings Papers on Economic Activity,* no. 2 (Fall 2004), pp. 101-87.

Figure 1: The federal budget and net national saving



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

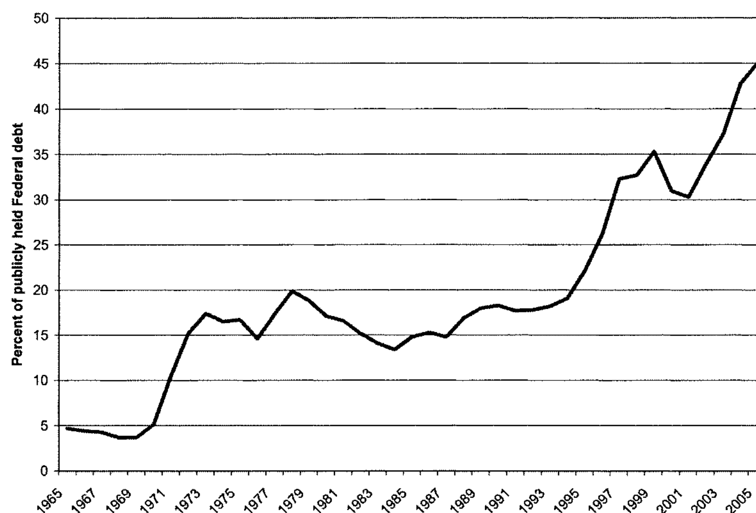
Figure 2: Net national saving and investment



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]

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[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

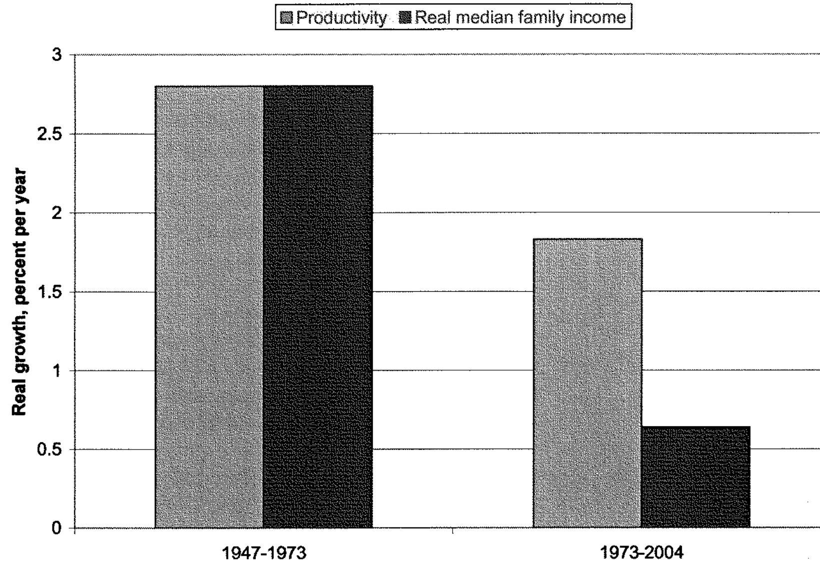
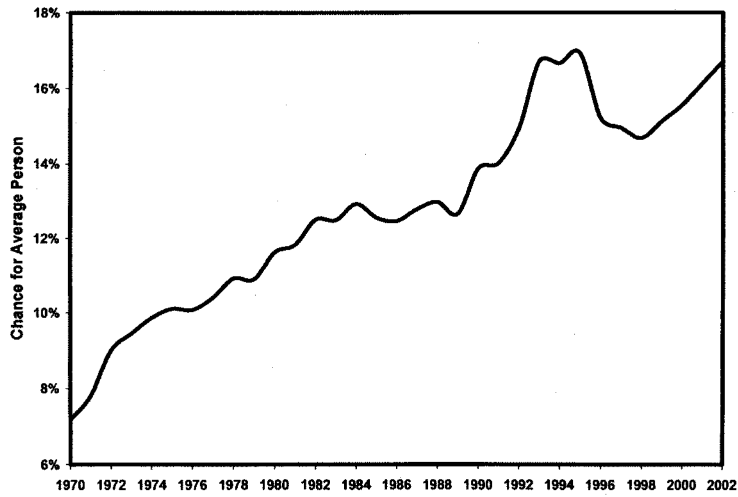


Figure 5: Predicted probability of family income decline of 50 percent or greater



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

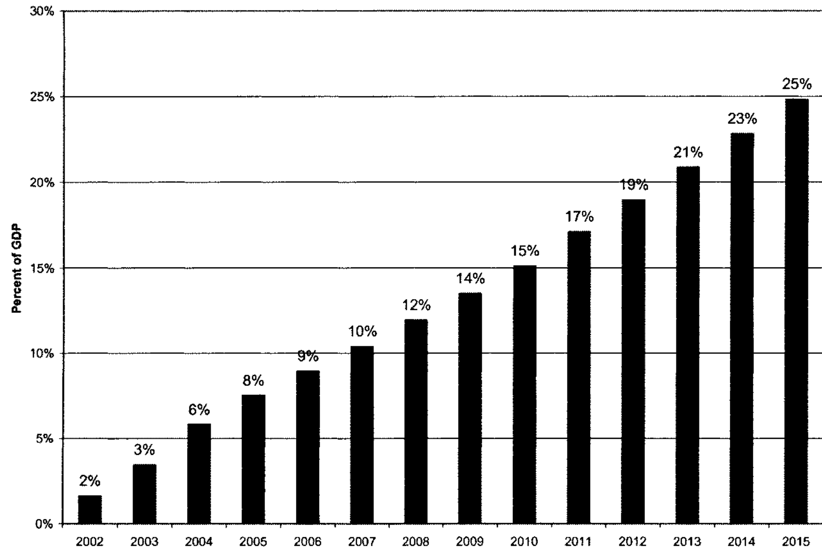
Type of legislation	*Share of legislation cost 2002-2011*
Tax cuts	49%
Defense, homeland security, international	35%
Entitlements	10%
Domestic discretionary (excluding homeland security)	6 %

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.

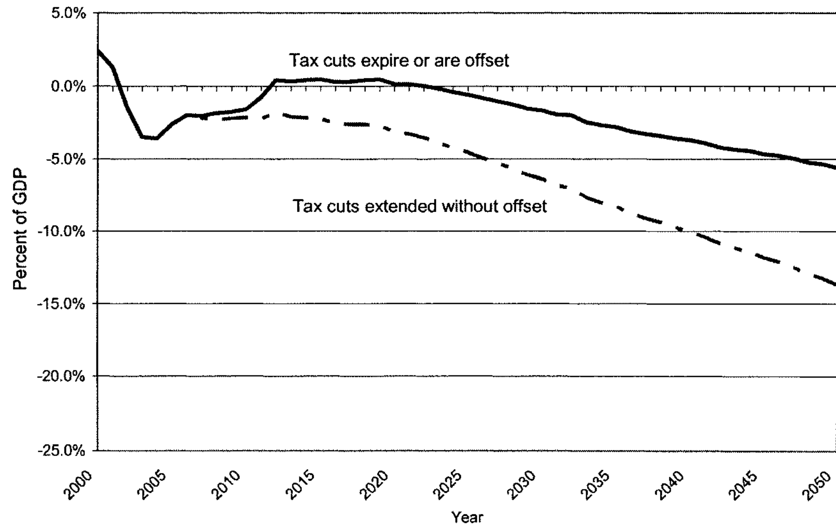
Figure 7, which is based on projections from the Center on Budget and Policy Priorities, provides further insight into the impact of extending the tax cuts (without offsetting their cost) on the budget outlook. As the figure suggests, despite the fact that the long-term problem facing the Federal budget 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 offered a good anti-recessionary bang for the tax cut buck. Although the tax cuts from

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

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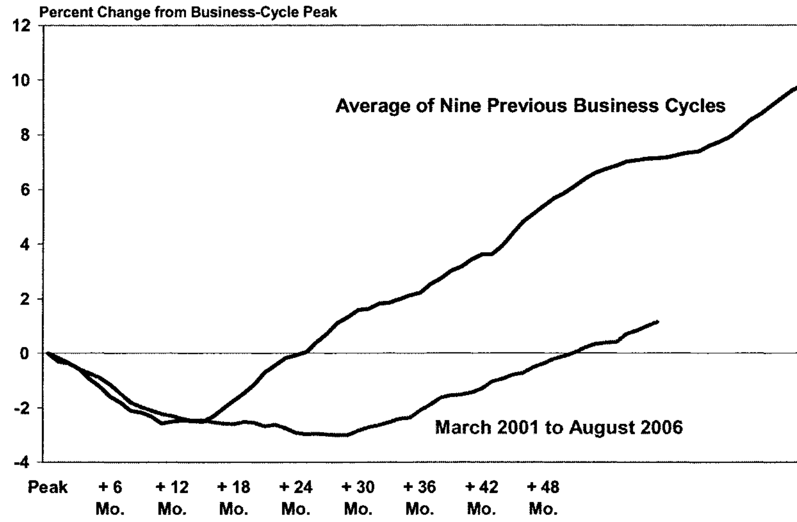
[10] See, for example, William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Short-term Stimulus," *Tax Notes*, November 1, 2004.

[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.

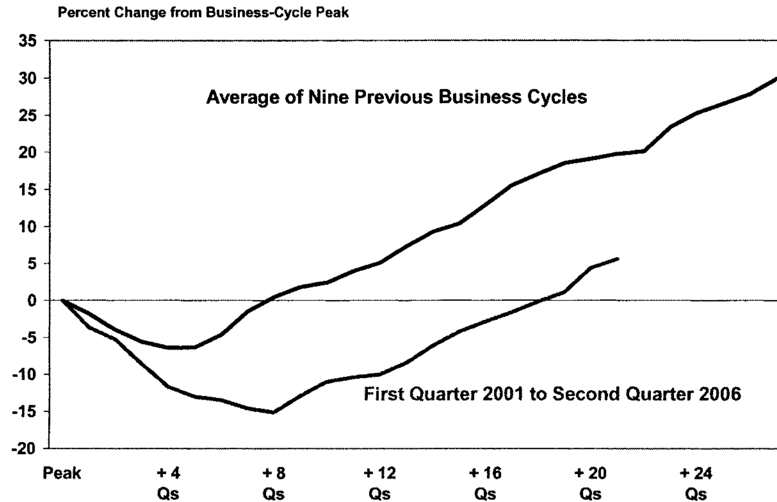
[13] Many households in the bottom half of the income distribution owe little or nothing in federal income taxes. Others higher up in the income distribution are subject to the Alternative Minimum Tax, which was only temporarily reduced by the tax cuts. As a result, a study using the tax model at the 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

[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.

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[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.

COMMITTEE HEARING
September 28, 2006

America's Public Debt: How Do We Keep It From Rising?"

Testimony of Charlie Stenholm, Senior Policy Affairs Advisor, Olsson, Frank and Weeda, P.C

And Former Member of Congress

Mr. Chairman, Senator Kerry and Members of the Committee. I am Charlie Stenholm, former Member of Congress from the 17th District of Texas and currently a Senior Policy Affairs Affairs Advisor at Olsson, Frank and Weeda. I am also a member of the Board of Directors of the Committee for a Responsible Federal Budget and the Concord Coalition. This testimony is my own and does not represent any position or conclusion of any of these organizations.

In my twenty six years in Congress, I worked with many members on both sides of the aisle, including several members of this committee, fighting to leave a better future for our children and grandchildren. We spent many years working extremely hard and casting many tough votes to eliminate the deficit and put us in a position to begin paying down the debt. It has been extremely frustrating to see the fruits of that labor squandered by the "deficit's don't matter" mentality that took hold in recent years. I am hopeful that this hearing and similar discussions about the dangers of continued deficits and the need to take action are a sign that the tide is shifting back to the bipartisan balanced budget consensus we had in the 1990s.

I have been asked to share my thoughts about how to deal with our nation's rising pubilc debt. My testimony can be summarized in three recommendations based on West Texas Tractor Seat Common Sense:

- First, acknowledge that we face a problem. Policymakers need to take to heart the message of The Concord Coalition's Fiscal Wake Up Tour that Bob Bixby described – our nation is on a fiscally unsustainable course and difficult choices must be confronted.

- Second, stop digging the hole deeper through debt financed tax cuts or spending programs.

- Third, begin a bipartisan process in which both parties put everything on the table and honestly negotiate the tradeoffs.

From Deficits to Surpluses and Back

In the 1990s, a bipartisan consensus in Congress recognized that we could not continue to allow deficits and debt to spiral out of control. We balanced the budget, and the benefits were enormous: the longest peacetime expansion of the American economy in 50 years, four straight years of budget surpluses, record low unemployment and poverty rates, and record high homeownership. In January of 2001, the Congressional Budget Office projected a budget surplus of $5.6 trillion over ten years. We were on path to paying off the publicly held debt. There were even warnings that we were in danger of paying off debt too quickly.

Today, our nation has returned to the era of deficits as far as the eye can see. The national debt broke through the $8 trillion barrier, a number that seemed incomprehensible just a few short years ago. The national debt is on track to exceed $10 trillion in debt by 2008 or early 2009.

The recent news that the deficit for 2006 will be nearly $60 billion below the $318 billino deficit recorded last year is good news, but the fact that a deficit of $260 billion is a cause for celebration is in itself an indication of how deep of a hole we have dug for ourselves. Even more troubling is the fact that most analysts have warned that the modest decline in the defict is temporary and will be followed by deficits climbing back over $300 billion. An update on the budget outlook issued by Goldman Sachs earlier this week estimated that the 2007 deficit will be $300 billion and will continue to grow in nominal terms and as a percentage of GDP through the rest of the decade. Goldman Sachs estimates that the cumulative deficit over the next decade will total $4.4 trillion. These estimates are in line with the estimates of other indpenendent analysts. These sobering assessments should temper any celebrations about the temporary decline in the deficit this year.

As my former colleague in the House Blue Dog Coalition Jim Cooper and others have pointed out, those numbers actually understate the true size of our fiscal shortfall. The Financial Report of United States Government issued by the Treasury Department calculated that the government ran a deficit of $760 billion 2005 on a net operating basis, and that number does not even include the accrued obbligations of Social Security and Medicare. The Government Accountability Office estimated that our total fiscal exposure of the federal government are in excess of $46 trillion.

It is true that our nation has faced unexpected emergencies that have contributed to the deficit, but that should not be an excuse for fiscal irresponsibility. Many of us warned that the anticipated budget surpluses were only projections and that it was dangerous to make commitments using all of the projected surpluses without leaving any room for error. We warned that if the projections didn't turn out exactly as hoped, we would return to deficits. We should have set aside some of the projected surplus as a cushion to prepare for unanticipated costs. And when we were faced with those unanticipated costs, we should have gone back and made changes in our budget plans.

Deficits Do Matter

Some defenders of our current economic and fiscal policies have argued that deficits don't matter. The reality is that deficits do matter, both for our economic security today as well as the future we leave for our children and grandchildren.

The United States has been able to sustain large budget deficits without an increase in domestic interest rates because the increased demand for borrowing has been offset by an increased inflow of capital from global markets. Our increased reliance on foreign capital to finance our deficits places our economic security at the mercy of global bankers and foreign governments. If foreign investors stop buying US bonds we would face higher inflation and higher interest rates, putting our economy at risk of a large scale recession.

Large deficits financed by borrowing from foreign investors are also a major factor contributing to the trade deficits which are exporting jobs overseas. We need to keep the value of the dollar high in order to attract the foreign capital we need to finance our debt. If the value of the dollar declines, US bonds will be less valuable to foreign investors. But the strong dollar we need to help Treasury finance our budget deficits hurts our businesses by making US exports more expensive.

Our current borrow and spend policies are worse than the tax and spend policies of the past, because they will leave a crushing debt tax burden for future generations who don't have any say in what we are doing and don't benefit from the tax cuts and spending programs for current generations. Our grandchildren will face ever higher tax burdens simply to cover increasing interest payments instead of addressing other needs such as keeping our military the strongest in the world, protecting our domestic security, providing health care, strengthening Social Security and Medicare, and investing in our education system.

A German philosopher named Dietrich Bonhoeffer once said that the ultimate test of a moral society is the kind of world that it leaves to its children. We cannot leave it to our grandchildren to shoulder the enormous burden of our debt. Our grandchildren do not have a vote. That is why it is so easy for us to say here today we can fight two wars, we can fund homeland security, we can fight the war on terrorism, we can rebuild the Gulf Coast and we can keep cutting taxes, because we are going to send the bill to our grandchildren.

One of my proudest moments in Congress was when the House passed the Balanced Budget Amendment to the Constitution, and one of my greatest disappointments was when the Senate fell one vote short of approving it. A Balanced Budget Constitutional Amendment and strong budget enforcement rules would protect the rights of future generations who are not represented in our political system but will bear the burden of our decisions today. If a Balanced Budget Amendment were already in the Constitution, we would not have been able to enact the budget policies advocated by the majority that have resulted in a rapid increase in our national debt.

The First Step Toward Getting Out Of The Deficit Hole: Quit Digging

My philosophy on budget issues has always begun with some simple West Texas Tractor Seat Common Sense – When you find yourself in a hole, the first rule is to quit digging. Unfortunately, the legislative agenda is filled with items that would dig the hole deeper through tax cuts and increased spending. The most notable example was the so-called trifecta bill which combined a temporary extension of business tax breaks, a permanent reduction in the estate tax and a new mandatory spending program for mine reclamation along with an increase in the minimum wage.

The Trifecta Bill is an example of the worst kind of legislative log-rolling: a debt-financed extension of politically popular tax breaks is used as the vehicle to advance a much larger tax cut which would result in a substantial reduction in long-term revenues and when the package ran into opposition a new spending program was added to the bill to gain enough support to overcome the opposition. While the individual items in the package may be worthwhile on policy grounds, the combination of cutting taxes and increasing spending in one bill without regard for how those costs would fit into the overall budget is a perfect example of how the legislative process has produced a large and growing debt.

Earlier this year Congress took a modest step toward controlling the growth of entitlement spending last year by utilizing the reconciliation process to address entitlements for the first time in eight years. Reconciliation bills making changes in entitlement programs as well as tax policy in order to reduce the deficit were a regular part of the legislative process prior to the surplus era. Unfortunately, the modest savings achieved in the spending reconciliation bill were more than wiped out by tax cuts enacted under reconciliation protections.

In recent years Congress has routinely used the special procedural protections under reconciliation to facilitate the passage of legislation that would increase the deficit. This is exactly the opposite way reconciliation was intended to be used. It was a bad precedent to set in a period of surpluses, and is even worse now that the budget is back into deficit. Reconciliation protections are intended to help Congress take actions that are responsible but politically difficult, not irresponsible but politically popular. Congress should prohibit the use of reconciliation protections for legislation that would increase the deficit and make reconciliation bills that achieve savings for deficit reduction a regular part of the annual budget process.

Dealing with our budget deficit must begin with reinstatement of budget enforcement rules to take away the shovels from Congress and the administration by restricting the ability of Congress and the President to enact legislation that would increase the deficit. The pay as you go budget enforcement rules and discretionary spending limits, which Congress and the President enacted in 1990 and extended in 1997 with bipartisan support, were an important part of getting a handle on the deficits in the early 1990s and getting the budget back into balance.

Reinstating paygo rules and discretionary spending limits would not balance the budget by themselves, but would represent an important first step in bringing discipline to the budget process by prohibiting policy changes that would further enlarge the deficit. They have been tested, and they worked. They didn't always work perfectly, but there is no question that they significantly improved the responsibility and accountability of the budget process.

The principle of paygo -- if we want to reduce our revenues or increase our spending, we need to say how we would pay for it within our budget – is something all families understand. If we want to reduce our revenues, we need to say what spending we will do without. If we want to increase spending, we need to say where we will come up with the revenues for the new spending or what other spending we will do without.

The concept of applying PAYGO rules to all legislation -- spending and revenues -- has received support from both sides of the aisle since it was originally enacted. "Two-sided" PAYGO was originally enacted in the bipartisan budget agreement of 1990 and extended in the bipartisan balanced budget agreement of 1997. Furthermore, it was included in the budget passed by the Republican Congress in 1995. Applying pay-as-you-go rules to tax cuts does not prevent Congress from passing more tax cuts. All it requires is that Congress must identify another source of revenue or spending reduction if it wants to enact or extend a tax cut.

Those who want to extend expiring tax cuts or make the tax cuts permanent should be willing to put forward the spending cuts or other offsets necessary to pay for them. Similarly, those who want to spend more in certain areas need to be willing to say where they would cut or how they would raise revenues to pay for their proposals.

I would say with all due respect to my Republican friends that if you are sincere in what say about controlling spending, you should not have a problem with reinstating pay as you go for taxes as well as spending because it would force Congress to actually cut spending to accompany tax cuts instead of just promising to cut spending in the future. The problem is that the actions of the majority in Congress haven't matched the rhetoric. Congress and the administration have cut taxes without cutting spending, and have charged the difference to our children and grandchildren by increasing the deficit.

The pay-as-you-go principle is not simply a matter of bookkeeping, but a key element of sound economic policymaking. A recent report issued by the Treasury Department providing a dynamic analysis of proposals to permanently extend the 2001 and 2003 tax cuts illustrate the importance of offsetting the revenue loss from tax cuts. Although the report cited economic models which found that certain tax cuts can result in higher savings and increasing capital stock the report noted that "when lower taxes on capital income are financed initially by issuing government debt, private investment is crowded out by an increase in government borrowing," limiting the economic benefit from the tax cuts. The report went on to say that in some instances the benefits from tax relief that increases the deficit are more than offset by the financing of government debt.

No reputable analyst believes that cutting taxes will result in higher revenues than would have occurred without the tax cut. While some tax cuts may result in economic growth that produces some revenue feedback, there is no credible analysis that claims those potential benefits would offset the revenue loss. Analyses from the Congressional Budget Office, the Joint Committee on Taxation, the Federal Reserve Board, and the President's own Council of Economic Advisors have all concluded that the tax cuts enacted over the last four years will have little or no impact on long term economic growth and cause deficits to be larger than they otherwise would have been.

Put everything on the table

A serious discussion about balancing the budget will require both parties to make sacrifices. All areas of the budget must be on the table and the burden of deficit reduction should be distributed fairly across the budget. I have always said that those of us in agriculture are willing to accept our fair share of reductions if all other areas of the budget are asked to sacrifice as well, but we aren't willing to shoulder an undue burden of cuts so that other areas of the budget can avoid budget discipline. I believe that this view is shared by advocates of other areas of the budget as well.

The Promise to Our Children and Grandchildren being circulated by For Our Grandchildren, a bipartisan Social Security education organization which has retianed me as a spokesman, embodies this approach. The promise asks candidates to seek an honest, bipartisan debate about Social Security and find responsible solutions to meet these challenges that the system will face in the years ahead. It doesn't commit candidates to any specific policy proposals. Rather, it calls on policymakers to put all options on the table to develop a solution which honestly addresses the pressure that the unfunded obligations that the current system will place on taxpayers and other budgetary priorities in a way that is fair to all generations, protects current retirees and strengthens the safety net for the most vulnerable. If all candidates from both parties conduct themselves in this spirit in the debate over Social Security and our other fiscal challenges it will be much easier to reach bipartisan agreement on responsible solutions.

The renewed public focus on the need to address the long-term problems facing entitlement programs has been encouraging. However, rhetoric about the need to make tough choices with regard to entitlement programs is undercut when it is not matched by a willingness to make similarly tough choices on the revenue side of the ledger. It is fiscally irresponsible and politically unrealistic to call for reforms of entitlement programs in the name of fiscal discipline while simultaneously advocating tax cuts that will make the short term deficit and long term fiscal imbalance worse. It is neither fiscally responsible nor politically viable to make cutbacks in some areas of the budget in the name of deficit reduction while exempting other areas of the budget from budget discipline. That is particularly true when deficit reduction efforts focus on the most vulnerable in society, while benefits for those in a better position to accept sacrifices are left untouched. It will take everyone pulling to get the wagon out of the ditch; we won't be able to get it out if some people are riding.

One specific proposal that would provide a substantial source of savings in a way that spreads the burden of deficit reduction broadly is utilizing a more accurate measure for indexing government programs as well as tax brackets and other provisions in the tax code. There is broad agreement among economists that the Consumer Price Index currently used for indexation of government programs overstates inflation. The Bureau of Labor Statistics has begun to publish a new "Chained Consumer Price Index" to provide a more accurate measure of inflation. Using the Chained CPI for indexation of government programs represents sound policy that reflects years of work by economists and other technical experts. Just as importantly, this proposal would achieve substantial budgetary savings – approximately $50 billion over the next five years -- in a way which would spread the burden of deficit reduction fairly across the entire span of government.

Increasing the Debt Limit

This Committee has been called on to raise the debt limit four times in the last five years to finance our deficit problem, and probably will need to be asked to do so again next year. While raising the debt limit is something that Congress must do, increasing the debt limit should be accompanied by a full and open debate about the fiscal policies that have made the increase necessary and a discussion about what should be done to stem the tide of red ink. In addition, I believe that any long-term increase in the debt limit should be accompanied by a plan to restore fiscal discipline. I would propose that when Treasury indicates that it is nearing the debt limit Congress approve a short term increase in the debt limit to avert the imminent crisis and provide for a longer increase in the debt limit contingent upon Congress taking action to reinstate paygo rules and other budget enforcement mechanisms.

Addressing Long-Term Fiscal Problems

Although our near term budget deficits are cause for concern in their own right, what makes them particularly worrisome is the looming financial pressures we will face when the baby boom generation begins to retire in 2008. We need to bring more attention to the long-term liabilities facing our nation as part of the budget process.

I had hoped that last year would be the year that Congress and the President would take action to address the financial challenges facing Social Security, but neither party seemed interested in a serious discussion about the tough choices that will be necessary. These challenges will continue to get worse and become harder to address the longer we wait.

According to projections by the Government Accountability Office (GAO), the combination of allowing the growth of entitlement programs to continue unchecked and making tax cuts permanent while keeping discretionary spending constant as a percentage of GDP will result in a deficit of 10 percent of GDP by 2024. By 2030, the costs of Social Security, Medicare, Medicaid and interest on the debt would consume nearly 22 percent of GDP and the debt to GDP ratio would be 150%.

While the higher revenues from allowing the tax cuts to expire would fall far short of closing this long-term fiscal imbalance, it makes no sense to make the gap worse by locking in permanently lower revenues *before* restraining the growth of entitlement spending. Unless Congress enacts major reforms slowing the growth of entitlement spending, revenues will need to increase well above current levels to meet these obligations and keep up with the growth in spending associated with the baby boomers' retirement and health care costs. Congress should defer action on any tax cuts or entitlement spending increases with long term costs – including extension of the tax cuts which expire in 2010 or expansion of Medicare prescription drug benefit -- until Congress has addressed the existing long-term fiscal challenges.

There is no magic bullet that will solve our long term fiscal challenges by itself. While stronger economic growth will help meet the burden of an aging population, higher economic growth alone will not be enough. GAO has estimated that we would need double-digit real economic growth for many decades to grow our way out of the fiscal problems. Slowing the rapid growth of health care spending will need to be part of the solution, but a substantial gap would remain even if we were somehow able to eliminate all excess health care cost growth. Proposals that have been put forward to raise revenues to finance the growing costs of entitlement programs should be considered, but it is unrealistic to expect that it is politically feasible or economically desirable to raise taxes enough to close the gap. Although I personally believe that individual accounts can be an important component of a comprehensive reform plan by providing a higher returns on worker contributions and a more reliable method of pre-funding benefit promises than government trust funds, they do not provide a painless solution to the financial challenges facing Social Security as some have claimed.

A serious solution to our long term fiscal challenges will likely require some combination of stronger economic growth, restraining the growth of health care costs, scaling back benefit promises of entitlement programs, increasing the eligibility age for Social Security and Medicare, increasing revenues, and other tough choices. There is plenty of room for debate over the exact mix of options that should be included in a plan, but policymakers need to begin by acknowledging that the solution will require tough choices and difficult tradeoffs.

Fiscal Commission

The experience of last year in which neither party in Congress was willing to take action on the financial challenges facing Social Security convinced me that we need to establish a bipartisan commission to objectively review the fiscal challenges facing our nation and make recommendations to Congress and the President about how to put the nation back on a fiscally sustaiable course.

Senator George Voinovich and Congressman Frank Wolf have introduced legislation, the Securing America's Future Economy (SAFE) Act which would establish such a commission. The commission would solicit input from the public and develop proposals to address four key concerns:

1) The unsustainable gap between projected spending and revenue,
2) The need to increase national savings,
3) The implications of foreign ownership of U.S. government debt, and
4) The lack of emphasis on long-term planning in the budget process.

Congress and the president would be required to act on the proposal developed by the Commission under a fast track procedure.

Senator Chuck Hagel, a Republican from Nebraska and Congressman John Tanner have introduced similar legislation establishing a commission to address the challenges facing entitlement programs, which are the primary source of our long-term fiscal challenges. The Stop Over Spending Act introduced by Senate Budget Committee Chairman Judd Gregg included a similar entitlement reform commission based on a proposal put forward by Senators Pete Domenici and Diane Feinstein.

As a former Member of Congress, I would like to believe that Congress could address these issues without the need for a commission. Unfortunately, the experience of recent years suggests that is extremely unlikely under the current political environment. Neither party wants to be the first to step out with tough choices out of fear that they will be attacked politically. Neither side is willing suggest that they are open to compromises out of fear that the other side won't reciprocate

A commission could help advance the debate, break the political stalemate and give all parties -- Republicans and Democrats in Congress, the current administration or whoever is elected President in 2008 -- the cover to to tackle the tough choices that they know needs to be made. Right now the perception is that a commission would give political cover to the current administration and leadership in Congress, but after the next election my fellow Democrats may have a greater obligation to say how they would address these issues and could use the political cover a commission would provide.

Earlier this year, the Concord Coalition sponsored a forum about the possibility of a commission to address long term fiscal issues. There were a few elements that everyone agreed were necessary for a commission to suceed:

1) The Commission must be truly bipartisan and represent a broad range of views

2) The Commission must be given a broad mandate to examine all aspects of fiscal policy, including entitlements and tax policy

3) The Commission should educate the public about the long-term fiscal challenges and engage the public in discussion potential solutions.

4) All policy options must be on the table. There should be no preconditions about what policy options can consider.

5) The commission proposal should be given an up-or-down vote in Congress with an opportunity for alternatives and amendments that would not reduce the total savings.

It is critical that members of the Commission not be asked to pass a litmus test about what options they would or would not support in a final solution. Everyone must resist the temptation to immediately shoot down ideas they don't like. Let an idea fly in the public debate long enough to consider its merits.

I agree with former Treasury Secretary Rubin that the commission should be allowed to examine rolling back tax cuts and other options to increase revenues. Increasing taxes to meet the growing costs of meeting our obligations to Social Security, Medicare and Medicaid as the baby boom generations retires is a legitimate option that the commission should be allowed to consider. Likewise, keeping taxes at current levels will require substantial changes to scale back the costs of these entitlement programs. In all likelihood the solution will require a combination of changes to restain spending and increases in revenues. The Commission should be allowed to consider and discuss the full range of options and debate the tradeoffs.

There is justifiably cynicism in Washington about proposals to establish a commission to study an issue. There are bookshelves filled with dust-covered reports from commissions that went nowhwere. A commission isn't a silver bullet that will solve our problems. It will still take action by Members of Congress and the administration to make the tough choices. But a commission that reflects the principles I have outlined could provide the leadership necessary to get the process started in a constructive fashion, especially if the President follows through on his pledge to address the issue in a bipartisan manner and continues to make addressing the long-term challenges facing entitlement programs a priority.

Conclusion

Reaching consensus on a balanced package that will prevent the publicly held debt from growing to unsustainable levels will require all of us to accept sacrifices. As long as everyone advocates balancing the budget by cutting someone else's priorities, talk about deficit reduction will remain just that. As a farmer, I choose to be an optimist and believe that all sides will be willing to put aside their individual political interests to find a solution that is in the best interests of our nation and our children's future.