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

Economic Growth Has Been Strong, But Is Moderating.

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

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

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

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

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

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

The Distribution of Growth

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

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

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

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

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

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

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

We also should recognize that we have had an adverse shock to inflation. The real growth rate of the top line CPI, for example, was 1.7 percent between 2001 and 2002, but

has accelerated to 3.8 percent between 2005 and 2006, marking the highest increase in the last 15 years.

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

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

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

The Near Term Budget Outlook

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

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

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

Figure 6 provides a similar comparison, this time respecting revenues, but has a more ambiguous implication. Revenues in 2006 have been much higher than expected in some years, and lower than expected in others. This likely reflects a number of factors. The 2001 outlook incorrectly (in retrospect) ratcheted up growth expectations right before a recession and 9/11. Relative to 2000 or 1999's long run projection for 2006, revenues

were fairly close to what was projected, even though those projections did not include the subsequent tax cuts.

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

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

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

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

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

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

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

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

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

The Longer Term Budget Outlook

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

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

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

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

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

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

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

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

If we add uncertainty, needy individuals, and redistributional objectives, then the labels matter more of course. However, the situation is ambiguous enough that it is safe to say that lines in the sand over labels make little sense economically, and that the opposing

sides in this debate are far closer on the true economic content than they may realize. That is reassuring, because the long-run outlook is so bleak that business as usual is not an option.

Figure 1.

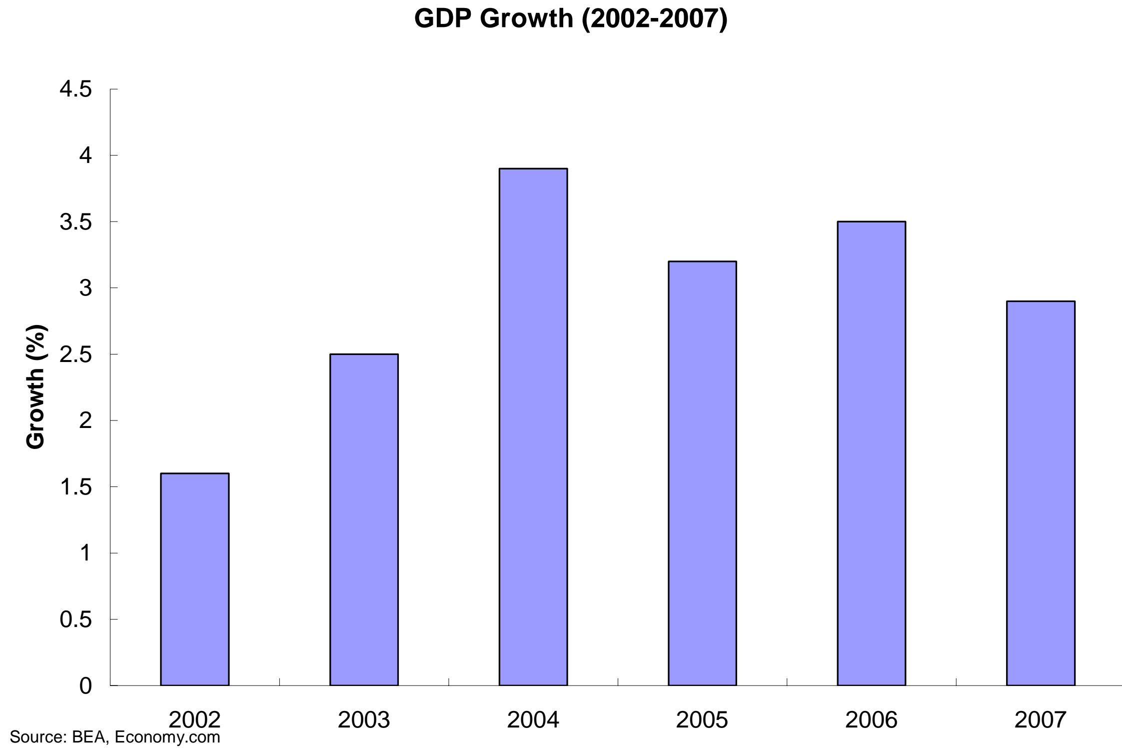


Figure 2.

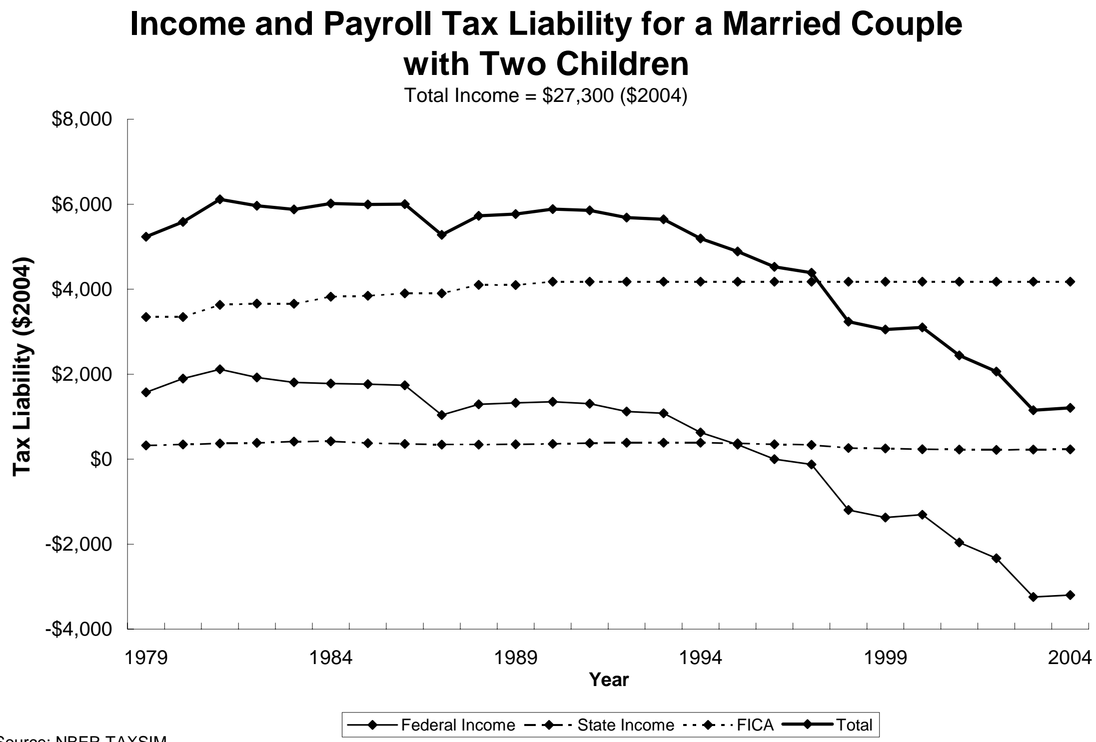
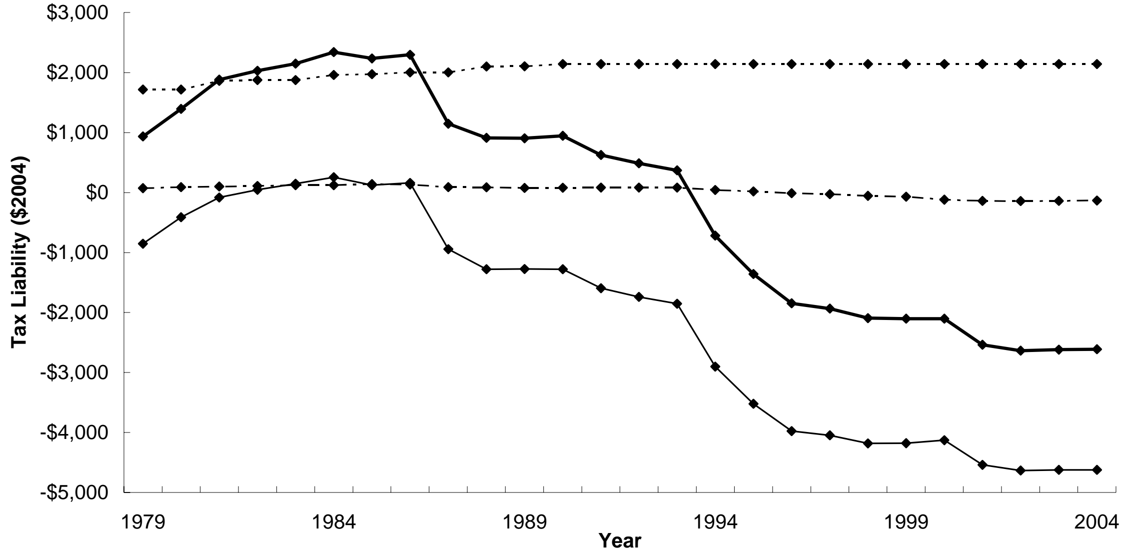


Figure 3.

Income and Payroll Tax Liability for a Single Parent with Two Children

Total Income = $14,000 ($2004)

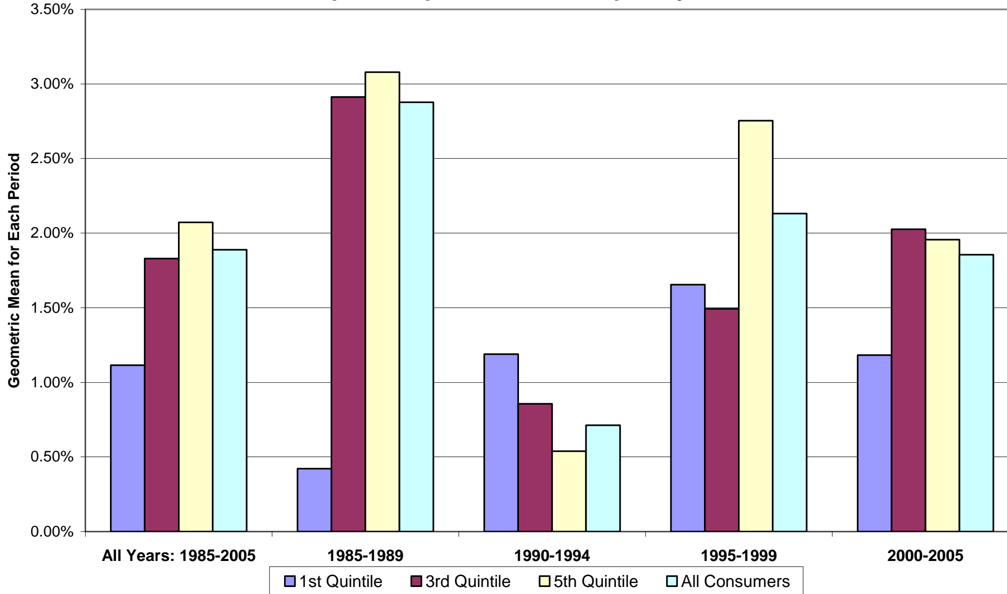


Source: NBER TAXSIM

Federal Income — State Income — FICA — Total

Figure 4.

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



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

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

Figure 5.

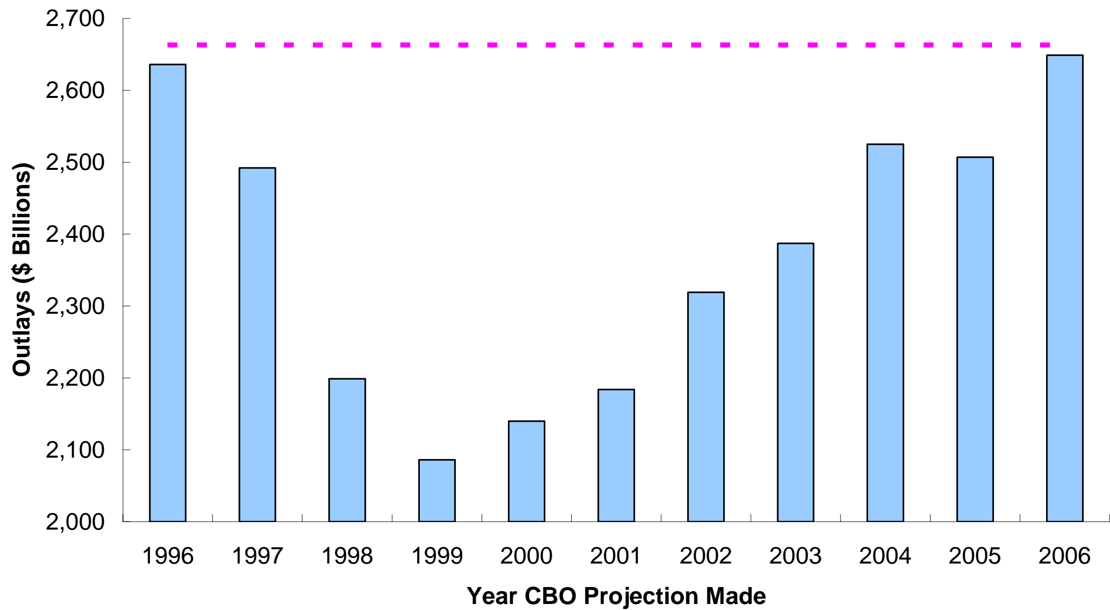


Figure 6.

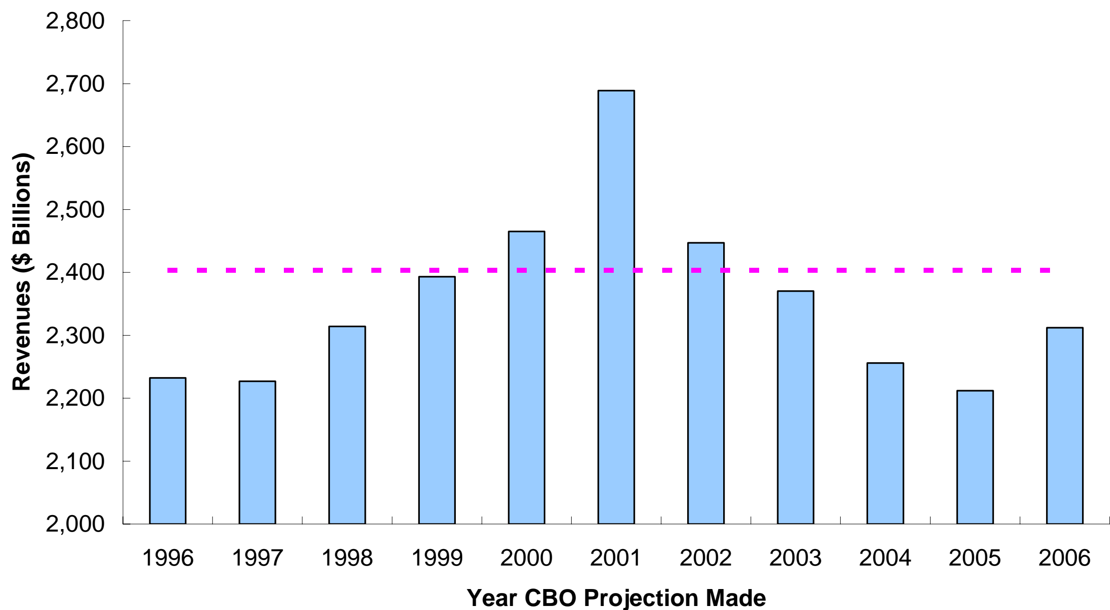


Figure 7.