United States Senate
Committee on Finance

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Statement of Senator Chuck Grassley on Chairman Frank's Explanation of the Democratic Stimulus Plan, Spending, and Future Tax Increases
Wednesday, Oct. 22, 2008

House Financial Services Committee Chairman Barney Frank is a leading architect of bicameral Democratic fiscal policy. Chairman Frank, who led the negotiations for House Democrats in the recently-enacted financial sector rescue legislation, appeared on CNBC's "Closing Bell" show Monday afternoon. Chairman Frank summed up the relationship between the additional spending, perhaps as much as $300 billion, the deficit impact of the spending, and future tax increases to restrain the deficit.

Chairman Frank stated: "I think at this point, there needs to be a focus on an immediate increase in spending and I think this is a time when deficit fear has to take a second seat…. I believe later on there should be tax increases. Speaking personally, I think there are a lot of very rich people out there whom we can tax at a point down the road and recover some of this money."

Chairman Frank may be giving us an honest assessment of what the grand fiscal plan is. Notice how spending is attached only to the word "increase"; nowhere is the word "cut" or "reduction" attached to the word "spending". The word "deficit" is used. Only the words "tax" and "increase" are connected.

The Senate Finance Committee conducted four hearings on tax reform this year. At each hearing, I asked a basic question about revenue neutrality, meaning that a new tax system brings in the same level of revenue as the current system. There are two ways to measure revenue neutrality. One way is to measure it against current law. The other way is to measure it against current policy. If current law is used, then a revenue-neutral plan means that we have to increase taxes. The tax increase is equal to the current-year levels of bipartisan tax relief, which is set to expire in 2011. That would mean tax reform would carry with it an automatic tax increase of between 20 percent and 30 percent, to be allocated across all individual taxpayers. If we measure revenue neutrality against current policy, then a tax reform exercise doesn't include a built-in tax increase of at least 20 percent to 30 percent. I'm very interested in pursuing tax reform in a bipartisan manner, but it is important to get this ground rule straight before we start the exercise. No one from the other side has answered this key question, but we're beginning to get some clues.

On August 14, 2008, Austan Goolsbee and Jason Furman, senior economic advisors to Sen. Obama,

wrote an op-ed in the Wall Street Journal. In the op-ed, Goolsbee and Furman adopted the current policy baseline. The only exception would be tax increases for single taxpayers above $200,000 of AGI and married taxpayers above $250,000 of AGI. They stated that Sen. Obama, if elected President, would aim for a tax system that kept federal revenues at their post-WW II historic average of 18.2 percent of GDP.

In recent days, leading opinion makers on the left have revised their positions on deficits. Now, with an Obama presidency a probability in their eyes, the fiscal effects of the government intervention in the financial system, and Sen. Obama's desire to significantly deficit spend for new social welfare programs, the leading opinion makers now seek to legitimize near-term outsize deficits (see the following New York Times article and the attached chart comparing the deficit impacts of the McCain and Obama plans).

Chairman Frank may have connected the dots on the whole plan. A President Obama will significantly deficit spend and then plan a tax increase "at a point down the road."

As we all know, the only serious revenue available under current law is in revoking the tax benefits of the bipartisan tax relief of 2001 and 2003 for the next two years – 2009 and 2010. So, if, by "down the road" Chairman Frank means two years from now, there is no revenue against the current law baseline. So, to what is he referring? Perhaps Democrats on the Hill, who have refused to rule out revisiting the current policy baseline in a tax reform environment, are considering tapping that source for the additional 20 percent to 30 percent in revenue it will bring in.

The leading Democratic fiscal policy makers, including Sen. Obama and his team, should be asked to reconcile these positions:

1. Does Sen. Obama stick by the August 14th Goolsbee/Furman op-ed which states that Sen. Obama's goal is to leave the federal tax take at historical levels of the economy?

2. If elected, is Sen. Obama going to insist on this position regardless of what is apparently a contrary position of leading Hill fiscal policy makers, like Chairman Frank?

3. If the answer is yes, then is Sen. Obama willing to disavow Chairman Frank's plans for a future tax hike?

4. Does Sen. Obama agree that a tax reform exercise doesn't change his stated goal of leaving the current level of taxation, 18.2 percent of GDP, in place?

5. If, as the combined analyses of the Tax Policy Center and the National Taxpayers Union Foundation show, Sen. Obama's tax and spend plans impact the deficit by at least $100 billion per year more than Sen. McCain's plans, and Sen. Obama wants to leave the federal tax take at 18.2 percent of GDP, how does Sen. Obama plan to reduce spending to reduce deficits?

If Congress drafts another economic stimulus package in November, it should include tax relief. I want to do what does the most good, and I think one of the best economic stimulus packages we can have would be some reductions of taxes because that encourages investment. I think we do need a stimulus package. It isn't so much if we need one or not. It's how it's structured. If we structure it

in such a way that we're setting ourselves up for tax increases later, I would oppose it.

The New York Times
October 20, 2008
Deficit Rises, and Consensus Is to Let It Grow
By LOUIS UCHITELLE and ROBERT PEAR
Like water rushing over a river's banks, the federal government's rapidly mounting expenses are overwhelming the federal budget and increasing an already swollen deficit.

The bank bailout, in the latest big outlay, could cost $250 billion in just the next few weeks, and a newly proposed stimulus package would have $150 billion or more flowing from Washington before the next president takes office in January.

Adding to the damage is that tax revenues fall as the economy weakens; this is likely just as the government needs hundreds of billions of dollars to repair the financial system. The nation's wars are growing more costly, as fighting spreads in Afghanistan. And a declining economy swells outlays for unemployment insurance, food stamps and other federal aid.

But the extra spending, a sore point in normal times, has been widely accepted on both sides of the political aisle as necessary to salvage the banking system and avert another Great Depression.

"Right now would not be the time to balance the budget," said Maya MacGuineas, president of the Committee for a Responsible Federal Budget, a bipartisan Washington group that normally pushes the opposite message.

Confronted with a hugely expensive economic crisis, Democratic and Republican lawmakers alike have elected to pay the bill mainly by borrowing money rather than cutting spending or raising taxes. But while the borrowing is relatively inexpensive for the government in a weak economy, the cost will become a bigger burden as growth returns and interest rates rise.

In addition, outlays for Medicare and Social Security are expected to balloon as the first baby boomers reach full retirement age in the next three years.

"The next president will inherit a fiscal and economic mess of historic proportions," said Senator Kent Conrad, Democrat of North Dakota and chairman of the Senate Budget Committee. "It will take years to dig our way out."

The Congressional Budget Office estimates that the deficit in the current fiscal year, which started this month, will reach roughly $700 billion, up more than 50 percent from the previous year. Measured as a percentage of all the nation's economic activity, the deficit, at 5 percent, would rival those of the early 1980s, when a severe recession combined with stepped-up federal spending and Reagan-era tax cuts resulted in huge budget shortfalls.

Resorting to credit has long been the American solution for dealing with expensive crises — as long as the solution has wide public support. Fighting World War II certainly had that support. Even now many Americans tolerate running up the deficit to pay for the wars in Iraq and Afghanistan, which cost $11 billion a month combined. And so far there is wide support for an initial outlay of at least $250 billion for a rescue of the financial system, if that will stabilize banks and prevent a calamitous recession.

"There are extreme circumstances when a larger national debt is accepted as the lesser of two evils," said Robert J. Barbera, chief economist at the Investment Technology Group, a research and trading

firm.

There are also assumptions that help to make America's deficits tolerable, even logical.

One is that people all over the world are willing, even eager, to lend to the United States, confident that the world's most powerful nation will always repay on time, whatever its current difficulties.

"So far the market is showing that it is quite willing to finance our needs," said Stephen S. McMillin, deputy director of the White House Office of Management and Budget.

Lenders are accepting interest rates of 4 percent or less, often much less, to buy what they consider super-safe American debt in the form of Treasury securities. The 4 percent rate means that the annual cost of borrowing an extra $1 trillion is $40 billion, a modest sum in a nearly $14 trillion economy, helping to explain why the current growing deficit has encountered little political resistance so far.

But if recent history repeats itself, the deficit is likely to be an issue again when the economy recovers.

Interest rates typically rise during a recovery, so the low cost of servicing the nation's debt will not last — unless a recession set off by the banking crisis endures, repeating the Japanese experience in the 1990s and perhaps even stripping the United States and the dollar of their pre-eminent status.

The assumption is that will not happen, and as the economy recovers, the private sector will step up its demand for credit, making interest rates rise.

Higher rates in turn would increase the cost of financing the deficit, and there would probably be more pressure to reduce it through cuts in spending. That happened in the late 1980s, as Congress and the White House coped with the swollen Reagan deficits. The Gramm-Rudman-Hollings Act, with its attempt to put a ceiling on deficits, came out of this period.

Another assumption, also based on 60 years of post-World War II experience, is that although the economy is sliding into recession, in a year or two that recession will end and the national income (also known as the gross domestic product) will expand once again.

When that happens, the national debt — the accumulated borrowing to finance all the annual deficits — will shrink in relation to the income available to pay off the debt.

The nation's debt as a percentage of all economic activity, while growing alarmingly now, is not at historic highs. The portion held outside the American government, here and abroad, in the form of Treasury securities was $5.8 trillion at the end of last month.

That is a relatively modest 40.8 percent of the nation's annual income, far below the 109 percent coming out of World War II or the nearly 50 percent in much of the 1990s.

Put another way, if the entire national income were dedicated to debt repayment, the debt would be paid off in less than five months. For most of the years since 1940, paying down the debt would have taken longer, putting a greater strain on income.

Still, these are not ordinary times. The banking system is broken, and the national economy, in response, is plunging toward recession in a manner that evokes comparisons with the Great Depression. To soften the blow, the administration and Congress ran up a record $455 billion deficit in the just-ended 2008 fiscal year, and they are en route to a shortfall of $700 billion or more this year.

"I do think we need to be ready for a very significant increase in the budget deficit," said Peter

Orszag, director of the Congressional Budget Office.

Apart from the war spending, outlays for unemployment insurance have risen by one-third and spending on food stamps has increased 13 percent over the last 12 months. Congress has agreed to expand education benefits for veterans of the current wars, and last spring it authorized $168 billion for a stimulus package, most of it in the form of tax rebate checks. Now the Democratic Congressional leadership is pushing for another stimulus of at least that much.

All of this is happening as tax revenues are falling, particularly corporate tax receipts, which were down $66 billion, or 18 percent, in the fiscal year that just ended. The decline accelerated in September.

Many Republicans would probably go along with two elements in the stimulus package proposed by the Democrats — a tax cut of some sort and extended unemployment benefits. But they resist stepped-up spending on public works projects and a temporary increase in federal aid to the states.

Representative Roy Blunt of Missouri, the House Republican whip, said the stimulus bill should not be used to finance “a huge public works plan” or to bail out “states that spent a lot more money than they should have on Medicaid and other social programs.”

To pay for the surge in spending — and the shortfall in taxes — the federal government increased the national debt by $768 billion over the last year, to the present $5.8 trillion, with $300 billion of that amount going to the Federal Reserve for a variety of rescue initiatives for the financial system.

The outlays swell as each day brings fresh reports of a financial system that is costly to repair and a rapidly sinking economy in need of a leg up.

“The deficit is a burden in a long-term sense,” Mr. Barbera, the economist, said, “but it is small beer compared to the concerns of the moment.”