Testimony to The Joint Economic Committee
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of

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Mr. Chairman:

Thank you for the invitation to testify before the Joint Economic Committee on the *Economic Report of the President*.

The main points that I wish to emphasize are these:

• An *Economic Report* can be no better than the policies it defends. *The current Economic Report is tied to an economic program that not only skirts the central fiscal problem* the United States faces—*how to prepare fiscally for costs that will be generated by retirement of the baby-boom generation—but one that aggravates those problems*.

• Although the Congressional Budget Office reports a ten-year, base-line cumulative budget surplus on the unified budget, *the Administration's program will push that budget into deficit by more than $1 trillion*.

• Under more realistic assumptions and more defensible accounting conventions, *the cumulative budget deficit over the next decade will be approximately $5.5 trillion*.

• By its reckless insistence on tax cuts, which aggravate the fiscal shortfall, and its use of trust fund accumulations to pay for current government spending, *the Administration's program will reduce growth* of national income by ever larger amounts—*just under $500 billion in 2013*. These tax cuts will add $130 billion annually to the governments interest payment burden in 2013.

• *The revenue sacrificed by the tax cuts* that the Administration has proposed since coming to office *is more than sufficient to eliminate the entire projected deficits of the Social Security system and Medicare Hospital Insurance, with enough left over to double federal aid to higher education and bio-medical research and to support a major initiative to improve life chances for America's children*.

I elaborate on these point below and ask that the full text of my remarks be included in the record.

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[1] The views expressed in this testimony are those of the author and do not necessarily represent those of the staff, officers, or trustees of the Brookings Institution.

The *Economic Report of the President* and the president's budget comprise the major economic statements of the Administration. They cannot be evaluated independently of one another. In fact, one of the foremost purposes of the *Economic Report* is to provide analytical arguments to buttress the president's proposals. This *Economic Report* is no exception. Nor is it exceptional in its inclusion of a welter of useful exposition, carefully reasoned and clearly written. The Council members and staff who prepared this document are, as ususal, skilled professionals.

The quality of the *Economic Report*, however, cannot be evaluated apart from the policies it advances. If those policies are flawed, no amount of analysis can spare the *Economic Report* from harsh judgment. To be sure, this *Economic Report* deals with many important matters. It contains sophisticated reviews of tax policy, regulation, and international trade. But *the central challenge facing budget policy in the United States is rather different—how to prepare the U.S. public finances for the fiscal challenge posed by the retirement of the baby boom generation*.

The first baby-boomers will become eligible for Social Security in just five years and for Medicare in eight. These dates usher in three decades of sharply increasing demands on the federal government to pay for pension and health benefits for the elderly, disabled, and survivors.

In brief, the federal budget will come under increasing stress—sooner rather than later. Action is required to prepare the nation to to handle this stress—now, and not at some indefinite future time. The fiscal challenge of the baby boom generation's retirement is not a distant problem that can be left to our children. It commences well within the ten-year planning horizon that Congress has been using for budget planning.

Yet *the president's 2003 budget* does nothing to meet these problems. On the contrary, if implemented, the president's budget proposals *would dramatically weaken the capacity of the federal government and of the nation to meet those challenges*. The Administration's tax program would add trillions to the national debt and slow economic growth. This indictment is harsh, but in no manner exaggerated. In my testimony, I shall draw on estimates of budget prospects beyond the five-year window shown in documents the Administration has released.

It is well known that budget prospects have deteriorated in the past two years. The magnitude of the deterioration is staggering, as shown in Table 1.

TABLE 1: PROJECTED BUDGET BALANCE (2002-2011)
January 2001, January 2003

Projection Date	Unified Budget (2002-2011)	On-Budget (excluding Social Security) (2002-2011)
January 2001	+ $ 5.6 trillion	+ $ 3.1 trillion
January 2003	$ 0 trillion	– $ 2.2 trillion
Net Change	**– $ 5.6 trillion**	**– $ 5.3 trillion**
Of which... Recession: outlay increases and revenue re-estimates	$2.6 trillion *46 percent*	
Other Outlays	$1.3 trillion *22 percent*	
Tax cuts	$1.8 trillion *31 percent*	

Source: Congressional Budget Office and tabulations by William G. Gale and Peter R. Orszag. [interest]

Three factors contributed to this deterioration—the recession (largely because of downward revisions of revenue projections), increased outlays (largely related to the military build-up), and tax cuts.

The *Economic Report* exonerates the current administration from responsibility for the recession. I think it is right to do so. The current recession is not the fault of the current president or of his predecessor. Variations in fiscal policy of the sort the United States has experienced in recent years do not cause short term economic fluctuations. With the wisdom of hindsight, most observers now agree that the giddy boom of the late 1990s was unsustainable. Perhaps different monetary policy might have resulted in a softer landing. Although this possibility will long be debated, history cannot be rerun. Few observers now believe that fiscal policy did play, or could have played, any significant role in preventing the recession. The automatic stabilizers doubtlessly helped attenuate the severity of the recession. But most economists now agree that fiscal policy can play only a small part in ending it.

Thus, in two years, the budget prospects of the United States have turned from rosy to gloomy. Unfortunately, even the comparatively dour projections embodied in the official budget projections from the Congressional Budget Office hugely understate the budget problems that the nation faces over the next ten years for four distinct reasons.

- *Official projections exclude the cost of the Administration's 2004 budget*.
- *The official projections exclude certain or highly probable legislation that will dramatically increase the deficit*.
- *The projections are based on imprudent accounting conventions*.
- *The projections are entirely silent on the daunting budget problems outside the ten year window*.

IMPACT OF THE ADMINISTRATION'S 2004 BUDGET

The Congressional Budget Office has not yet made public its estimates of the cost of the proposals in the Administration's 2004 budget. Independent staff estimates suggest that the *initiatives contained in the 2004 budget will increase the unified budget deficit by an estimated $2.7 trillion* (see table 2). Tax cuts and associated increases in debt service account for nearly two-thirds of this $2.7 trillion shift in the budget. Based on graphs in the Administration's *Analytical Perspectives* (pp. 41-45), it is clear that the Administration expects the budget to remain in deficit forever under its proposed policies. [These projections appear in a chapter entitled "Stewardship." Whether Administration officials saw the irony in this title is not clear.]

TABLE 2: PROJECTED BUDGET BALANCE (2004–2013)

	Net change	Balance
CBO Baseline, January 2003		
CBO Baseline, modified to include effects of the Administration's 2004 budget	– $2.7 trillion	– $1.3 trillion
Adjustment for expiring tax provisions and corrections in the AMT	– $0.8 trillion	– $2.1 trillion
Adjustment for retirement funds	– $3.4 trillion	

UNREALISTIC ASSUMPTIONS

The official projections embody a number of unrealistic assumptions. Nearly all understate prospective budget deficits. For example, *official projections assume that a variety of expiring tax provisions will be allowed to expire although they have been slated to expire in the past and have been repeatedly extended*. They also assume *that the sunset provisions of the 2001 tax cut will be allowed to take effect, although the Administration is on record that it wishes to make these provisions permanent* (and, in addition, to accelerate their effective dates, the consequence of which is included estimates of the effects of the Administration's 2004 program). Finally, they assume *that Congress will do nothing to prevent tens of millions of filers from becoming subject to the Alternative Minimum Tax*. Should this development occur, these households would not receive the full benefit of tax cuts legislated in 2001. If one assumes that repeatedly renewed tax provisions are once again not allowed to expire, that the 2001 tax cut is made permanent as the Administration requests, and that the Administration will take steps to assure that households will receive the benefits of the 2001 tax cut that spread of the AMT would block, then the projected budget deficit over the next decade rises to $2.1 trillion.[2]

PROPER ACCOUNTING FOR RETIREMENT PROGRAMS

Corporations are required by federal regulation to maintain adequate reserves for accrued pension liabilities. These reserves may not be used to pay for current company expenses. They may not be used to fund dividend payments, the corporate equivalent of federal tax cuts. *It is foolhardy to count as part of revenues available to finance current government operations reserves being accumulated to pay future Social Security, Medicare, or federal employee retirement benefits*. These additions to reserves, to be sure, are real saving...if these reserves were not being accumulated and other government spending and revenues were the same, the federal government would have to borrow more from the public and national saving would be correspondingly lower. But treating these additions to pension and health reserves as current revenues understates the degree to which revenues outside the pension and health trust funds fall short of current outlays. Over the decade 2004-2013, additions to reserves for future pension and health care benefits will total $3.4 trillion.

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[2] I assume that expiring elements of the AMT which would tend to increase the number of filers to whom it applies will be extended and that AMT exemptions, brackets, and phase-outs are indexed for inflation starting in 2004. The revenue estimates, which are based on tabulations from the Urban-Brookings Tax Policy Center, include feedback effects of increased interest on the public debt, and are reported by William G. Gale and Peter R. Orszag in "Perspectives on the Budget Outlook," *Tax Notes*, February 10, 2003, pp. 1005-1017.

WILL THE REAL ADMINISTRATION BUDGET PLEASE STAND UP!

Over the next ten years, a combination of Administration-favored tax cuts, increased defense needs, the residual effects of the economic slow-down, and the Administration's insistence on using trust fund surpluses to paper over its unwillingness to pay for current government spending mean that, by a proper accounting for the government budget, the federal government will be in deficit by a total of $5.5 trillion. Favorable events could make the actual deficit smaller; unfavorable events could make it larger. I have omitted one further adjustment that makes still larger deficits likely. I have assumed that domestic discretionary spending will remain constant in real terms. Should Congress decide, as seems plausible, that the richer and larger population in 2013 might wish to have more courts, national parks, air traffic controllers, and biomedical research than exists in 2004, the deficits would be larger by any such increment.

WHY THE ADMINISTRATION BUDGET IS ANTI-GROWTH

The numbers in table 2 indicate that with a proper accounting for the federal budget's prospects the United States faces a deficit of $5.5 trillion over the next decade. *The Administration is not responsible for all of this problem, but table 2 indicates that Administration tax policies have made it $3.5 trillion worse*. Any deficit means that the federal government is covering current public consumption with private saving that could otherwise have been invested in U.S.-owned capital. *Assuming that such investment yielded the current marginal return to capital, reducing U.S. owned capital by $3.5 trillion would* ***decrease*** *U.S. gross domestic product by about $280 billion in 2013*. In contrast, a policy of balancing the federal budget and saving additions to the trust funds would ***boost*** GDP by about $200 billion in 2013. *The $480 billion difference between a reduction in GDP caused by the large deficits that the Administration's program threatens and a policy of saving the trust funds' cash flow surpluses is the true price of the Administration's budget program*. That price would continue to grow steeper with each year, as federal deficits are enlarged by previously-enacted tax cuts that the Administration now wishes to accelerate and make permanent and the new tax cuts that it is seeking.

Rather than helping the nation prepare, the Administration's budget undermines the nation's capacity, to meet the fiscal challenge that the retirement of the baby-boom generation initiates. Years ago, my colleague, Charles Schultze, referred to such deficits as "not as the wolf at the door, but termites in the woodwork." The budget policy of the administration does not threaten any immediate calamity. Indeed, budget deficits during times of economic slack, such as the nation has experienced for the past two years, can help maintain demand and output. Over the medium and long term, however, demand will be determined largely by monetary policy, which is set by the Federal Reserve System. The budget serves primarily to influence how resources are allocated—within the public sector, in terms of domestic priorities—and between current consumption and saving, through the size of the deficit or surplus. *Administration policy not only lowers economic growth, it also squanders an opportunity to pay down the publicly held government debt and reduce a key element of government spending, government interest payments*. Instead, its

policies will add roughly $130 billion annually to debt service costs at the end of the current ten-year budget window.

THE DISTORTED PRIORITIES OF THE ADMINISTRATION BUDGET

Budgets express the policy priorities of any administration. What are the priorities of this administration? Are they ones that should command the respect of members of Congress? Do they justify the president's self-designation as a "compassionate conservative"? These are matters of personal judgment on which I have no special standing as an economist. But one can make informed judgments only if one knows the cost of the options the president has embraced and the costs of options he has rejected.

For at least two reasons, the ten year budget window is too brief a period to permit one to gauge the size of the policy choices that are at stake. First, some of the president's proposals are designed to cost little at first but much more later on. Pricing such initiatives over ten years misleadingly understates their long term cost. The so-called saving incentives in the 2004 budget illustrate the problem. Traditional IRAs and 401k plans exempt income deposited in such accounts from current income taxation but subject withdrawals to tax. The revenue cost of these tax breaks is immediately apparent, because the government immediately foregoes income taxes that it would have levied if funds deposited in such accounts had been used for other purposes.

The 2004 budget proposes to replace such accounts with plans modeled on Roth IRAs. Such deposits occasion no immediate income tax deduction, but all withdrawals are exempt from income tax. Because withdrawals take place many years or even decades in the future, the long-term cost of these tax concessions is largely excluded from the ten-year budget window. Expanding these accounts implants within the government budget a fiscal poison pill that slashes revenues, but not until long in the future. The actual proposals are even more insidious in that they enable many holders of traditional tax sheltered accounts to shift balances to the new accounts. This shift results in no new private saving. But it increases current revenues, which the administration uses to pay for other tax cuts, ignoring lost revenue later on. This step is equivalent to borrowing to finance today's tax cuts, but it is not recorded as an increase in the official public debt.

The second reason why a longer term perspective is desirable is that many of the most important obligations of the federal government entail obligations spanning several decades. Both the Social Security and Medicare actuaries annually present estimates of costs and revenues over the succeeding seventy-five years. All responsibly managed pension systems, including that serving federal employees, routinely solicit projections spanning periods much longer than ten years. For that reason, it is instructive to compare the long term cost of the tax cuts enacted in 2001 and proposed this year with the long term cost of dealing with the projected shortfalls in pension and health programs.

As with any large tax cut, the Administration's proposals would produce some beneficial effects. Lower taxes reduce economic distortions. Repealing the tax on dividends, for example, would as the Administration claims reduce some distortions in business investment planning. But it would also leave others untouched. A superior alternative, put forward by Urban Institute economist, Leonard Burman, would remove more distortions at less revenue loss than the Administration plan.[3] The Administration plan would also expand tax shelter opportunities and would almost certainly complicate tax planning. The expansion of limits on tax-sheltered personal saving would probably slightly increase saving by a small fraction of the wealthiest Americans. Unfortunately, it would also open up massive opportunities for tax avoidance by enabling the wealthy to shift assets from taxable accounts into tax-sheltered accounts.

These so-called "saving" provisions could also reduce saving by low and middle income families. This counter-intuitive effect requires some explanation. Most filers do not use currently-available sheltered saving vehicles to the maximum possible extent. Increasing maximum deposits would mean nothing to them. However, higher ceilings could cause some employers to drop qualified pension plans that were instituted primarily to provide shelter opportunities for highly compensated employees. Current nondiscrimination rules require that such plans be extended to employees who are not highly compensated. High limits on individual do-it-yourself sheltered saving will permit such employers to dispense with their qualified pension plans because they can save enough individually while saving costs "wasted" on pensions for others.

Whether the good direct effects of the various tax cuts will outweigh the bad effects is debatable. The direct distributional effects, however, are quite clear. They accrue disproportionately to upper income households.

Tax change	Percent of benefits flowing to filers with annual income greater than or equal to	
	$500,000	$200,000
Enacted, but not yet implemented, elements of EGTRRA[+]	55.1	60.8
"Economic Growth" package[+]	37.1	55.9
Making 2001 cuts permanent[#]	33.6	40.5
Distribution of tax payments*	n.a	40.1

Source: *Urban Brookings Tax Policy Center and Joint Tax Committee*

[+] Estimate for 2010

[#] Estimate for 2012

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[3] Leonard Burman, "Taxing Capital Once," Urban-Brookings Tax Policy Center, 21 January 2003, http://www.taxpolicycenter.org/research/Topic.cfm?PubID=410611 .

* Estimate for 1999

To call attention to such distributional patterns is sometimes labeled "class warfare." But if class warfare is present, it is initiated by those who insist on cutting taxes disproportionately for the wealthy while pleading poverty when asked to provide aid to states now forced to cut poor children and elderly from the Medicaid rolls, suspend social services, and curtail public library services. Those of us who call attention to who gains and who loses are not engaging in class warfare; we are merely reporting news from the front on the actions of those who have initiated hostilities.

My main point, however, is that tax cuts are not free lunch. The net benefit of any tax cut requires that one include what one must sacrifice in order to have the tax cut. We have to pay for them. Either we must pay more of other taxes or we must sacrifice public services. Given the enormous deficits that the nation faces under reasonable assumptions (see table 2 above), it is clear that the price of the Bush tax cuts is either higher future taxes or reduced public services. Table 3 below provides an illustrative menu of what the United States could have had instead of the Administration's tax cuts. It focuses on the tax initiatives that President Bush has embraced. The *Economic Report* goes to some pains to defend these initiatives.

The Bush tax program (including the 2001 tax cut and new proposals) will reduce revenues and increase debt service approximately $3.6 trillion over the period 2004-2013. Measured over seventy-five years, the reduction is equivalent to roughly 3 percent of gross domestic product. ***The value of these tax cuts is roughly twice the cost of completely closing the projected deficit over seventy-five years in the Old-Age, Survivors, and Disability Insurance program (Social Security) and the Hospital Insurance program (Medicare Part A)***. By citing this comparison, I do not mean to minimize the importance of the projected short-falls in these two programs. Furthermore, increases in the cost of Medicare, part B, three-quarters of which is funded by general revenues, will also make demands on the budget. Furthermore, Medicare is deficient as an insurance plan. It ranks at about the 15th percentile in terms of generosity when compared with private insurance for working Americans.[4] Nor should one ignore the budget costs for Medicaid, which will increase as retiring baby-boomers gradually become the frail elderly. *Rather I wish to emphasize that those who fret over the increased cost of entitlements should recognize that the Bush tax cuts have effectively derailed for years the nation's best—and I pray not the last—chance of dealing with these problems before they are upon us*.

Table 3 shows that even after one has closed the projected deficits in the nation's two largest entitlements, revenue absorbed by the Bush tax cuts would suffice to pay for several other federal activities that many would regard as high priorities.

[4] Correspondence with Kenneth Thorpe.

TABLE 3: What Tax Cuts Cost

	10 year 2004-13 (trillion $)	75 year (% GDP)		10 year 2004-13 (trillion $)	75 year (% GDP)
2001 Tax cut	$ 1.7	1.5–1.9	Close Social Security deficit	0–0.8	0.7
Make 2001 cuts permanent	0.6		Close Medicare Hospital Insurance deficit	0–0.9	0.8
"Economic Growth" Package and other tax cuts	1.3	0.8	Children's program	0.9	0.7
Subtotal	$3.6	2.3–2.7	Double higher education assistance	0.5	0.4
AMT fix	0.7	0.5	Increase biomedical research 50 percent	0.3	0.3
			Short term fiscal relief to state and local governments	0.1	0
Total	$ 4.3	2.8–3.2	***Total***	$1.8–3.5	3.1

Source: Estimates of the Center on Budget and Policy Priorities and of William G. Gale and Peter R. Orszag

- College attendance is worth much more today than it was in the past because the payoff to education has risen sharply. Students from upper income families have taken advantage of this development and are attending college at increasing rates. Students from lower income families have not. Doubling college aid would contribute both to social and economic equality and to economic growth. The cost would be about one sixth that of the Bush tax program.

- Opportunities in bio-medical research are exploding. Opportunities for curing disease and extending life are proliferating in the wake of sequencing the human genome. The

National Institutes of Health have been forced to deny funding for high quality projects that would have been funded in the past. The cost of doubling government spending on bio-medical research would be less than one-seventh that of the Bush tax program.

- State and local governments closed deficits of approximately $50 billion for fiscal year 2003. By mid-fiscal-year, it is apparent that they will face additional deficits of more than $25 billion. For 2004, prospective deficits total $70-75 billion.[5] As a result, up to 1 million Medicaid eligibles will be cut from the rolls.[6] (The proposed legislative changes in Medicaid included in the 2004 Budget will result in at least 200,000 additional Medicaid enrollees losing eligibility.) Regressive state taxes will be increased. Not only does the Administration budget do almost nothing to relieve this fiscal distress, it aggravates these problems by lowering state revenues. Provision of $100 billion in fiscal relief spread over three years would cost 3 percent of the projected ten-year cost of the Bush budget program and would have a negligible long-run cost.

- A group of scholars organized by my colleague, former OMB Associate Director, Isabel Sawhill, has prepared a program of interventions to help improve the life prospects of disadvantaged children.[7] This program includes cash assistance to families with children under age 5 and annual incomes below $60,000; increased earned income tax credits and child care for full-time earners; health insurance for children, and universal pre-school for four-year olds. The total cost of these and other smaller items would be approximately $75 billion annually, about 0.7 percent of GDP.

My purpose in presenting this list of alternative uses of the revenues that the Bush tax program will absorb is not to embrace these specific measures, although I believe that many merit serious consideration. Revenues will be needed for other purposes, and tax cuts deserve to be on any list of such uses. But it is bad policy analysis to focus on the consequences of tax cuts—which are usually beneficial—without simultaneously counting the cost of the taxes that will later have to be paid to fill in the resulting fiscal gap or the value of the services we and our children will be denied. Nor does it make sense to embrace as reasonable and prudent the tax cuts that have already been enacted and others now on the table and, at the same time, to say that the fiscal challenges of

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[5] These estimates are from Iris Lav, Center on Budget and Policy Priorities.

[6] Leighton Ku, et al., "Proposed State Medicaid Cuts Would Jeopardize Health Insurance Coverage for One Million People," Center on Budget and Policy Priorities, 6 January 2003 http://www.cbpp.org/12-23-02health.htm.

[7] *One Percent for the Kids: New Policies, Brighter Futures for America's Children.* Isabel V. Sawhill, editor (Brookings Institution, forthcoming 2003).

restoring balance to Social Security and Medicare are fearsome burdens that should make us all quail. It is also wrong to say that we cannot afford to provide any fiscal relief to struggling states and localities because the nation faces unexpected outlays for national defense.