PERSPECTIVES ON THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

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HOUSE OF REPRESENTATIVES

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PERSPECTIVES ON THE ECONOMIC OUTLOOK

THURSDAY, MARCH 8, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9 a.m. in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Present: Representatives Nussle, Spratt, Sununu, Bentsen, Hoekstra, Clayton, Gutknecht, Price, Collins, Moran, Hooley, Brown, Watkins, Culberson, Brown, Moore, and Holt.

Chairman NUSSLE. Good morning. We have a number of outstanding witnesses that we have asked to come before us today to testify before the committee on their perspectives on the future of our economy and the impact that that will have on the budget and vice versa. Before I begin, I would like to take a certain prerogative in that I would also invite Mr. Spratt as well, we have with us here today someone who at least from a committee standpoint needs absolutely no introduction. But I just want to highlight the fact that returning to our committee room today is Richard Cogan, who worked for this committee for 127 years. [Laughter.]

Actually I don't think it's quite that long. I believe you started with the Library of Congress and CRS back in about 1973, is that right?

Mr. COGAN. Right.

Chairman NUSSLE. And after CRS is one of the longest-serving staff members, majority or minority staff members, and you are now with the Center on Budget and Policy. While there have been times in the past when there has been good-natured, in a bipartisan manner, disagreements over particular policy, I have come to know Mr. Cogan during the discussion on budget process reform. He is an outstanding advocate for the budget and for the process for the 1974 act. I don't know if there's anyone in town or anywhere who has better knowledge about the budget policy and process.

Even though you were on the other side many times, we welcome you back. We congratulate you on your retirement. We're kind of glad you're gone. [Laughter.]

But I understand you keep coming back and that on a regular basis you're still providing some assistance. So we'll look forward to working with you in the future.

But welcome back, and I'd invite Mr. Spratt, if he'd like to say anything.

Mr. SPRATT. Richard Cogan is sort of like Bill Clinton when he was at Andrews Air Force Base, and he said, everybody's wishing me goodbye, I'm not going anywhere. [Laughter.]

We're glad you're here, Richard, and glad you're still available.

And to our entire panel, let me say, Mr. Greenstein, Mr. Gale, Mr. Mitchell, Mr. Bartlett, I think we have a good segment of the spectrum represented here today. We're glad to have all of you. We appreciate your input, not just today, but from time to time, and we look forward to your testimony today.

Chairman NUSSLE. We have four witnesses. First is Robert Greenstein, who's the Executive Director for the Center on Budget and Policy Priorities. Next is Bill Gale, Senior Fellow, in the Economic Studies Program at the Brookings Institution. Next we have Dan Mitchell, who is with the Heritage Foundation, a Senior Fellow in political economy. And last, certainly not least, is Bruce Bartlett, a Senior Fellow with the National Center on Policy Analysis.

We welcome all four of you today. We appreciate your willingness to come and share your perspectives. And we would invite you, I'd ask unanimous consent that all members be allowed to put a statement in the record if they care to, and that all our witnesses be allowed to enter their full statement in the record, and that they take their time, if you can, to summarize your testimony in about 5, 6, 7 minutes if you could, so that we can get into some questions and some comments.

So I'll invite Mr. Greenstein to begin. Welcome, and we'll receive your testimony.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES; WILLIAM G. GALE, JOSEPH A. PECHMAN FELLOW, THE BROOKINGS INSTITUTION; DANIEL J. MITCHELL, MC KENNA SENIOR FELLOW IN POLITICAL ECONOMY, THE HERITAGE FOUNDATION; AND BRUCE BARTLETT, SENIOR FELLOW, NATIONAL CENTER FOR POLICY ANALYSIS

STATEMENT OF ROBERT GREENSTEIN

Mr. GREENSTEIN. Thank you very much, Mr. Chairman. It's a pleasure to be here.

If I could say just before starting, in your packets is my testimony. The testimony in this case is a series of charts and tables. I actually would like to walk through some of them, so I think it would work better, if it's possible, for members to have that out. Mr. Chairman, these are mostly tables with numbers in them, so it won't surprise you that the person who helped put together a lot of these numbers is the aforementioned Mr. Richard Cogan.

If I were to start right at the beginning on these tables, you'll find first a table labeled Uncertainty of CBO Surplus Projections. The point I simply wanted to make here is the importance of the Congress exercising real caution with these projected budget surpluses. If you look at the bottom of the page, it tells you that based on CBO's estimates, CBO as you know has a chapter on uncertainty in its new report, that the chance, according to the CBO figures that the non-Social Security, non-Medicare HI surplus will

only be half as large as projected is about one in three, the chance that we'll slip back into deficits with no change in policy is about one in five.

To me this indicates the importance of taking a significant share of what is only a projected budget surplus and setting it to the side and using it for neither tax cuts nor spending increases at this point.

The second table looks at the best information at this time of the cost of the tax cut in the President's budget. The first two figures are from the President's budget itself. The President's estimate of the budget's estimate of the tax cuts, which is a little over $1.6 billion, and of the interest costs associated with that, which are printed in the budget. Then we go to the Joint Committee on Taxation re-estimates of several provisions in H.R. 3 that are listed there, including but not limited to the acceleration. The joint committee believes the rate reductions in the plan will cost a bit more than the President's budget estimates. When we add those in we're up to $2.2 trillion.

The final item on that list, if you flip back one page, you see a table that the Joint Tax Committee gave to the Ways and Means Committee last Thursday. It shows that under current law, the number of filers subject to the alternative minimum tax will explode from 1.5 million to 21 million by 2011 and that under H.R. 3 that will jump to 36 million. The joint committee also estimated the cost at nearly $300 billion simply of keeping the number of filers subject to the AMT at 21 million in 2011, rather than 36 million.

Now, I recognize that fixing the AMT problem is not part of H.R. 3 or the President's budget as submitted. But I think, Mr. Chairman, we all know that we're going to have to address this, it will be addressed sometime in the next few years. Therefore, we need to leave room in the budget for it. The $300 billion figure I've shown here, it's really the $292 billion figure off the next page, really could be considered an unfunded liability of the President's tax proposal, because his proposal, according to the Joint Tax Committee, increases by $292 billion the cost of fixing the AMT.

So we have a projection, we have figures here that suggest that about $2.5 trillion of the surpluses outside Social Security would be consumed by the tax cut. I would note that while there are some estimates and other witnesses here today will testify the economy could grow faster and that could reduce the number, there's an upside risk as well.

And the upside risk is that these estimates do not include further revenue loss from substantial tax avoidance that could result from complete elimination of the estate tax. There are now a growing number of tax experts, tax attorneys, tax accountants, there have been two articles in Tax Notes, one in the New York Times, all outlining the kinds of tax avoidance strategies with regard to income and capital gains taxes that would likely develop from elimination of estate tax as currently proposed.

Now, the question this next leads to is, does the budget reserve take care of this problem? The budget lists an $842 billion reserve. First off, because the tax cut is now being adjusted upwards by the Joint Tax Committee, that $842 billion would be a smaller starting

number. But let's use the $842 billion that's in the budget. Over half of that, $526 billion, is really the surplus building up in the Medicare Hospital Insurance trust fund. The administration's budget takes the unprecedented step of adding together the total costs of Medicare Parts A and B, and comparing them to Medicare revenues from payroll taxes and premiums.

But as you know, under the Social Security Act, Medicare Part A is supposed to be self-financing, Medicare Part B is supposed to have three-quarters of its financing coming from general revenues. To add the cost together in this fashion and leave out the general revenues and then argue that there's no surplus in the Medicare Hospital Insurance trust fund doesn't make a whole lot of sense. If you followed that logic, it would mean that every program in the Federal budget that is financed by general revenues is running a deficit. The Pentagon is running a deficit, the Military Pension Program is in deficit, it needs reform, we should cut back on pension benefits. The education and health research programs the President proposes to expand are in deficit.

By this logic, everything in the budget that doesn't have an earmarked tax is in deficit. The Congress has purposely set up Medicare Parts A and B with different funding structures, and the situation in Part A is like that in Social Security. We have temporary surpluses now while the boomers are in their peak earning years. They all get drawn down when the boomers retire and all those funds are eventually needed.

Ironically, if one does the kind of presentation the administration has to add, to artificially make the Medicare HI surplus disappear in order to add $500 billion to the surplus and the general fund, it makes it appear as though the Medicare surplus funds are available for other purposes, and that there's more room in the budget for the tax cut. But it really leaves less room for other things.

Ironically, one of the tradeoffs is that if the tax cut is enacted, there will be less money available for an adequate Medicare drug benefit and for the infusion of resources into Medicare to restore long term solvency. No plan, Breaux-Frist, Breaux-Thomas or any other reform plan that has been proposed to date closes even half of the long term financing gap in Medicare. If we're not going to raise Medicare payroll taxes, then we're going to have to use general revenues to close the rest of the gap. But if the money's all gone on a tax cut, we don't have the general revenues left.

Now, if we account for the Medicare surplus properly, that leaves only a little over $300 billion in the reserve. But there are several inevitable costs that are left out of the budget, and they consume more than $300 billion. Table S11 in the budget, Mr. Chairman, shows funding for agriculture programs cut nearly in half, because the budget does not include the continuation of the roughly $10 billion a year in payments to farmers Congress has provided on a bipartisan basis each of the last 3 years. I think we all know that something like that will be continued, and therefore $100 billion is needed in the budget for that.

There is the alternative minimum tax problem I've mentioned. We now have Joint Tax Committee estimates keeping this from exploding into the middle class in a way neither party would want to see happen or will accept, entails a cost of $300 billion to $400

billion over the next 10 years if the Bush tax cut is passed. The budget takes some of the extenders, the tax credits that expire every 2 years and are always extended, it extends some of them for 1 year only.

We know they're going to ultimately be extended for all 10 years; $25 billion is left out for the cost of extending them through the 2d through the 10th year. When you simply add these three costs and the associated interest payments, it adds about $550 billion, which exceeds the $300 billion or so left in the reserve.

In other words, to get out of all the technical detail, the bottom line is that when you add the numbers up, there really is no reserve left. The only way the numbers in the budget add up is if we go into the Medicare Hospital Insurance or Social Security reserves and use some of those funds for the rest of the Government, something that the House voted 407 to 2 or something like that a few weeks ago not to do. You either would have to do that, or do significant cuts in programs that are not specified in the budget.

With that, let me turn to the table called Discretionary Spending in the Budget. Table S2 in the budget says that over the next 10 years, total discretionary spending will go up $30 billion. But it also lists initiatives in discretionary spending for education, defense, health research and a few other areas, at plus $260 billion over the next 10 years. Although there's a little question of what baseline that $260 billion is off of.

If these numbers are right, it means the administration and the Congress would have to find $230 billion in unspecified discretionary cuts over the next 10 years, possibly more than that after the missile defense request comes up.

Going to the next page, this raises questions such as, while the President said in the address to the Congress that education is the highest priority, do the numbers in the budget really support that? What we see here, maybe the easiest way to look at this is to take the 2011 column, everything is in full effect here. In the 2011 column, we see the budget has $4.5 billion for education increases. The budget says that the tax cut that year is $254 billion. That is more than 50 times the amount for education in that year.

Estate tax repeal alone is $60 billion, according to the President's budget. That's 14 times the education increase. Or if you go to the final figure here, half of the estate tax is paid by a tiny fraction of the estates, the biggest ones. About 4,000, the estates of about 4,500 people in 2011, 7 percent, the largest 7 percent of the taxable estates, the taxable estates of the wealthiest one of every 1,000 people who die, would pay half of the estate tax. To repeal the estate tax, there is a $30 billion tax cut in 2011 for the estates of the wealthiest 4,500 people who die. Those 4,500 estates would get seven times the entire increase for the entire Nation in the education budget.

The next page also shows you that if you look in the President's budget and the President's baseline over the next years, Function 500, which includes education, has no increase. It's an increase of $100 million over the whole next 5 years. How do we explain this?

The only explanation can be that each dollar of increase in education is offset by a dollar of cuts in job training, child care or other

programs in Function 500. There's no other way to interpret the numbers here.

Let me conclude with two larger observations. A table I passed over, it's about the third or fourth table, it's called Policy Changes from the Budget in 2011. It tells you that in 2011, the policy proposals in this budget would add $25 million on the spending side, about half of that in a modest Medicare drug benefit. And there's a $253 billion tax cut, about 10 times as much.

This helps explain the figures that are on the table called Tax Cuts for Top One Percent versus Tax Cuts for Initiatives. If one looks at not the Joint Tax Committee figures, not counting the AMT, bending over backwards to benefit the President, just looking at the cost of the tax cut as listed in his budget, without the higher Joint Tax Committee figures, and if we use figures for the proportion of the tax cut going to the top 1 percent that use the Treasury methodology for estate and corporate taxes, what we find is that about $555 billion over 10 years would go in tax reductions to the top 1 percent.

If we then look at all of the initiatives in the budget, Medicare, education, health research, defense, a health insurance tax credit, everything in the budget combined here, it adds up to about $485 to $495 billion. That's before you lower the number to reflect the unspecified and other spending reductions that are in the budget. The point is that the top 1 percent would indeed get more in tax reductions under the budget than every initiative area in the budget combined, including defense.

So the bottom line, in my view, Mr. Chairman, is that a tax cut is appropriate but the budget lacks balance. The tax cut is much too large, the risk is high that at the end of the day, either Congress would have to go into the Social Security and Medicare Hospital Insurance trust funds to fund the rest of Government, or the Congress in future years would have to come up with several hundred billion dollars in cuts that are not specified today, and at the same time this is done, some of the biggest problems facing the country are largely unaddressed. There is no new money for long term Medicare solvency, the attention to the uninsured is small, and the drug benefit appears to be of a magnitude that wouldn't allow us to cover more than about 50 percent of drug costs until the senior incurred about $11,000 or $12,000 a year in out-of-pocket drug expenditures.

So I think there is a problem with the balance here. There's really only one priority in the budget, and it is the tax cut.

[The prepared statement of Robert Greenstein follows:]

UNCERTAINTY OF CBO SURPLUS PROJECTIONS

	5-Year Total
CBO's Baseline Surplus	
Excluding Social Security and Hospital Insurance	$0.8 Trillion
Size of CBO's Average Error (10-year figure is a projection)	±$1.1
Result if CBO Proves Too Pessimistic	$1.9
Result if CBO Proves Too Optimistic	-$0.3
Chance that baseline surplus excluding Social Security and Hospital Insurance will be less than half as large as projections	35%
Chance that there will be *no* baseline surplus outside of Social Security and Hospital Insurance	20%

Source: CBO and CBPP Calculations

Cost of Tax Cuts

	(in trillions of dollars)
From the President's Budget	
Revenue Reductions	$1.647
Interest costs	.373
Joint Tax Committee Upward Revisions in H.R. 3.	
Rate reductions	+59
10% bracket, including acceleration	+67
Interest costs	+54
Subtotal	180
Revised total, including costs of H.R. 3	2.200
Joint Tax Committee estimate of cost of preventing rate reductions from subjecting an additional 15 million fillers to Alternative Minimum Tax, plus interest	300
Total	2.500

(Note: total does not include cost after 2002 for certain extenders or cost for preventing number filers subject to AMT from rising from 1.5 million this year to 20.7 million in 2011, under current law. These two costs exceed $100 billion.)

New Joint Tax Committees Estimate on Alternative Minimum Tax

Taxpayers Affected by AMT by Calendar Years (in millions of taxpayers)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Current Law	1.5	3.5	4.3	5.6	7.1	8.7	10.5	12.8	14.9	17.5	20.7
H.R. 3	1.9	5.3	7.6	11.1	13.6	18.8	21.3	24.3	27.5	31.3	35.7

Cost of Preventing AMT from Reducing Tax Cuts in H.R. 3, by Fiscal Year (in billions of dollars)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2011
0.1	1.0	3.7	7.0	13.3	20.9	36.6	42.5	48.8	55.5	62.7	292.2

Policy Changes From Baseline in 2011 Under Bush Budget

Spending (exclusive of interest payments)	+$25 billion
Taxes	-$254 Billion

THE ADMINISTRATION'S BUDGET RESERVE

The budget lists a $842 billion reserve. Closer examination, however, indicates that no such reserve is likely to be available.

1. Medicare: The budget does not set to the side the surpluses in the Medicare Hospital Insurance trust fund, claiming that Medicare has no surpluses and is in deficit. Tables in the budget show that OMB projects the Medicare Hospital Insurance trust fund will run a $526 billion surplus over the next 10 years. The Medicare HI surplus, which policymakers of both parties have voted to set to the side and not to use to finance tax cuts or other programs, amounts to more than half of the so-called "reserve."

Medicare Hospital Insurance (Part A) is financed by payroll taxes and, to a small degree, by a portion of the income taxes that are collected from the taxation of a portion of the Social Security benefits of higher-income beneficiaries. Medicare Hospital Insurance has its own trust fund. The physician's services part of Medicare (Part B) is funded separately and, unlike Part A, was never intended to be self-financing. One-fourth of its financing of Medicare Part B comes from monthly premiums that beneficiaries pay, but the other three-fourths comes from general revenues. This is how Medicare was designed.

The administration takes the unprecedented step of adding the total costs of Medicare Parts A and B and then comparing them to Medicare revenues from payroll taxes and premiums. Since three-quarters of Medicare Part B is intended to be funded by general revenue, the effect is to make it look like Medicare's costs exceed Medicare's income. The administration then pronounces the Medicare HI surplus as meaningless and claims that Medicare is in deficit so it has no surpluses to save. By this logic, all programs funded by general revenues—including the Pentagon, the military pension program, and the education and health research programs that the administration proposes to expand—are in deficit and thus in need of reform, as is everything in the budget not specifically financed by an earmarked tax.

By artificially making the Medicare HI surplus disappear, the budget is able to add the $526 billion Medicare HI surplus to the surplus in the general fund. This makes it appear as though these Medicare HI funds are available for other purposes. This also makes it look as though there is more room in the budget for the tax cut and masks the trade-offs the large tax cut creates for the rest of the budget. Ironically, one of those trade-offs is that if the tax cut is enacted, there will be less money available for an adequate Medicare drug benefit and for an infusion of more general revenue into Medicare as part of a Medicare reform package that restores long-term solvency to the program.

Once the Medicare HI surpluses are set to the side, only a few hundred billion dollars of the Administration's $842 billion reserve remains.

2. Inevitable Costs that are Left Out. The budget leaves out a number of inevitable costs. These include:

• Continuing current payments to farmers, at a cost of about $100 billion over 10 years (Table S–11 shows spending for agricultural programs plummeting from $26.1 billion in 2001 to $14.9 billion in 2003 and smaller amounts in subsequent years, because of the administration's failure to include the virtually inevitable costs of continuing these farm payments);

• Fixing a well-known problem in the Alternative Minimum Tax so it does not subject millions of middle-class families to the AMT, which entails a cost of $300 billion to $400 billion over 10 years if the Bush tax cut is passed; and

• Extending the expiring tax credits for 10 years (the budget shows the cost of extending most of these credits for only one year), which adds about another $25 billion.

• The more-than-$400 billion in costs just mentioned would also generate additional costs for interest payments on the debt. This would bring these costs to more than $550 billion, which exceeds the amount left in the reserve when the Medicare HI trust fund surplus is set to the side.

3. Additional Costs the Administration has not specified. The budget does not include funds for a national missile defense or other defense spending increases that are likely to emerge from the Administration's defense review.

CONCLUSION

Rather than creating a reserve for unforeseen contingencies, the budget lacks sufficient funds to avoid a return to deficits outside the Social Security and Medicare HI trust funds, unless sizable reductions in domestic programs are enacted.

Is the Budget Reserve Real?

	(in billions of dollars)
Size of Reserve from President's Budget (Table S-3, p. 187)	$842
Remove Medicare HI Trust Fund Surplus	-526
Subtotal	316
Inevitable Costs Not Shown in Budget	
Continuing aid to farmers	100
Tax extenders	25
AMT reform	>300
Total with interest costs	>550
Additional Presidential Initiatives not included in budget	
National missile defense and other defense spending increases	?
Estimates in Budget that May Prove Unrealistic	
Reducing Discretionary spending outside of defense, education, health research, and other favored areas by $230 billion	
The level of funding for a Medicare prescription drug benefit	

Discretionary Spending in the Budget

	10-year Totals (in billions of dollars)
Total Discretionary Spending (from Table S-2)	+30
Discretionary Spending Initiatives for Education, Defense, Health Research and seven other smaller areas (from Table S-5)	260*
Necessary but Unspecified Discretionary Cuts	-230*

*The $260 billion figure for initiatives appears to overstate funding for domestic initiatives and understates funding for defense initiatives. For domestic initiatives, the increases appear to be relative to a baseline used in the campaign, rather than the current CBO baseline. As a result, the size of the domestic initiatives is overstated. On the defense side, these figures do not include funds for national missile defense and other defense spending increases that will be submitted after completion of the defense review.

Each dollar of additional defense spending increases will have to be accompanied by a dollar of reductions in non-defense discretionary programs to fit within the discretionary spending caps the Administration is proposing.

Is Education the Highest Priority?

	2002-2011	2011
Gross Education Increases	41.1	4.5
Net Education Increases	less than 41.4	less than 4.5
Tax Cut		
From President's budget	$1,646.5	$253.6
With H.R. 3	$1,772.8	$264.8
With H.R. 3 and AMT Fix	$2,064.8	$327.5
Estate Tax Repeal	266.6	60.2
Estate Tax Repeal for estates of wealthiest 1 of every 1,000 people who die (largest 7% of taxable estates)	NA	30.1

Function 500, Education, Training, Employment, and Social Services, As Compared with the Baseline

	Outlays for Discretionary Programs 5-year Total (2002 - 2006)
Bush Budget (page 198)	$330.4 Billion
Bush Baseline	$330.3
CBO Baseline	$328.2

Departments with Overall Discretionary Funding Cuts Below a Freeze Level in FY2002

Agriculture

Commerce

Energy

Interior

Justice

Labor

EPA

Tax Cuts for Top 1% vs. Initiatives

Tax Reductions for Top 1%	$555 billion
Initiatives Net of Offsets	$485 - $495 billion
Medicare	153
Discretionary spending	260*
Other mandatory spending initiatives	2
Health insurance tax credits	70 - 80
Total	$485 - $495

*Figure overstates initiatives in domestic discretionary programs. Figure does not reflect additional defense increases likely to be requested after completion of defense review.

Federal Spending as Percentage of GDP

	Level	Comment
2000	18.2%	Lowest level since 1966
2001	18.0%	since 1966
2011-CBO baseline	15.1%	since 1951
2011-OMB baseline	15.2%	since 1951
2011-Bush budget	15.9%	since 1951

Discretionary Spending

2000	6.3%	Lowest on record (Data go back to 1962)
2001	6.3%	Lowest on record
2011-CBO baseline	5.1%	Lowest on record
2011-OMB baseline	5.2%	Lowest on record
2011-Bush budget	5.2%	Lowest on record

Tax Cut as a Percent of After-tax Income

(when fully phased in)

	Top 1%	Next 4%	Next 15%	Fourth 20%	Middle 20%	Second 20%	Lowest 20%
Entire Bush Tax Package	6.2%	2.4%	2.4%	2.3%	1.9%	1.2%	0.6%
House Rate Cuts	3.8%	0.6%	1.1%	1.2%	1.2%	1.0%	0.5%

Based on Institute for Taxation and Economic Policy model for income tax; Treasury methodology on distribution of estate and corporate taxes.

Percentage Reduction in Total Federal Taxes Under Administration Plan

Income Group	
Bottom 20%	-5.5%
Next 20%	-6.3%
Middle 20%	-7.0%
Next-to-highest 20%	-6.9%
Top 20%	-8.5%
Top 1%	-12.9%

Based on Institute for Taxation and Economic Policy model for income tax; Treasury methodology on distribution of estate and corporate taxes.

The "600 Billion Spending Increase" in 2000

The CBO Estimate of Projected Increases in Spending 2001-2010 Due to Actions in 2000	
Discretionary Spending	368
Mandatory Spending	66
Interest Payments Associated with Spending Increases	118
Total	552

Composition of Discretionary Spending Increases	
Defense	105
Education	50
Health research and other health	40
Science and space	12
Total	207
Percentage of Discretionary Spending Increase That Occurred in These Four Areas	56%

Composition of Mandatory Spending Increases	
Medicare	84
Medicaid	-64
Military retiree health	28
Other	18
Total	66

Chairman NUSSLE. Thank you, Mr. Greenstein. Mr. Gale.

STATEMENT OF WILLIAM G. GALE

Mr. GALE. Thank you very much, Mr. Chairman, Mr. Spratt and members of the committee. It's my pleasure to speak here.

I think it's particularly important to be discussing tax cut issues in the Budget Committee, because what we're really having is a

budget debate, or what we really should be having is a budget debate, not just a tax debate. It seems very difficult to assess the appropriateness of any tax or spending policy in the absence of an overall budget framework.

So in my comments, I'd like to focus on three items. The first is the budget outlook, the second is the President's budget and tax proposals, and the third is a brief discussion of some of the arguments put forth for and against the President's tax cut.

Let's start with the budget outlook. The most recent CBO forecast projects a surplus of $5.6 trillion over the next decade. But there's really only about $1.7 trillion there or less even that should be thought of as available for new tax cuts or new spending initiatives, if Congress is willing to adopt responsible budgeting practices and realistic forecasts of tax and spending policy.

How do I get from $5.6 trillion to $1.7 trillion? It's basically in two steps. The first step, and the biggest step, is to note that almost 60 percent of that $5.6 trillion is due to accumulations in retirement trust funds, including Social Security, Medicare Part A and Government pensions for military and civilian workers. Congress has shown overwhelming support for protecting the Social Security and Medicare trust funds with the compelling logic that these funds represent current tax accumulations that are committed to future payments.

As you all know, the House voted both last year and this year to protect Social Security and Medicare from invasions for other uses, and the Senate voted on two separate bills last year, passing both of them, and 98 out of 100 Senators voted in favor of at least one of those bills. So at least up until now, there's been overwhelming support in the Congress for the responsible fiscal policy of not spending the Social Security and Medicare surplus.

If you remove Social Security and Medicare, the $5.6 trillion falls to $2.7 trillion. But there's a third Government pension fund that doesn't get discussed much, and that's pension reserves that are set aside for military workers and civilian workers. Those pension funds are projected to run a surplus of $400 billion over the next 10 years. I would submit to you that the economic case for not allocating those funds to new spending or new taxes is identical to the economic case for not invading the Social Security and Medicare trust funds.

Certainly no responsible firm would consider its pension fund as a source of expenditure for current operating expenses. No household, if it had a budget like the Government's, would think of itself as anything but drastically under-saving for retirement. So the Government and the Congress should not be fooled into thinking that $5.6 trillion is the right starting point. At the very least, we want to remove pension funds from the budget, and that reduces the total surplus to $2.3 trillion.

Let me put it differently. The budget contains the assets in these pension funds, but it does not record the liabilities in the pension funds. If we included the liabilities, we all know the Government would show a deficit right now, because it's severely underfunded in Social Security and Medicare in the long term. If you're not going to include the liabilities, at the very least, don't include the assets as funds that can be spent.

So the best solution would be to include the liabilities and therefore show a deficit. If that were the case, we wouldn't be talking about $2 trillion tax cuts. But at the very least, if you don't include the liabilities, don't include the assets either. Just set it aside and focus on the rest.

So that brings us down to $2.3 trillion. You get from $2.3 trillion to $1.7 trillion by adjusting for problems for sort of rosy scenario assumptions about spending and tax policy. In particular, under current law, the number of people that are projected to be under the AMT is going to rise dramatically, as Mr. Greenstein mentioned. Also, current law assumes that the expiring tax provisions will actually expire. The budget prediction also assumes that real discretionary spending will fall by 10 percent on a per capita basis.

So if you just hold discretionary spending constant per person and fix the AMT and expiring tax provisions, that's another $600 billion that's used up. That leaves you with $1.7 trillion.

I want to emphasize, though, that the $1.7 trillion is just the surplus over the next 10 years. If we did Government budgeting correctly, if we budgeted the way a firm did, right now we would show a long term deficit, not a surplus.

Having said that, let's turn to the President's budget proposal. The President's budget essentially threatens to undo most of all of the hard-won fiscal gains of recent years. There are two items I'd like to emphasize. The first is the President proposes to divert about $1 trillion of Social Security and Medicare funds from the surpluses to other programs. He would take $600 billion of surplus in the Social Security fund and divert it from debt repayment. He would not use those funds to buy private assets to hold in revenue for future Social Security benefits either.

But if the money is used for any purpose other than Social Security, other than for paying down debt or Government purchase of assets, then in fact the money is being taken away from the Social Security fund and would violate longstanding policy to keep Government's hands off that money.

As Mr. Greenstein mentioned, the President would also spend the $400 million surplus in the Medicare Part A trust fund on supplemental medical insurance for the elderly, rather than having general revenue finance SMI. But the point is that the Medicare Part A surplus is legislatively committed to paying future Part A benefits. The Part A fund is in a cash flow surplus right now, but it's in long term deficit.

So taking money away from the Medicare Part A current surplus makes the long term deficit there worse, and taking the money away from there and using it to finance the tax cut is at best ironic and at worst much worse than that.

The second part of the President's proposal, besides allocating $1 trillion to Social Security and Medicare trust funds to other uses, is a very large tax cut. Mr. Greenstein went through the calculations. I could go through a different set of calculations that gets to the same $2.5 trillion figure. I won't go through those calculations.

I will mention, however, that the President's budget has a non-Medicare, non-Social Security surplus of $2.5 trillion. If you take what I view as the realistic estimates that the JCT has made of H.R. 3, of Bush's previous proposal, of the proposals in the Presi-

dent's budget, and if you add in the AMT adjustment and interest costs, the total cost of the tax cut is $2.5 trillion. That is according to the administration's own budget forecast, and realistic assessments of the cost of the tax cut. There is nothing left to do anything over the next 10 years unless Congress is willing to invade the Medicare and Social Security surplus.

Well, how does the President get this $842 trillion reserve fund? Basically, he invades the Medicare and Social Security surplus, as I stated earlier. So the invasion of Social Security and Medicare is directly linked to the magnitude of the President's tax cut. And the magnitude of the President's tax cut means that from a budget perspective, there's no money left to do anything else the entire next 10 years unless one is willing to invade the Medicare-Social Security trust fund.

Let's talk about some other aspects of the President's tax plan. The administration's rhetoric on the distributional effects of its plan has been exceedingly misleading and disingenuous. There is no doubt that this is a tax cut that is tilted toward high income households. Any reasonable measure of the distribution of the tax cut shows it's tilted toward high income households. They get a higher percentage increase in after-tax income, they get a larger percentage reduction in their total taxes, not their income taxes, but their total taxes. And of course, they get a hugely larger dollar tax cut. The administration has presented some very deceptive numbers on this, which are discussed in my testimony that I would be happy to discuss further in questioning.

One of the most puzzling and misleading aspects of the President's defense of his tax cut, and of the defense put forth of H.R. 3 is that it's going to stimulate the economy. I don't think anyone takes this view seriously any more. Even H.R. 3, which accelerates the cut, only had $6 billion of stimulus in the first year, in a $10 trillion economy. On top of that, if you did want to stimulate the economy, you would want to put the money in hands of people who would be more likely to spend it, which are low and middle income households. These are also the households that are more likely to lose their jobs if there really is a recession.

On top of that, because of how large the President's tax proposal is, and the implied need to fix the AMT, the magnitude of the tax cut could well force interest rates up, which of course would have a negative short term effect on the economy. So if ever there were a plan that were not designed to fight an immediate recession, it's the President's tax cut. And that shouldn't be surprising, because the President's tax cut was designed 15 months ago when there was no sign of recession on the horizon.

Some people will argue that tax cuts are needed to prevent Government from going on a spending spree. I think we can all see there's some validity to that concern. But in the fact, in the past year, vast portions of existing surpluses have been allowed to accumulate, and discretionary spending right now is a smaller share of the economy than at any time since 1962, and it's projected to fall even more.

So it's hard to argue that Government is vastly overspending relative to the size of the economy. In addition, if the Congress wants to impose spending discipline, the best way to do that is not to

spend the Social Security and Medicare surpluses, rather than taking $1 trillion out of those surpluses for other uses.

Chairman NUSSLE. Mr. Gale, if I could ask you to—don't rush, but if you could summarize the remainder of your testimony so we can hear from the other witnesses and get to questions from the members. Then if there are any points that you haven't had a chance to get to, by all means, in the question and answer period, you'll have full liberty to expand a little bit.

Mr. GALE. May I take 15 more seconds?

Chairman NUSSLE. No, don't rush, just if you could summarize the rest of your testimony briefly, we could move to the other two witnesses.

Mr. GALE. Finally, if the argument is that we need a tax cut to restrain Government, even if that's the argument, we don't need a tax cut that is disproportionately tilted to high income households. So even if you think we need a tax cut to restrain Government, you don't have to cut taxes by tens of thousands of dollars for the highest 1 percent, and by tiny amounts for households in the bottom 40 percent of the income distribution.

Finally, let me just briefly address the economic effects, and I'll be happy to talk about this more in questioning. We had a rise in the top tax rate from 31 percent to 39.6 percent in the early 1990's. At the time it was predicted that that would cause a recession, that that would cause a drastic cutback in the taxable income and the economic activity of high income households. In fact, we've seen exactly the opposite over the ensuing decade. We've had a huge spurt in reported income and in after-tax income among high income households after the 1993 tax increase.

So if anyone tells you that cutting the tax rates by less than we increased it in 1993 is going to cause a huge positive spurt in economic activity, realize that that implies that the huge "increase" in 1993 should have caused a gigantic recession, and that we saw nothing like that.

Thank you.

[The prepared statement of William Gale follows:]

PREPARED STATEMENT OF WILLIAM G. GALE, JOSEPH A. PECHMAN FELLOW, THE BROOKINGS INSTITUTION

Part of the analysis discussed in this testimony is the result of collaborative work with Professor Alan Auerbach, Department of Economics, University of California, Berkeley. All opinions should be ascribed to the author, however, rather than to Professor Auerbach or the trustees, officers, or staff of the Brookings Institution.

Mr. Chairman and Members of the Committee: Thank you for giving me the opportunity to discuss the budget outlook and the options for tax policy. My testimony is divided into two sections. The first provides a summary; the second provides the background analysis that supports these views.

SUMMARY

1. THE BUDGET OUTLOOK

The most recent Congressional Budget Office baseline forecast projects cumulative surpluses of $5.6 trillion between 2002 and 2011. But there is really only $1.7 trillion or less that can be thought of as "available" for new tax cuts or new spending, under responsible budgeting practices and realistic forecasts of tax and spending policies.

Almost 60 percent of the projected surplus is due to accumulations in retirement trust funds. No financially responsible firm would consider its pension reserves as a source of financing for current operating expenses, and neither should the federal

government. Both Houses of Congress have shown overwhelming support for protecting the social security and medicare trust funds, because they represent current tax collections that are committed to future uses. Cordoning off social security reduces the available surplus to $3.1 trillion. Protecting the Medicare trust fund reduces the amount to $2.7 trillion. Protecting the pension reserves of government military and civilian workers—which makes sense for same reasons as protecting social security and medicare—would reduce the available surplus to $2.3 trillion.

Extending the temporary tax provisions, and fixing problems that already exist under current law with the alternative minimum tax reduces the available funds to $2.1 trillion. Allowing real discretionary spending per person to remain constant reduces the amount of available funds to $1.7 trillion over the next 10 years. If discretionary spending were to grow at the rate of GDP, the available surplus would fall to $1.0 trillion.

There is nothing sacrosanct about a 10-year planning horizon. For public policies such as social security and medicare, the official planning horizon is 75 years. Looking beyond the 10-year horizon is particularly important for assessing the budget outlook because the rapid growth in entitlement programs driven by an aging population and rapidly rising medical care expenditures is not projected to begin until later dates. Despite current surpluses, estimates in this testimony show that the government continues to face a long-term financial shortfall. This fundamental fact counters claims that Americans are being "overcharged" for government currently.

2. PRESIDENT BUSH'S BUDGET AND TAX PROPOSALS

The President's budget threatens to undo most or all of the hard-won fiscal gains of recent years. The budget is hugely fiscally irresponsible in two main ways.

First, the President proposes to divert about $1 trillion of social security and medicare surpluses from the trust funds for those programs. He would take $600 billion of surplus in the social security trust fund and place it in a general "reserve" fund that could be used for any future (and currently unspecified) purpose. He would spend the $400 billion surplus in the medicare part A trust fund on supplemental medical insurance for the elderly (Medicare part B), even though Medicare part A is in long-term deficit, and even though part B is funded by general revenues and insurance premia by statute.

Second, the President has proposed a massive tax cut. The tax cut in his budget differs from the tax cut he sent up to Congress just a month earlier. The tax cut would cost in excess of $2 trillion, inculding interest costs. As implemented in HR 3, the tax cut would leave 36 million on the AMT by 2011. Fixing that problem would raise the cost to over $2.5 trillion.

Thus, the President's budget:

- violates the otherwise consensus view that social security and medicare funds should be protected and effectively diverts $1 trillion from those funds to other purposes;
- proposes a tax cut that would use up the entire non-social security, non-medicare budget, according to the President's own proposals;
- would leave no funding left for anything else, without either tapping into retirement trust funds or running a deficit, for the next decade.

3. EVALUATING THE PRESIDENT'S TAX PROPOSALS

The Administration has had a very difficult time providing a coherent justification for its tax package. Notably, the President's justifications for his tax proposal keep changing, but the proposal does not.

Over the next 10 years, HR3, the other components of the tax plan that the President sent to Congress on February 8, and the new proposals in the budget would cut taxes by about $1.8 trillion. The AMT adjustments would total $292 billion, and the added interest payments on the federal debt caused by the reduction in federal revenues would cost another $418 billion. Thus, although the proposal is often referred to as a $1.6 trillion tax cut, the real cost would exceed $2.5 trillion over the next 10 years. This is much larger than the "available surplus" noted above, and implies that no other policy priorities could not be met unless Congress were willing to finance new programs with balances in the retirement trust funds or with deficit spending.

The proposed tax cut would roughly triple the severity of the long-term fiscal problem. Properly adjusted, Bush's tax cut is about as large as the net tax cut created by the 1981 and 1982 tax acts. But taxes on most families were much higher then than they are now, and tax rates had been rising steadily in years before that. In recent years, the tax burdens on most families have fallen.

Besides being too large, the Administration's tax cut would be disproportionately tilted toward high-income taxpayers, who would receive a bigger percentage decline in tax payments, a bigger percentage increase in after-tax income, a bigger share of the total tax cut than their current tax share, and a gigantic cut in dollar amounts. The Administration's rhetoric on distributional effects has been particularly misleading and disingenuous.

The President's efforts to "take down the tollbooth to the middle class" and to address the marriage penalty leave out households with earnings below $20,000, who often face the highest effective tax rates and the largest marriage penalties.

One of the most puzzling and misleading aspects of the President's defense of the tax cut is his claim that it would be an effective way to fight a brewing recession. It is not clear that a recession will emerge, and most economists (myself included) feel that tax policy is a poor way to counter a recession. Even if tax policy were a good way to counter a recession, the President's tax proposal is incredibly poorly designed for that purpose. It is so big it would raise interest rates, which would hurt the economy. It is delayed (no tax cuts in 2001 and only $20 billion in 2002), and so cannot help fight a recession now. And it is geared toward high-income households, when it is low- and middle-income households that would be most likely to lose their jobs and most likely to spend the tax cut.

Another argument the president uses to justify tax cuts is that tax revenues are at historic highs and therefore that Americans are being crushed by overburdensome taxes. But if a high aggregate federal tax burden justifies tax cuts, it should justify cuts in a variety of taxes, not just the income and estate taxes. About 74 percent of families pay more in payroll taxes, for example, than in income taxes. Focusing tax cuts only on income taxes and estate taxes thus ignores the major tax burden facing almost three-quarters of American families. In fact, for most families, taxes are as low or lower than they have been in the past 20-30 years. Overall tax payments have risen because the rich have gotten richer at an impressive rate.

Some argue that tax cuts are needed to prevent government from going on a spending spree. There is clearly some validity to this concern, but the vast portions of existing surpluses have been allowed to accumulate, and discretionary spending is a smaller share of GDP today than it has been in any year since at least 1962, so the argument is weakened considerably. And it is Congress that has been willing to cordon off Medicare, not the Administration. Finally, even if this argument justifies a tax cut, it does not provide a rationale for why the tax cut should be focused on the highest-income households.

An argument put forth recently by Alan Greenspan, and quickly repeated by tax cut advocates, is that under current surplus projections, the government will pay off all available government debt by around 2006 or shortly thereafter. Greenspan and others argue that having the federal government hold such assets would raise a number of difficult issues. These issues are real, but the concerns are seriously overstated. Currently, for example, state and local government pension funds hold private assets equal to 28 percent of GDP.

4. POLICY OPTIONS

The current fiscal surpluses are a significant accomplishment, and should not be taken lightly or for granted. There is clearly room for a tax cut, for spending priorities, and for debt reduction. But I believe that the most important budgeting decision for the Congress is to establish a new set of budget rules, and that these rules should be established before making a significant set of tax and spending changes.

A. BUDGET RULES

The fiscal accomplishments of the last decade should be preserved and enhanced, not squandered. The old rules are expiring. And the current budget situation has dangers associated with it, since there are short-run surpluses but long-term deficits. Consideration of policy rules should take several factors into account. First, there is a certain asymmetry in policy options. It is always easier to reduce taxes later than to raise them. Second, new and unforeseen policy priorities frequently arise, so prudent fiscal management would suggest the equivalent of a "reserve fund" of some sort. Third, both budget projections and economic forecasts are subject to considerable uncertainty, which suggests another reason not to commit all available resources immediately.

- Reaffirm the commitment to protect social security and medicare and extend the same treatment to government pension reserves.
- Adopt a proposal put forth recently by Robert Reischauer to cordon off increasing amounts of future surpluses from current commitments.

B. TAX POLICY

Tax policy should be made inside of a budgetary framework that recognizes the importance of other public policy goals-such as education, health, defense, the refurbishing of social security and medicare and so on. In addition, fairness, efficiency, and simplicity remain the core principles of tax policy regardless of the size of the surplus.

• Create a new, lower tax bracket of 10-12 percent, covering a range of income broader than the 10 percent bracket proposed by President Bush.

• Combine or integrate interactions between the child credit, earned income credit, and personal exemption. This would simplify taxes, improve incentives to work and marry, and provide added resources to low-income households. A crucial element would be to increase the refundability of the child credit.

• Simplify the tax code by raising the standard deduction, providing a uniform exclusion for capital gains income rather than the complicated patchwork of capital gains tax rates we currently have.

• Provide tax cuts to high-income taxpayers and simplify the tax system further by removing the phaseout of personal exemptions and the limitations on itemized deductions. Either reform or abolish the alternative minimum tax.

• Reform the estate tax by raising the effective exemption, modestly reducing rates, indexing the tax for inflation, and closing down a number of egregious sheltering practices.

EVALUATING THE BUDGET SURPLUS AND TAX POLICY OPTIONS

1. THE BUDGET OUTLOOK

After decades of deficits, the federal budget has recently yielded increasing annual surpluses. The most recent Congressional Budget Office baseline forecast, released in January projects cumulative surpluses of $5.6 trillion between 2002 and 2011, including $2.5 trillion in the social security trust fund (the "off budget" surplus) and $3.1 trillion in the rest of the budget (the "on-budget" surplus).

Just as perennial budget deficits dominated policy discussions in the 1980s and early 1990s, choices regarding how to use these surpluses will shape fiscal debates for years to come. Debates regarding these choices are almost always carried out in the context of CBO's baseline forecast. However, while it provides a common and visible benchmark, CBO's baseline is limited in several crucial ways and does not provide sufficient information to assess various policy options.

To assess policy options accurately requires a measure of the surplus that would be available for tax cuts or new spending under responsible budgeting procedures, plausible assumptions about the maintenance of current policy, and appropriate time horizons. To obtain these measures, it is necessary to adjust the baseline forecast for the treatment of retirement funds, the definition of "current policy;" and the time horizon employed. These adjustments provide different perspectives on the size of the available surplus and generally imply that the funding likely to be available for new tax cuts or spending programs is substantially less than the baseline forecast-and the current policy debate-would suggest.

A. THE TREATMENT OF RETIREMENT TRUST FUNDS

No financially responsible firm would consider its pension reserves as a source of financing for current operating expenses. Neither should the federal government. This simple but fiscally prudent observation has a significant impact on estimates of the available surplus.

As noted above, a substantial portion of currently projected budget surpluses over the next 10 years occurs because the Social Security trust fund will take in about $2.5 trillion more in payroll tax revenues and interest received on its assets than it will pay out in benefits and administrative costs. Leaders of both political parties agree that accruing Social Security trust fund balances should contribute to improving that program's long-term financial viability, and should not be used to finance tax cuts or other spending programs.

Medicare pays for health care for the elderly, and is divided into two parts. Part A, hospital insurance, covers hospital costs and is financed by payroll taxes. Part A is very similar in structure to social security. Workers contribute payroll taxes to a trust fund while working and receive promised benefits when they are elderly. Part B, supplementary medical insurance, is financed by a combination of user fees and general revenues. Over the next 10 years, the Medicare (Part A) trust fund is projected to run surpluses totaling $392 billion (CBO 2001, p. 19). Although Medicare is officially part of the on-budget surplus, both Houses of Congress voted last

year to support measures that protected the Medicare trust fund from being used to finance other programs or tax cuts. The House of Representatives approved the measure by a vote of 420-2. The Senate passed two separate measures; 98 Senators voted in favor of one or both. The strong votes demonstrated overwhelming Congressional support for preserving the Medicare trust fund. In 2001, the House again has voted overwhelmingly to protect Medicare surpluses.

While the social security and Medicare trust funds have received significant attention in the budget debate, a third set of retirement funds has not. Trust funds holding pension reserves for federal military and civilian employees will accrue surpluses of $419 billion over the next 10 years (CBO 2001, p. 19). Under current budget procedures, these surpluses are a component of the on-budget surplus. Like Social Security and Medicare, however, these trust funds represent current accumulations intended to provide retirement benefits to future workers. Thus, the same economic logic that has led fiscally responsible leaders to protect Social Security and Medicare balances, implies that government pension reserves should be protected as well. Many states, in fact, already separate their pension reserves from funds available for tax cuts and other spending. A recent proposal (H. RES. 23) by Representatives Baron Hill (D-Indiana) and Gene Taylor (D-Mississippi) would protect the pension reserves owed to military workers. Fiscal responsibility requires that the same protections be accorded to civilian pensions as well.

B. THE DEFINITION OF CURRENT POLICY

In order to project future spending and tax revenues, assumptions must be made about how tax and spending programs will evolve. The CBO's baseline forecast is intended only to measure the implications of maintaining "current policy." But how one should project current policy into the future is not always obvious. The baseline forecasts project current policy subject to a variety of statutory requirements, which limit the scope of the forecast's underlying assumptions and time horizons and can be at variance with reasonable expectations.

Mandatory spending-e.g., entitlements, such as Social Security-is generally assumed to continue as it is currently structured in the law. Discretionary spending, however, poses problems with regard to defining "current policy." Unlike mandatory spending, discretionary programs-e.g., defense, education, the environment, or infrastructure-are not automatically included in the annual budget and thus require annual appropriations from Congress. As a result, no consensus exists about how to project current policy for discretionary programs. In light of this quandary, CBO simply assumes that real discretionary spending authority will remain constant at fiscal year 2001 levels (CBO 2001, p. 76).

This assumption is clear, but may not be very reasonable. Discretionary spending totaled 6.3 percent of GDP in 1999 and 2000, the lowest share since at least 1962. Under CBO's baseline forecast, discretionary spending would fall to 5.1 percent of GDP. That is, it would fall by 20 percent relative to the size of the economy. It would also fall by over 10 percent in per capita terms. In a growing economy with large surpluses, growing defense needs, and other concerns, this seems to be a particularly draconian baseline.

At the very least, it would be more reasonable to have real discretionary spending grow at the same rate as the population (about 1 percent per year). This would hold real discretionary spending per person constant, but would still allow spending to fall to 5.6 percent of GDP by 2011. Incorporating this baseline would raise discretionary spending by $359 billion (CBO 2001, table 4-4) and, counting the added interest payments on federal debt that would be required, would reduce available surpluses by about $418 billion.[1]

A more ambitious alternative baseline would have discretionary spending grow at the same rate as nominal GDP, thus keeping the ratio of discretionary spending to GDP constant. This would raise spending by $905 billion (CBO 2001, table 4-4) and reduce the available surplus by $1,055 billion between 2002 and 2011.

To put these figures in perspective, note that in the campaign President Bush proposed new spending programs totaling $475 billion, along with cuts in government spending of $196 billion, for a net spending increase of $279 billion between 2001 and 2010 (table 1). This is virtually identical to the cost of having real discretionary spending grow by 1 percent over the same period (rather than over 2002-2011, see CBO table 4-4). Thus, this suggests that having real discretionary spending grow

[1] Interest payments are estimated by assuming the federal government pays an average of the 3-month rate and the 10-year rate on outstanding debt (CBO 2001, table E-2), that half of the increased expenditures in a given year accrue interest costs during that year, and all of the increased expenditures in a given year accrue interest costs in future years.

by 1 percent is a lower bound for the likely path of discretionary spending, both because Congressional Democrats and Republicans may have proposals of their own sometime over the next 10 years, and because President Bush may have more proposals for spending-especially on defense-after his initial round of proposals.

At least two aspects of current policy toward taxation merit consideration. The first regards the alternative minimum tax (AMT), one of the most complex areas of individual tax law. The AMT was implemented as a sort of backstop confronting the small number of taxpayers who are considered to be too aggressive in creating shelters and claiming deductions to avoid paying taxes.

In practice, the AMT has affected few taxpayers. In 2000, for example, about 2 million taxpayers faced the levy. Under current law, however, the Treasury projects that by 2011, 21 million taxpayers will be affected by the AMT. The main reason why is that the AMT exemption is not indexed for inflation. CBO's surplus forecasts assume that the dramatic rise in AMT taxpayers will occur. However, the increase would be fought fiercely by the affected groups. Indeed, the problem has already received significant attention, even though only a small portion of taxpayers currently face the tax.

"Current policy" would be better represented by indexing the AMT for inflation. This would keep the number of taxpayers on the AMT limited to about 1.9 percent by 2010. The lost tax revenue from this policy would total $113 billion over the next 10 years. Counting the added interest, the net cost would be $130 billion.[2]

A second tax issue relates to temporary tax provisions, a number of which are scheduled to expire over the next decade. For all taxes other than excise taxes dedicated to trust funds, CBO assumes that legislated expirations occur as scheduled. In the past, however, the temporary provisions have typically been extended another few years each time the expiration dates approached. In light of this practice, current policy is more aptly viewed as assuming that these so-called "extenders" will be granted a continuance. Extending the provisions-except the one relating to AMT, which is addressed above-through the 10-year horizon would cost a net of $69 billion in lost revenues (CBO 2001, table 3-12), plus an estimated additional $13 billion in interest costs.

C. IMPLICATIONS FOR THE AVAILABLE SURPLUS OVER THE NEXT 10 YEARS

Table 2 shows that these adjustments have a profound effect on the amount of funds that should be considered to be available for tax cuts or new spending. (Appendix table 1 provides year-by-year estimates of the alternative surplus measures.) The total 10-year projected surplus of $5.6 trillion is shown in the first line. Removing the social security trust fund surplus generates an "on-budget" surplus of $3.1 trillion. Removing Medicare trust funds reduces the surplus to $2.7 trillion. Protecting government pension funds from invasion for other purposes reduces the available surpluses to $2.3 trillion. That is, almost 60 percent of the projected 10-year surpluses are due to the retirement trust funds.

Adjusting for the issues regarding the AMT and expiring tax provisions reduces the available surplus to $2.1 trillion. If real discretionary spending were held constant on a per capita basis-or if President Bush's spending plans were implemented-the net available surplus for other programs would be just under $1.7 trillion. In contrast, if discretionary spending were held constant as a share of GDP, the remaining available surplus would be about $1 trillion (table 3).

Thus, depending on what is considered the most reasonable assumption regarding current policy toward discretionary spending, the available surplus is between $1.0 trillion and $1.7 trillion. This represents between 18 and 30 percent of the total surplus, and roughly one-third to one-half of the on-budget surplus over the 10-year period. The Center on Budget and Policy Priorities (CBPP) has made a similar set of adjustments and estimated an available surplus of about $2 trillion over the next 10 years (Greenstein and Kogan 2001).[3]

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[2] Estimates of the revenue loss from indexing the AMT from 2002 to 2010 are taken from Rebelein and Tempalski (2000). The estimates rise steadily and reach $18 billion by 2009, and $24 billion by 2010. I extrapolate the 2011 revenue loss to be $30 billion.

[3] The CBPP estimates differ from the estimates presented here in a number of ways. CBPP focuses on holding discretionary spending per capita constant, does not adjust for government pension reserves, and includes adjustments for some other programs, such as farm spending. The differences between the CBPP estimates and the ones presented above, however, are small relative to their similarities: both studies make the case that the surplus available for new spending programs or tax cuts is much less than it appears to be, based on the baseline forecast.

D. LOOKING BEYOND THE 10-YEAR HORIZON

There is nothing sacrosanct about a 10-year planning horizon. For public policies such as social security and medicare, the official planning horizon is 75 years. Indeed, an analysis of social security's finances that focused only on the next 10 years would not pass a laugh test. Likewise, many important private economic decisions, such as how an investor values a firm's stock, or how a family sets the parameters of a financial plan, also typically depend on perceptions of events that will occur more than 10 years into the future. Looking beyond the 10-year horizon is particularly important for assessing the budget outlook because the rapid growth in entitlement programs driven by an aging population and rapidly rising medical care expenditures is not projected to begin until later dates.[4]

To take these and other factors into account, previous research (Auerbach 1994 and 1997, Auerbach and Gale 1999, 2000) estimates the long-term "fiscal gap" under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required *now* to keep the long-run ratio of government debt to GDP at its current level. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

These estimates use the current CBO 10-year forecast through 2011 and CBO long-term budget forecasts through 2070. In subsequent time periods, all revenues and non-interest expenditures are assumed to remain a constant share of GDP. Social Security and Medicare outlays follow the intermediate projections in the reports released by the trustees of the funds. Discretionary spending, federal consumption of goods and services, and all other government programs, with the exception of net interest, are assumed to grow with GDP after 2010. Tax revenues are a constant share of GDP, except for supplementary medical insurance premiums collected for Medicare, which grow relative to GDP.

Table 4 shows that different measures of current policy can have a significant impact on the long-term fiscal status of the federal government, if these policies establish levels of spending or taxes that are preserved (relative to GDP) after 2011.[5] Under the CBO baseline assumptions about discretionary spending, the fiscal gap through 2070 is projected to be 0.67 percent. That implies that a permanent tax increase of 0.67 percent of GDP, which would currently be about $67 billion, would be required to restore fiscal balance through 2070. The fiscal balance on a permanent basis is currently 3.33 percent of GDP. Allowing discretionary spending outlays to remain constant as a share of GDP raises the fiscal gap further, to 1.45 percent of GDP over the next 70 years and 4.14 percent on a permanent basis.

In light of the recent political pressure to raise spending and/or cut taxes, it seems highly unlikely that there will be any immediate action to reduce the fiscal gap. But delaying the implementation of necessary tax increases or spending cuts will raise the required fiscal correction at the time of implementation.

All of the calculations above show that systematically incorporating longer horizons implies that the government faces significant financial shortfalls. This, of course, significantly damages the case for large-scale tax cuts today. Remarkably, however, some tax cut advocates try to use horizons (slightly) longer than 10 years to justify large tax cuts. They argue that when the 10-year projection period changes next year to 2003 to 2012 (from the current 2002 to 2011), the 10-year projected surplus will rise dramatically because adding the surplus projected for 2012 will far outweigh the loss of the surplus projected for 2002. Their claim is correct as far as it goes, but is misleading. It is essentially arguing for an 11-year perspective, which completely ignores the long-term fiscal shortfall.

E. UNCERTAINTY

It is difficult to predict the course of the economy over a period as short as 6 to 9 months. Thus, it should not be surprising that all of the estimates above are subject to a considerable amount of uncertainty. A few comments on the uncertainty of the forecasts are warranted.

First, CBO's underlying economic assumptions do not appear to be unreasonable. Their forecast for GDP growth over the next two years-2.4 percent in 2001 and 3.4 percent in 2002-is in the middle of the Blue Chip forecasters. Notably, CBO does

[4] Although CBO is the source of the 10-year baseline forecast, CBO itself warns several times of the dangers of ignoring the longer-term situation (see CBO 2001, p. xiv and pp. 4-5) and in fact regularly publishes estimates of the federal government's long-term fiscal status (see CBO 2000). David Walker, head of the General Accounting Office, also testified recently on the importance of taking the long-term budget picture into account.

[5] I thank Alan Auerbach for providing the estimates in table 4.

not foresee a recession in 2001, just a slowdown. Just as notably, CBO projects that the economy will turn around and growth will accelerate in 2002, even without any changes in tax or spending policy. CBO predicts a growth rate of about 3.1 percent for the rest of the decade, which does not seem out of line with reasonable expectations. CBO (2001, p. 60) points out that its forecast does not depend on a continuation of high capital gains revenues or high stock market values and in fact projects a decline in the share of revenues from capital gains.

Second, there is simply a huge amount of uncertainty regarding the evolution of the economy and the surplus. CBO (2001, p. 99) reports optimistic and pessimistic scenarios for the economy, where the 10-year surpluses range from $8.8 trillion to $1.6 trillion. In the latter case, there is an on-budget deficit of about $525 billion over the 10 years. CBO (2001, p. 96) also notes that on average their revenue forecast has been off by 11 percent of revenues after 4 years. If revenues were 11 percent higher or lower than forecast over the next 10 years, the surplus would differ from baseline by about $3.9 trillion. Interestingly, CBO (2001, p. 102) estimates that a mild recession followed by higher-than-trend growth would have little effect on the 10-year surplus, but that does not preclude a deeper, longer recession or a change in the long-term growth rate from having a significant impact.

Third, an important source of uncertainty stems from the fact that the surpluses are expected to rise over time. Only 12 percent of the projected total surplus and 10 percent of the projected on-budget surplus occurs in the first two years. Likewise, only 36 percent of the projected total surplus and 32 percent of the projected on-budget surplus occur in the first five years.

Fourth, other things equal, long-term estimates are inherently more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues, for at least two reasons. First, the serious consequences of a relatively bad long-term outcome should spur a precautionary response from policymakers now (Auerbach and Hassett 2000). Second, over the next 10 years, the primary factor affecting surpluses will be the course of the economy, which as noted above, is uncertain. In contrast, in the longer-term, the demographic pressures that are due to an aging population are far more certain to occur.

F. IMPLICATIONS FOR THE TAX POLICY DEBATE

These findings suggest some useful lessons for the current debate about how to allocate the surplus. The virtually exclusive emphasis given to baseline 10-year budget projections in current fiscal policy debates is inappropriate. The baseline forecast suggests the availability of trillions of dollars for tax cuts or new spending, but is based on a particular set of views of what constitutes current policy. Fiscal responsibility and plausible notions of current policy reduce the available 10-year surplus to between $1.0 and $1.7 trillion.

Despite the recent strong improvement in the government's fiscal position, there is still a long-term imbalance. This imbalance is a "future" problem only insofar as our budget accounting rules ignore the existence of liabilities already accrued.

Given this long-term imbalance, the fiscal climate may be more troubling now than in previous years. The short-term surplus and the decline in the long-term fiscal gap are no doubt improvements, but fiscal discipline may be especially difficult to impose under current conditions. In the 1980s and early 1990s, when the country faced both short-term and long-term deficits, the short-term deficits helped focus attention in a way that also helped reduce long-term gaps. Today, the United States faces the same trade-off between current and future generations as in earlier decades, and it is still confronting a long-term shortfall. But the current policy discussion focuses on ways to use the surplus that would likely exacerbate the long-term situation.

2. PRESIDENT BUSH'S BUDGET AND TAX PROPOSALS

President Bush's budget predicts a baseline surplus of about $5.6 trillion, a non-social security surplus of $3.0 trillion, and a non-medicare, non-social security surplus of $2.5 trillion. While these numbers are reassuringly similar to the CBO figures, the budget departs from fiscally responsible actions in three main ways.

The first concerns the social security trust fund. Normally, trust fund surpluses are used to add to government saving, by paying down the debt. The President, however, would divert $600 billion of social security trust fund surpluses from debt repayment into a "reserve fund." The Administration argues that it cannot use those surpluses to finance debt repayment because there will not be enough purchasable government debt outstanding. An alternative (discussed below) would be to purchase private assets with the funds, but the Administration claims to be philosophically opposed to such a view (even though the state of Texas holds $21 billion in

private assets as part of pension fund for government workers). The "reserve fund" is the only alternative left, according to the Administration. However, the amount of available debt to be repurchased is controversial and CBO and Fed Chairman Alan Greenspan both suggest that the relevant amount that can be repurchased is hundreds of billions of dollars larger than the Administration claims. Moreover, if those funds are placed in the "reserve fund" they are not being used to protect the social security surplus and thus represent a violation of the virtually unanimous agreement in both Houses of Congress to protect those funds.

The second fiscally irresponsible act involves siphoning off the Medicare trust fund surplus to pay for the rest of Medicare. Medicare part A is financed by payroll taxes and is currently running a cash flow surplus. That surplus, however, is nowhere near sufficient to finance future Medicare part A payments-the part A system as a whole is in long-term deficit. That is why it is important not only to save the part A surplus, but to supplement that surplus with additional funds over the years. The Administration goes in exactly the opposite direction. Not only does it make no effort to fund the long-term deficit in Medicare part A, it also takes away the surplus in part A by spending the funds on current supplemental medical insurance for the elderly. This is a gross violation of the use of the Medicare surplus, and flies in the face of efforts of responsible members of Congress from both parties who have tried to protect the fund.

The third fiscally irresponsible act is the President's tax proposal. The proposal contains several major elements, and is phased in gradually over time (Bush-Cheney 2000, JCT 2000a). The most important elements, listed in order of their revenue cost when fully phased in, are:

• *Reduce the highest income tax rates.*

By 2006, tax rates in the 39.6 and 36 percent brackets would fall to 33 percent, and rates in the 31 and 28 percent brackets would fall to 25 percent.

• *Abolish the estate tax.*

The estate tax would be reduced gradually and then abolished in 2009. It is unclear whether any changes in the taxation of capital gains at death would occur.

• *Create a new 10 percent tax bracket.*

The first $6,000 of taxable income for singles and $12,000 for married couples would be taxed at 10 percent rather than 15 percent.

• *Expand the child credit to high-income households, reduce the phase-out rate, and double the credit amount.*

Eligibility for the full credit would be extended to all taxpayers with income below $200,000 (up from $110,000 for married couples and $75,000 for singles, currently), the phaseout rate would fall from 5 percent to 2 percent, and credit would double to $1,000. The credit would remain non-refundable.

• *Allow a two-earner deduction.*

Allow a 10 percent deduction for the earnings of the lower-earning spouse in a two-earner family. The maximum deduction would start at $12,000 in 2002 and rise to $30,000 in 2005.

Other components include allowing a charitable contributions deduction for households that do not itemize, allowing individuals aged 55 and over to make penalty-free withdrawals from their IRAs to make charitable contributions, raising the cap on corporate charitable contributions from 10 percent to 15 percent of taxable income, expanding the limits and uses of educational IRAs, and permanently extending the credit for research and development.

Recently, HR 3 included the creation of a new bracket and the reduction in the marginal tax rates, with the latter accelerated one year. The Joint Committee on Taxation has estimated that if HR 3 were enacted, approximately 36 million taxpayers would face, or be affected by, the AMT by 2011. This is 15 million more than the 21 million that would be placed under the AMT under current law. The Bush administration has acknowledged that the AMT creates a problem for the proposed tax cut . Indeed, the tax program on the Bush campaign web site (where voters could calculate how much of a tax cut they would receive under Bush's plan) did not allow for the AMT to reduce anyone's tax cut, and thus implicitly assumed that an AMT fix was a *de facto* part of the Bush plan. For all of these reasons, I include the necessary AMT adjustments as part of the Bush plan. To be clear, these adjustments would merely undo the increase in AMT taxpayers due to the Bush plan. They would not address the increase in AMT taxpayers that is expected to occur under current law even in the absence of tax changes.

3. EVALUATING THE PRESIDENT'S TAX PROPOSALS

The justifications for a tax cut are a crucial part of the proposal, for at least two reasons. First, the goals themselves might be criticized. For example, trying to use

a tax cut to prevent the economy from falling into a recession may not be an achievable goal, and thus may not be worth pursuing. Second, the goals may be laudable, but proposed tax cuts might not achieve the goals very effectively. For example, fighting a current recession with a tax cut that is substantially delayed would not be very effective.

More generally, different justifications naturally lead to consideration of different policies, and the appropriate size, timing, and distribution of tax cuts depends on the justifications put forth. The justification given must pass two tests: it must justify a tax cut in general, and it must justify the particular cut that is being proposed.

In practice, the Administration has had a very difficult time providing a coherent justification for its tax package. The President's justifications for his tax proposal have changed markedly over time, though the proposal itself has not. Most recently, the goals appear to include: to provide a fairer distribution of tax burdens, to improve access to the middle class, to reduce the marriage penalty, to stimulate the economy, and to reduce the high tax burdens on families (White House Press Office 2001). In this section, I evaluate the President's plan along these and other criteria.

A. SIZE OF THE TAX CUT

Interestingly, "maintaining fiscal discipline" is not usually stated as a goal of the President's tax plan, and it is easy to see why. Table 5 breaks down the costs into three components. (Year-by-year and provision-by-provision estimates are provided in Appendix Table 2). The provisions of HR 3 would reduce taxes by $958 billion over the next 10 years. Other components of the plan the President submitted to the Congress on February 8 would cost $717 billion. Additions to the plan that were in the President's budget, but not in the earlier submission to Congress cost another $127 billion. The adjustments required to avoid having taxpayers bear the burden of the AMT because of Bush's tax cuts would total $292 billion. The added interest payments on the federal debt caused by the reduction in federal revenues would cost another $418 billion. Thus, although the proposal is often referred to as a $1.6 trillion tax cut, the real cost of the proposal now comes to an astonishing $2.5 trillion over the next 10 years.

Note also that these figures *underestimate* the cost because some of the estimates are based on JCT estimates from May 2000. Projected revenues in the January 2001 CBO baseline are about 9 percent, or $2 trillion, higher than in the January, 2000 baseline. If the revenue effects were estimated from the current revenue base, they would be larger.

Ultimately, assessments of whether the Bush's proposed tax cut is too large are in "the eyes of the beholder." Several analytic perspectives, however, suggest the tax cut is excessive. First, the magnitude of the tax cut exceeds the "available surplus" listed in tables 2 and 3 by between $800 billion and $1.5 trillion. Thus, enacting Bush's tax cut would imply that no other important policy priorities could not be met unless Congress is willing to finance the programs with balances in the retirement trust funds. The Bush tax cut is exactly equal in size to the Bush administration's non-medicare, non-social security surplus.

Some have claimed that economic responses to the tax cut would reduce the costs by one-quarter. However, these economic responses leave out the reduction in national saving that would occur along with the cut in tax rates. The reduction in national saving would reduce productivity growth and place a drag on economic growth. Analysis by Peter Orszag for the Center for Budget and Policy Priorities suggests that the decline in national saving would reduce revenue by about as much as the improved incentives have been claimed to raise revenue. Hence, the net effect would be roughly a wash.

Third, the proposed tax cut would substantially increase the long-term fiscal gap listed in table 3. Even if discretionary spending were held constant in real terms, so that it fell continuously as a share of GDP, Bush's tax cut would triple the long-term fiscal gap through 2070 and raise it by 150 percent on a permanent basis. This would significantly worsen the long-term fiscal problem the government faces. This should not be surprising. By 2011, the Bush tax cut, including the AMT adjustment, would reduce income tax revenues by over 16 percent on a permanent basis.

Some tax cut advocates have asserted recently that Bush's proposals are smaller than the 1981 tax cut signed by President Reagan. This claim is misleading. When evaluated on an equivalent basis, the two plans are about the same size. Several adjustments are needed to evaluate the plans on an equivalent basis, though. Reagan's tax cut has been estimated by the CBO (1983) and the Treasury (Tempalski 1998) to have reduced revenues by between 4.2 percent and 5.6 percent of GDP. However, recall that the tax system was not indexed for inflation in 1981. CBO

(1983) estimates that at least 40 percent of the Reagan tax cut was simply an elimination of tax increases that would have occurred because of inflation. In addition, as soon as the 1981 act was passed, politicians on both sides of the aisle recognized that the tax cut was too large and moved to raise taxes in 1982 by about 1.2 percent of GDP. Adjusting for these two factors places the Reagan cut at between 1.3 percent and 2.1 percent of GDP (Orszag 2001).

Bush's proposed tax cut, of course, would occur above and beyond the inflation indexing that will automatically occur over the next decade. Bush's tax cut is phased in slowly over time and the costs are heavily backloaded. Table 5 shows that about three-quarters of the costs occur in the second five years of the forecast period. Thus, estimates of the cost of the plan relative to GDP over the 10-year period are misleading. In 2009, when the plan is fully phased in, the cost of the tax cut and the accompanying AMT adjustments is estimated at 1.7 percent of GDP. Note that this places the costs exactly in the middle of the range of the costs of the Reagan plan.

Moreover, the case for tax cuts is much weaker currently than it was in 1981. The 1981 tax act reduced the top rate from 70 percent to 50 percent, which is higher than the top rate is today. Also, Treasury data show that in 1981, income tax burdens for families of four with half-median, median and double-median income were the highest they have been in any year since 1955 (Lerman 1998). Income tax burdens had risen for five years in a row for the low-income family, the previous 7 years for the median income family, and the previous 10 years in a row for the high-income family. As of 1999, the low-income family's tax burden is 7 percentage points lower than it was in 1981, the median income family's burden is 4 percentage points lower than it was in 1981, and the high-income family's tax burden had fallen by 5 percentage points as well. Congressional Budget Office (1999) data show that for families in all five income quintiles, income tax burdens in 1981 were higher than they are today and in almost all other years.

B. DISTRIBUTIONAL EFFECTS

The allocation across income groups of the tax cuts proposed by President Bush has proven controversial. The main reason why is that during the campaign and since the Inauguration, the Administration has launched a non-stop campaign of tortured logic, misleading examples, and outright false characterizations of the plan. The main results are clear: by any reasonable standard, the plan provides disproportionate benefits to high-income households. But the Adminstration's efforts to obfuscate this point have confused a significant number of commentators and are worth exploring carefully.

The administration (White House 2001, p. 1) characterizes the tax plan as follows:

(i) "The highest percentage cuts go to the lowest income Americans"

(ii) "Lower income taxes for all"

(iii) "Everyone who pays income taxes benefits"

(iv) "The greatest help for those most in need"

(v) "The typical American family of four will be able to keep $1,600 more of their own money."

The Administration likes to focus on two aspects of their tax cut, each of which is extremely misleading in understanding the progressivity of the cut. First, they claim the plan benefits the lowest income Americans most because it gives them the highest percentage cut in income taxes. Second, the Administration notes that under its plan, high-income households would pay a larger share of income taxes than they currently do.

First, the Administration apparently defines "the lowest income Americans" as those with income of $22,000 or higher. In fact, more than 40 million tax units have income below that figure. Second, the income tax for the family of four with $26,000 in 2001 is only $20 per year, so their 100 percent reduction in income taxes raises their after-tax income by trivial amounts (Greenstein 2001, Greenstein and Shapiro 2001).

More generally, there are many ways to report the size of tax cuts, but the percentage reduction in one particular tax or the percentage share a particular tax-which the Administration has chosen to emphasize—is very misleading. To see why, examine table 6, which works through these issues in a hypothetical example. In the current system, a waitress earns $22,000 pays $72 in income taxes (after the child credit and before the EITC) and $3,366 in payroll taxes. The payroll tax includes both the employer and employee share since most economists believe that payroll taxes are passed on to workers in the form of lower wages. A lawyer earns $200,000 and pays $48,612 in income taxes and $15,250 in payroll taxes.

The Bush tax cut would reduce the waitress' income tax by $72 and the lawyer's by $8,413. Who gets the bigger tax cut? The administration would say the waitress did. Her tax cut is a larger share of her *income tax,* and she pays a smaller share of income taxes after the tax than before.

However, most reasonable observers would likely conclude that the lawyer got the larger cut. After all, the lawyer had a bigger percentage decline in the sum of payroll and income taxes, a bigger percentage increase in after-payroll-and-income-tax wages, and, most importantly, a larger percentage increase in after-tax income. Needless to say, the lawyer also received a tax cut that in absolute terms is gigantic compared to the waitress's tax cut. Indeed, the lawyer's tax cut is equal to 4.5 months of earnings for the waitress, yet the Administration claims that the attorney gets the worse part of the deal!

It is important in these comparisons to emphasize total taxes, rather than just income taxes, because policy makers could choose to cut any of a variety of taxes and it is the overall impact of the tax cut that matters, not just how one tax is affected.

Table 7 shows the estimated distributional impact of Bush tax cut proposal. As in the hypothetical example, taxpayers in higher income brackets receive a larger percentage reduction in *total* federal taxes, a larger percentage increase in after-tax income, and a much larger tax cut in absolute terms. These figures demonstrate that the largest benefits under the Bush proposal go to high income households.

The administration notes that everyone who pays income taxes will benefit. However, there are many households that pay substantial amounts of payroll taxes, but not income taxes, who would not benefit. If the goal is to provide help for those most in need, it is unclear why the beneficiaries should be limited to income tax payers. For example, table 7 shows that 75 percent of tax filing units in the bottom 20 percent of the income distribution and 37 percent in the next quintile receive *no* benefit from the tax cut proposal. This shows that it is simply false to claim that "the greatest help goes to those who are most in need."

Table 7 also shows that 89 percent of all tax filing units, including 95 percent of those in the bottom 80 percent of the income distribution, would receive less than $1,600 in tax cuts when the cuts were fully phased in. Thus, it may be that some typical family defined by some metric receives $1,600, but the overwhelming majority of households will receive less, and 27 percent will receive no tax cut at all (CTJ 2001).

A common, and reasonable, response to complaints that high-income taxpayers receive a large share of proposed tax cuts is that high income taxpayers pay a large share of existing taxes. However, under the Bush plan, households in the top 1 percent would receive tax cuts that are far in excess of the proportion of taxes they pay. Table 8 shows that the top 1 percent paid about 21 percent of total federal taxes in 1999, but under the Bush plan, they would receive at least 35 percent of the tax cut. Under other estimates, not shown in the table, they would receive as much as 43 percent of the cut.

Finally, the administration trumpets its expanded child credit as helping families with children. But one study found that 82 percent of the benefit of the expanded child credit would go to households in the top 40 percent of the income distribution. Moreover, about one-third of all children live in families with incomes too low to receive any benefit from the credit. (Shapiro, Dupree and Sly 2001).

C. TOLLBOOTH TO THE MIDDLE CLASS

The President's proposal attempts to reduce what he calls the "tollbooth" to the middle class, that is, the high effective marginal tax rates that working families face. The effective marginal tax rate varies as a function of income level and is a combination of federal and state income taxes, payroll taxes, and the phase-outs of various programs. However, it is well known that the highest effective marginal tax rates are faced by those earning less than $20,000. The President's proposal does not address these problems at all. As Shapiro et al (2001) note, expanding the EITC would help both this group and the higher-income group (in the mid $20,000s) that Bush's proposal is aimed to assist. In addition, there is little econometric evidence that the high effective marginal tax rates created, for example, by the EITC, actually reduce labor supply.

D. MARRIAGE PENALTY

Bush's proposal to address the marriage penalty is to restore a second-earner deduction that was in place between 1981 and 1986. When fully phased in, the two-earner deduction would allow up to $30,000 of the earnings of the lower-earning spouse to be deducted from income. This would reduce the marriage penalty for two-

earner families, who are the ones most likely to face such penalties. However, the proposal is poorly targeted in two ways. First, it would enlarge the marriage subsidies that already exist for many couples. Second, it would provide no benefits for lower income households. This is important both on distributional grounds and because the EITC imposes some hefty marriage penalties.

E. TAX CUTS AND A RECESSION

One of the most puzzling and misleading aspects of the President's defense of the tax cut is his claim that it would be an effective way to fight a brewing recession. First, whether there is a recession or simply a slowdown in the growth rate is unclear. Second, almost all economists, including top Bush economic advisers Larry Lindsey and John Taylor, have argued that tax policy is a difficult way to fine tune the economy (See Lindsey 1999, pp 28-9 and Taylor 2000, p. 27). Tax laws have to be drafted, debated, passed, reconciled, signed and implemented. Counter-cyclical tax cuts could also make the Federal Reserve Board's job more difficult by adding a new element of uncertainty. In contrast, the Federal Reserve Board can cut interest rates quickly and decisively to stimulate the economy.

But even if there is a recession, and even if tax cuts could in general fight recessions effectively, the President's tax proposal is incredibly poorly designed to fight a recession that is happening currently. For starters, there is simply no tax cut proposed for fiscal 2001 (which ends on September 30, 2001). It is hard to see how a tax cut could boost the economy now if it is not providing any tax cuts now. In addition, the President's plan would only provide tax cuts of $21 billion (about $75 per person or 0.2 percent of GDP) in fiscal 2002. Thus, in the next 18 months, the plan would provide virtually no stimulus at all.

In addition, an anti-recession plan should put money in the hands of low- and middle-income households. These are the people who are most likely to lose their jobs in a recession, and the ones for whom tax cuts would give the biggest bang for the buck in stimulating the economy. In contrast, the President's plan gives the vast bulk of funds to high-income households, as shown above.

Finally, an anti-recession tax package should be small enough not to raise interest rates. However, tax cuts that would use up more than $2 trillion of surpluses during the next 10 years could well lead to higher interest rates. Note that this would actually be counterproductive to fighting a recession, so that the plan could make matters worse. Nor does a plan that grows in costs over time make sense as an anti-recessionary device. Recessions are temporary. We do not need to cut taxes by $1.1 trillion between 2007 and 2011, as Bush's plan would, to stave off a recession in 2001.

Bush supports the idea of making the tax cuts immediate, but his proposal does not contain such a feature. Moreover, accelerating his package would provide few benefits but would create significant problems. It would only give the economy a tiny stimulus ($21 billion) in fiscal 2001, and so would do little to help fight a recession directly. And it might indirectly hurt the economy. My own estimates, based on JCT data, and a similar analysis by Greenstein (2001) show that accelerating the plan would raise the 10-year cost by $400 billion. This would further crowd out other spending priorities and would likely put increased pressure on interest rates. The net effect could be to make the economy less productive in the short run. And, of course, accelerating the package would not change the distributional effects.

F. ARE AMERICANS OVERTAXED?

Another argument the president uses to justify tax cuts is that tax revenues are at historic highs and therefore that Americans are being crushed by overburdensome taxes. The first claim is right. Federal tax revenues were 20.6 percent of GDP in 2000, the highest peacetime level ever. Note, however, that this total includes all federal taxes, not just income taxes. Thus, if a high aggregate federal tax burden justifies tax cuts, it should justify cuts in a variety of taxes, not just the income and estate taxes.

However, even granted that total revenues are high, it is not true that most households are bearing higher tax burdens than they would have with the same income in the past. In fact, for most families, taxes are as low or lower than they have been in the past 20-30 years. Overall tax payments have risen because the rich have gotten richer at an impressive rate and because they have faced higher tax rates due to policy changes in 1990 and 1993. This distinction between what is happening to most households and what is happening at the aggregate level is crucial to the debate. Tax cut advocates typically prefer to focus on the aggregate numbers. But even the Wall Street Journal editorial board, a staunch supporter of tax cuts, has

acknowledged recently that "taxes on a typical middle income family have fallen to their lowest level in more than 20 years" (Wall Street Journal 2001).

A Department of Treasury study (Lerman 1998), using a methodology that has not changed over the course of several Administrations, shows that across a wide range of income levels, federal income taxes as a share of earnings are down. A four-person family with earnings of about $55,000 paid 7.5 percent of that amount in federal income taxes in 1999, the lowest rate since 1966. For families with earnings half as large, the 1999 income tax rate was the lowest since 1955, when the estimates begin. Families with earnings of almost $110,000, who are squarely in the top 10 percent of the income distribution, the 1999 income tax burden of 14.1 percent was the lowest rate since 1972 (see figure 1). Adding social security and medicare taxes to the Treasury income tax estimates raises the estimated tax burden, but does not change the conclusion that taxes are low relative to previous years (see figure 2).

Congressional Budget Office (1999) estimates show that, for households in the bottom 40 percent of the income distribution, the burden of all federal taxes is at a twenty-year low (see figure 3). For households in the 40th to 80th percentile, federal taxes are at approximately the average share that they have been in the past. Only among the top 20 percent of households did total federal taxes rise in the last 15 years. Notably, those households received the largest cuts in 1981, as shown in figure 3, and despite the increase in their average tax burden, their after-tax income has increased faster than income in any other quintile (see figure 4). The after-tax income of high-income households rose particularly fast between 1995 and 2000. Thus, their tax burden rose primarily because their incomes rose so much and the U.S. has a progressive tax system.

American tax burdens are also low compared with those in other industrialized countries. Among the 20 largest OECD countries in 1996, the U.S. had the lowest ratio of taxes to gross domestic product.

Ultimately, whether Americans are overtaxed is a judgment call. The measure of appropriate tax levels depends on many factors, including an analysis of how the money is used. But the evidence speaks clearly: the vast majority of American families forfeit the same or smaller share of their income to taxes today than they would have in the past with the same income, and those that forfeit more have generally experienced huge income gains in the past decade.

G. ARE TAX CUTS NEEDED BECAUSE GOVERNMENT WOULD WASTE ANY SURPLUS FUNDS?

Another set of arguments claims that we need tax cuts because surpluses lead to bloated government spending. There is certainly an element of truth to this characterization of the problem. For example, Congress exceeded the spending caps by increasing amounts in each of the past three years. However, the vast portions of existing surpluses have been allowed to accumulate, so the argument is weakened considerably.

Moreover, it is especially inappropriate for defenders of the Bush administration's tax cut to make this argument, for several reasons. First, President Bush himself has proposed about $500 billion in new spending programs over the next decade (see table 1). The President clearly believes that not all government spending is wasteful. Second, reforming social security and medicare and increasing defense spending, as the President has indicated he would like to do, will cost additional funds. Third, while both Houses of Congress have voted to protect Medicare surpluses from being used for other purposes, it is the White House that is currently resisting this effort.

Finally, even if this argument justifies a tax cut, it does not provide a rationale for why the tax cut should be focused on the highest-income households.

H. PAYING OFF THE DEBT WOULD FORCE THE GOVERNMENT TO INVEST IN PRIVATE ASSETS

An argument put forth recently by Alan Greenspan, and quickly repeated by tax cut advocates, is that under current surplus projections, the government will pay off all available government debt by around 2006 or shortly thereafter. At that point, with more surpluses pouring in every year, the government would have to start accumulating private assets, either bonds or stocks. Greenspan and others argue that having the federal government hold such assets would raise a number of difficult issues, concerning government interference in the operation of private companies, the selection of assets to go into the government portfolio, etc. Greenspan and others claim that it would be preferable to avoid that situation by cutting taxes now, rather than being forced either to cut taxes or raise spending massively at some point in the future or have the government invest in private assets.

Many supporters of fiscal discipline, however, recognize that these issues are important, but believe that Greenspan has overstated the problem. For example, government agencies could invest passively in index funds, in the manner of the Federal Thrift Savings Plan. Orszag (2001b) notes that state and local government pension funds have invested in private assets for a long period of time. In 2000, state and local pensions held the equivalent of 28 percent of GDP in bonds and other assets, including almost $2 trillion (equivalent in size to about 19 percent of GDP) in corporate equities. Research suggests that such funds perform relatively well (Munnell and Sunden 1999). Foreign governments also have extensive experience in private investments. Canada, Norway, and Denmark have all had favorable experiences with investment of government funds in private assets. In addition, note that giving tax cuts in order to avoid paying off the national debt will likely reduce national saving, and thereby impose a cost on future generations.

A related concern is that paying off the debt will make the market for Treasury bills and bonds evaporate. Treasuries play several important roles in financial markets-as a safe asset, a source of liquidity, an index against which other loans are priced, as a mechanism for Federal Reserve Board open market operations, etc. However, paying off government debt does not preclude the government from continuing to issue bonds. It would merely collect the funds and then reinvest them. Moreover, if the government did not issue any new bonds, fierce competition among private suppliers of debt could be expected.

In any case, how government would handle investment in private assets and how the Treasury market would respond to paying off the government debt are important questions that should be addressed. But they do not provide a justification for large tax cuts, nor do they provide a justification for tax cuts aimed at the highest-income households.

I. ARE TAX CUTS NEEDED BECAUSE THE AMERICAN PEOPLE ARE BEING OVERCHARGED?

President Bush and others have claimed that tax cuts are needed because Americans are being overcharged for government currently. Apparently, "overcharged" refers to the idea that current revenues exceed current outlays, under budget procedures that are in place now. Unfortunately, it is not that simple. As noted above, the government faces a long-term shortfall, not a surplus. That is, Americans have collectively promised themselves more in benefits than they have been willing to commit to in taxes. That hardly qualifies as overcharging themselves.

A related argument claims that "It is the American people's money. Give it back to them." Again, that argument is correct as far as it goes-it is the American people's money. But the long-term financial shortfall is also the American people's financial obligation.

A slightly more sophisticated version of the same argument says that if the deficits in the 1980s and early 1990s justified tax increases, then the surpluses that are currently in existence should justify tax cuts. However, in the 1980s and early 1990s, the nation faced long-term deficits and short-term deficits. The short-term deficits helped focus attention on improving the fiscal status of the government, but the real problem was the longer-term situation. Now, short-term cash-flow surpluses are obscuring the real problem, which is that we still have a long-term financial shortfall.

4. POLICY OPTIONS

The current fiscal surpluses are a significant accomplishment, and should not be taken lightly or for granted. There is clearly room for a tax cut, for spending priorities, and for debt reduction. But I believe that the most important budgeting decision for the Congress is to establish a new set of budget rules, and that these rules should be established before making a significant set of tax and spending changes.

A. BUDGET RULES

There are several reasons to develop a new set of rules. The fiscal accomplishments of the last decade should be preserved and enhanced, not squandered. The old rules are expiring. It will be more difficult to make wise choices in the absence of an overall budgetary framework. And the current budget situation has dangers associated with it. The emergence of significant cash-flow surpluses over the medium term will create understandable pressures to use the funds for tax or spending initiatives. However, most of the surpluses stem from the retirement trust funds (tables 2 and 3), which prudent budgeting suggests should not be used to finance other programs, and the long-term fiscal stance is still negative (table 4).

Consideration of policy rules should take several factors into account. First, there is a certain asymmetry in policy options. It is always easier to reduce taxes later

than to raise them. Second, new and unforeseen policy priorities frequently arise, so prudent fiscal management would suggest the equivalent of a "reserve fund" of some sort. Third, both budget projections and economic forecasts are subject to considerable uncertainty, which suggests another reason not to commit all available resources immediately. A set of budget rules that is consistent with these views would include the following:

• Reaffirm the commitment not to spend social security trust funds on other programs.

• Reaffirm the votes taken last year that protect Medicare Part A trust funds from being spent on anything other than hospital insurance. This is especially important because the Bush administration has not committed to this view.

• Accord similar protections to the balances in trust funds for military and civilian pensions.

• Elevate the importance of budget outcomes over longer time horizons by having CBO report its long-term forecast at the same time, and in the same document, as the 10-year Outlook that is produced every winter and the Update that is produced every summer.

• Adopt a proposal put forth recently by Robert Reischauer, President of the Urban Institute (Reischauer 2001). Under the Reischauer rule, Congress and the President would establish a benchmark surplus measure and would only allow themselves to commit a certain percentage of projected benchmark surpluses to new spending or tax cuts, with the percentage declining over the 10-year horizon. Reischauer suggests the benchmark surplus should be the non-social security, non-medicare surplus, and that 80 percent of the benchmark surplus projected in years 1 and 2 would be available, 70 percent in years 3 and 4, and so on concluding with 40 percent of the benchmark surplus in years 9 and 10. Making this adjustment would result in a 10-year "usable" surplus of about $1.4 trillion (determined by applying the Reischauer percentages to the appropriate figures in appendix table 1). The non-retirement trust fund surplus (thus removing government pensions as well as social security and medicare) is an alternative possible benchmark. In practice, this alternative definition does not make a huge difference; the available surplus would be $1.2 trillion. These proposals may not be as radical as they first appear. Last year, for example, the House passed a resolution to devote 90 percent of the coming year's surplus to debt reduction. This is merely an extreme version of the Reischauer rule.

There has also been discussion of making tax cuts or new spending programs contingent on actual budget surpluses in the previous year. The "trigger mechanism" has an admirable goal-to ensure that Congress does not promise more than it can afford. But I believe the Reischauer rule would work better, for two reasons. First, a trigger mechanism introduces uncertainty about future taxes. Second, if the goal is to ensure that tax cuts can be paid for, the trigger mechanism may fall short. A trigger mechanism would allow a tax cut in a given year, if the surplus in the previous year surpassed a target level. The problem is that the tax cut would typically be permanent (for example, if rates were cut), but the surplus may only be temporary. The fact that the surplus the previous year surpassed a target does not guarantee that surpluses in future years will be sufficient to cover the permanent costs of the tax cut. One way around this problem is to use the trigger each year to generate a one-time tax rebate. The rebate would not be repeated the following year, unless the surplus was sufficiently large. This removes the question of whether the tax cut could be funded but limits the scope of policy that could be undertaken.

B. TAX POLICY

Tax policy should be made inside of a budgetary framework that recognizes the importance of other public policy goals-such as education, health, defense, the refurbishing of social security and medicare and so on. In addition, fairness, efficiency, and simplicity remain the core principles of tax policy regardless of the size of the surplus. A number of important tax policies are consistent with these objectives and a prudent budget framework:

• Create a new, lower tax bracket of 10-12 percent, covering a range of income broader than the 10 percent bracket proposed by President Bush.

• Combine or integrate interactions between the child credit, earned income credit, and personal exemption, along the lines proposed by Sawhill and Thomas (2001), Ellwood and Liebman (2000) or the Economic Policy Institute (2000). This would simplify taxes, improve incentives to work and marry, and provide added resources to low-income households. A crucial element would be to increase the refundability of the child credit.

• Examine the potential for an income tax credit that is based on payroll tax liabilities.

• Simplify the tax code by raising the standard deduction, providing a uniform exclusion for capital gains income rather than the complicated patchwork of capital gains tax rates we currently have, and consolidating the various education programs and the various retirement saving programs.

• Provide tax cuts to high-income taxpayers, and simplify the tax system further, by removing hidden taxes and "take back" provisions. These taxes are imposed even when a taxpayer is complying perfectly with the law, but ends up with what the law has deemed "too many" deductions or "too little" income. These items adversely affect incentives, raise little revenue and create unnecessary complexity.

Personal exemptions are phased out for high-income taxpayers. Two percent of the exemption is eliminated for each $2,500 or fraction thereof that AGI exceeds certain thresholds. The total amount of itemized deductions a taxpayer may claim is reduced by 3 percent of households' income above certain (different) thresholds. These two items can raise effective tax rates by more than 3 percentage points above statutory tax rates, and should simply be repealed.

The major reason individuals get placed on the AMT is that they have high deductions for state and local taxes or large families (Rebelein and Tempalski 2000). This is hardly the egregious tax sheltering behavior that the AMT was intended to capture. Either the AMT exemption should be increased substantially (by $100,000) and indexed for inflation, or the AMT should be abolished. However, before abolishing it, Congress should study what sort of sheltering opportunities would be created and act preemptively to close them off.

• Another way to assist high-income taxpayers is by reforming the estate tax. The effective exemption could usefully be raised and the rates brought down modestly. In addition, the exemptions and rate brackets should be indexed for inflation. Making these changes would provide room to eliminate the most egregious and abusive sheltering practices, of which there are many. (See Gale and Slemrod 2001, or Schmalbeck 2000, for further discussion.)

It would also make sense to decide whether the expiring tax provisions should be made permanent or should be abolished. Finally, there has been substantial discussion of tax rebates. Rebates have the advantage that they can be administered immediately, and they make the most sense either if Congress desires to put money in citizens' hands quickly, or if a tax cut is made contingent upon the size of a surplus. However, as discussed above, tax policy is generally not a useful counter-cyclical policy tool, and making a tax cut contingent on the size of the surplus introduces unnecessary uncertainty.

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TABLE 1.—PRESIDENT BUSH'S CAMPAIGN PROPOSALS FOR NEW SPENDING: 2001–2010

	$ Billions
Medicare Prescription Drugs and Reform	158.0
Additional Medicare	40.3
Health	131.9
Defense	45.0
Education	47.6
Compassion/Charity	23.9
Agriculture	7.6
Housing/IDAs	6.6

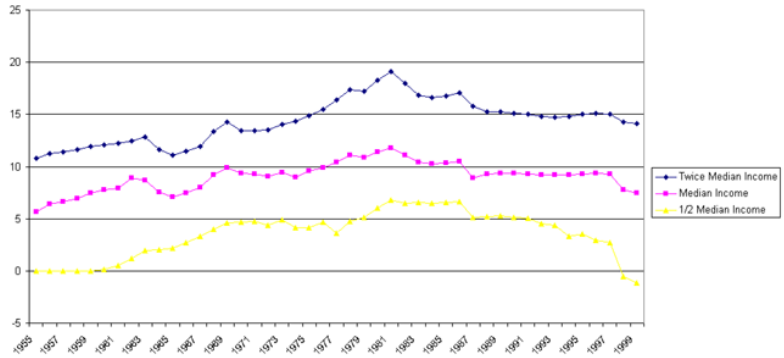
TABLE 1.—PRESIDENT BUSH'S CAMPAIGN PROPOSALS FOR NEW SPENDING: 2001–2010—Continued

	$ Billions
Environment	5.3
Crime	0.7
Other Domestic	7.8
Subtotal	474.6
Less Savings from Government Reform	–196.4
Total Spending	278.2

Source: Bush Campaign. September 5, 2000. ''Bush Budget 2001–2010,'' http://www.georgewbush.com/Media/PDFs/SummaryBudgetSept052000.pdf.

Figure 1

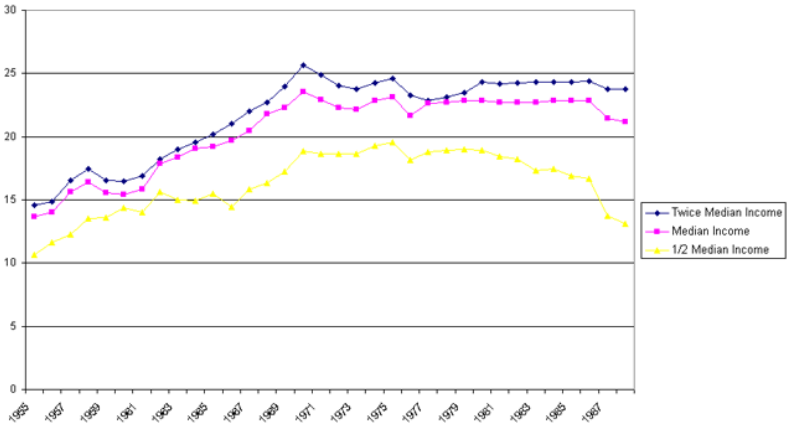
Average Federal Income Tax Rate



Source: U.S. Department of Treasury. 1998. *Average and Marginal Federal Income, Social Security, and Medicare, and Combined Tax Ratesfor Four-Person Families at the Same Relative Positions in the Income Distribution, 1995-1999." Office of tax Analysis, Jan .15.*

Figure 2

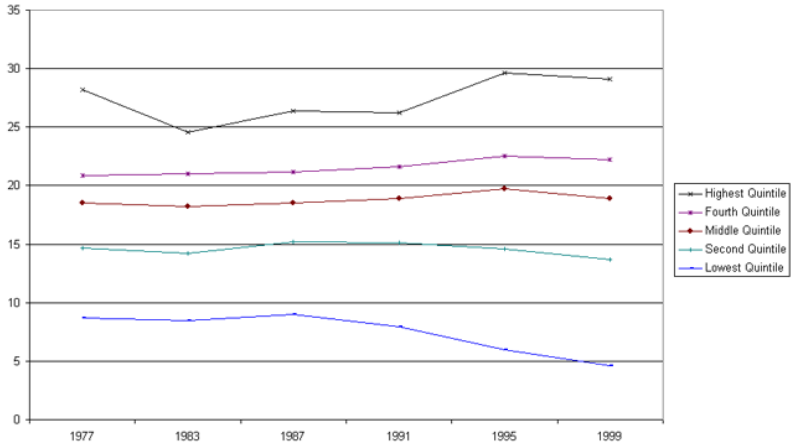
Average Federal Income Plus Payroll Tax Rate



Source: U.S. Department of Treasury. 1998. Average and Marginal Federal Income, Social Security, and Medicare, and Combined Tax Ratesfor Four-Person Families at the Same Relative Positions in the Income Distribution, 1995-1999." Office of tax Analysis, Jan .15.

Figure 3

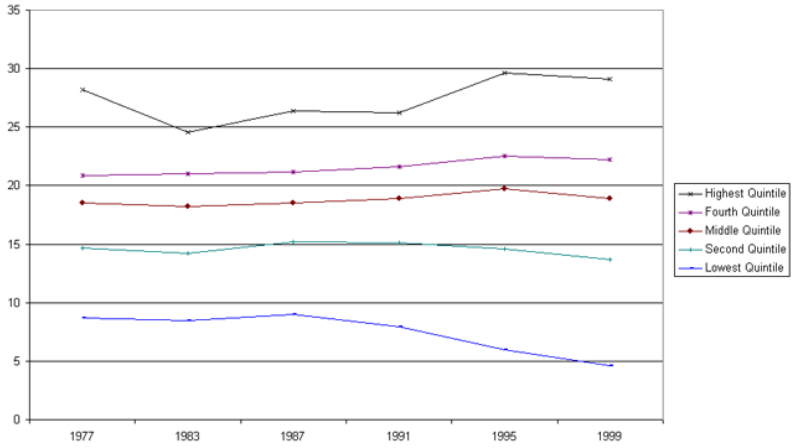
Average Federal Tax Burdens by Income Quintile, 1977-1999



Source: Congressional Budget Office. 1999. *Preliminary Estimates of Effective Tax Rates*, Table 1.

Figure 3

Average Federal Tax Burdens by Income Quintile, 1977-1999



Source: Congressional Budget Office. 1999. *Preliminary Estimates of Effective Tax Rates*, Table 1.

Chairman NUSSLE. Mr. Mitchell.

STATEMENT OF DANIEL J. MITCHELL

Mr. MITCHELL. Thank you. If I could submit my full testimony for the record and just focus on the highlights.

I'd like to address four questions. One, is the economic forecast being used to guide policy accurate? Two, are there policies that can affect the economy's performance? Three, what is the best use of surplus? And four, is Government debt a serious problem?

The first question I think is easy to answer. Neither CBO nor OMB are going to get it right. But it doesn't matter, so long as we

assume that the errors are random and that the average long term growth rate is somewhere close to what they're projecting. If you look at the CBO and OMB forecast compared to the consensus blue chip forecast and other estimates that are out there, I don't think there's any reason to believe that there's a rosy scenario, so to speak. If anything, they're probably understating growth rate and understating the amount of revenue that's going to come flowing in in the next 10 years, in large part because they make an assumption that taxes as a percent of GDP, assuming no changes in policy, are going to decline, when of course normally you would expect taxes as a share of GDP to rise slightly because our tax system imposes higher rates on people as their income climbs.

The second question is whether certain policies affect the economy's performance. I think this is much more important. And I think it's important because some people are incorrectly assuming that the economy's growth path and therefore the revenues that are going to come in are somehow independent of the fiscal policy decisions that will be made in the near future. I think this is a big mistake. Substantial reductions in tax rates will of course improve the economy's performance.

As economists, we all may disagree on the amount of additional growth that will be generated when tax rates are reduced. But one will be hard pressed to find a credible economist who would argue that there is no impact whatsoever. Likewise, if we reduced the tax code's bias against savings and investment, we are going to see positive economic results from that. This is why the elimination of the death tax is going to cause an increase in economic output. This doesn't even consider the dramatic reduction in compliance costs and the substantial improvement in the efficiency of investment if the death tax disappears.

Tax policy is important, but it's not the only thing that can have an effect on the economy's long term performance and therefore the tax revenues that will be generated by the economy. Social security reform is something that lawmakers are very likely going to address in the next 2 years. That could have a profound impact. If we make a transfer from a pay-as-you-go system that reduces employment and lowers national savings to a system based on personal accounts, as so many other countries have done, we would very likely see substantial long term benefits.

Then of course, no discussion of the economy's performance and the budget would be complete without addressing the size of Government. Regardless of whether Government is financed by taxes or by borrowing, you're shifting resources from the productive sector of the economy to the Government. Unless you're willing to believe that Government spending is more efficient than private spending, you're very likely causing some substantial drag on the economy. And as a result, if there can be even a modest level of fiscal discipline, such as holding the aggregate growth of spending to 4 percent a year, that should create benefits compared to allowing spending to grow faster.

This of course plays into the whole issue of dynamic scoring. The President in effect in his budget has taken a worst case scenario, assuming that his tax cuts and other proposals to reform the economy are going to have zero economic impact, zero benefit and of

course, our economic history in the U.S., world economic history shows that countries that move to lower tax rates and more fiscal discipline will grow faster and perform better. Therefore, it's very, very likely that the President's tax cut will actually have a revenue loss of much, much less than $1.6 trillion, whether it's 33 percent less, 50 percent less, no one's going to know the exact answer. But we know from history that it will be substantially less.

The third question is how best to use the surplus. I actually think in some sense this is the wrong issue. Whether or not we have a surplus or deficit is not nearly as important as whether we have a tax code that rewards productive behavior or at least doesn't punish it as heavily. It's not as important as whether or not we can modernize the Social Security system to address the huge long term problems that Mr. Gale pointed out. And it's not as important as whether or not we can reduce the size of Government and the burden it imposes upon the American economy.

In short, deficits and surpluses do not have much impact on the economy's performance. Self-proclaimed debt hawks assert that fiscal balance is important, because interest rates will remain low, yet there is virtually no empirical evidence for that proposition. Indeed, the evidence actually suggests that both fiscal balance and interest rates are dependent on the economy, not vice versa. In other words, a healthy economy will generate the tax revenues that balance the budget, but a healthy economy will also probably create attractive investment opportunities and this will tend to bid up interest rates.

If we like low interest rates, we should go back to the Great Depression. Real interest rates were very, very low at the time, because no one wanted to borrow any money, because there was nothing to invest in. Moreover, the idea that changes in our fiscal balance are going to have a dramatic impact on interest rates is rather questionable, given the sheer magnitude of international capital markets. Can anyone seriously believe that a $50 billion to $100 billion shift in the U.S. annual fiscal balance will have a noticeable impact in interest rates, when more than $2 trillion changes hands every day in world financial markets?

But having issued all these caveats that the surplus or the deficit isn't the appropriate measure, let me now talk about what I think is the best use of the surplus. Tax cuts, specifically lower tax rates and reduction in the double taxation of income that is saved and invested, will improve the economy's performance and thereby create more opportunities for American families. Indeed, because certain tax cuts will have significant supply side effects, the amount of tax relief can actually be much larger than the package proposed by the administration. The $1.6 trillion figure, as I mentioned, is based on static estimates and therefore greatly overstates the actual revenue left to the Treasury.

Social Security is another very desirable use of the surplus. But frankly, it should happen even if we didn't have a surplus. Simply stated, the current system faces two big crises. The first crisis is the long term deficit, the second crisis is that it's a bad deal for workers. They have to pay record levels of taxes into the system, and they get very meager benefits in exchange.

I think America should learn from countries like Australia, Sweden, Chile, England, countries all over Latin America, all around

the world, that are shifting to personal retirement accounts. These professionally managed personal retirement accounts are allowing workers to build up nest eggs that will give them comfort and security in retirement.

Now, of course, an important component of any Social Security reform plan is to hold all current retirees and older workers completely harmless. In other words, the Government should fulfill its part of the contract and give them all the benefits they've been promised. This guarantee could be fulfilled, as other countries have shown, even if there wasn't a surplus. But certainly, having all this extra tax revenue coming into Washington will make this commitment very easy to discharge.

This brings us to my final question, which is, what about the national debt? Shouldn't we use all the surplus to pay down the national debt? I would argue that the national debt is only a minor irritant. At just over $3 trillion, it is a small fraction of our annual income. Compared to other nations, our national debt is trivial. And the burden of debt will continue to keep falling, even if we don't redeem a single bond, so long as the economy continues to grow.

The national debt today, for example, is much bigger than the debt we had at the end of World War II. But because our economy has expanded so much in the last 50 years, the burden of debt measured as a share of GDP is less than one-third of its World War II high. The real debt problem, for those concerned about debt, is of course Social Security. The long term deficit in Social Security, even after adjusting for inflation, is more than $20 trillion. That's seven times bigger, roughly, than our national debt.

This of course is a debt that does threaten future generations, assuming we don't want massive payroll tax increases or massive benefit cuts, this is the debt, this is the issue that our surplus should be at least in part dedicated to solving.

Now, some critics complained that shifting to personal accounts will use up the surplus, make it harder to pay off debt. But this is akin to not removing a tumor for fear of leaving a scar. Social Security reform may use up some of today's surpluses, but the long term reduction in the program's unfunded liability makes this one of the most effective investments that lawmakers can make.

In effect, Social Security reform is like refinancing a mortgage when interest rates drop. Yes, there may be some upfront costs, the transition expense of fulfilling the contract with older workers and current retires. But the long-term savings will more than make up for that short-term cost. This is why it is so misleading to talk about the cost of the transition to Social Security reform. If lawmakers consider the total impact on Government finances, Social Security is a big money saver. But more importantly, it's good for the American people.

Thank you for the opportunity to discuss these questions.

[The prepared statement of Daniel Mitchell follows:]

PREPARED STATEMENT OF DANIEL J. MITCHELL, MCKENNA SENIOR FELLOW IN POLITICAL ECONOMY, THE HERITAGE FOUNDATION

Mr. Chairman, members of the committee, thank you for the opportunity to testify on the economic and budget outlook. I must stress, however, that the views I ex-

press are entirely my own and should not be construed as representing any official position of The Heritage Foundation. I would like to focus on four key questions:

1. Is the economic forecast being used to guide policy accurate?
2. Are there policies that can affect the economy's performance?
3. What is the best use of the surplus?
4. Is government debt a serious problem?

The first question is easy to answer. Neither the CBO forecast nor the OMB forecast is accurate. But the fact that economists have never been able to predict the economy's short-term performance is not a cause for concern-as long as there is reason to believe that the errors are random and balance out over time.

In other words, a forecast is a good guide for policymakers if the average annual growth rate over the 10-year period is reasonably close-perhaps within 0.5 percentage points-to what actually happens. Using this more sensible performance standard, both CBO and OMB are basing their economic estimates on very reasonable predictions of the two key components of real GDP-population growth and productivity gains.

As such, there is no reason to believe that either forecast is systematically optimistic. Indeed, it is more likely that they are understating revenue growth over the next ten years-and thereby low-balling the surplus. This is not because the growth estimate is necessarily too pessimistic, but rather because the forecasts assume that tax revenues as a percent of GDP will decline slightly from today's record levels.

This is somewhat puzzling. As long as real income is increasing, and as long as we have a tax code that imposes harsher penalties on people for earning more income, tax collections should slowly climb as a share of economic output. The fact that the forecasts show just the opposite indicates that CBO and OMB are making some rather interesting assumptions. These assumptions may be reasonable, but this is an issue the committee may want to investigate.

The second question is whether certain policies can affect the economy's performance. This is a much more important topic to address. Many policymakers incorrectly are assuming that the economy's growth path is somehow independent of the fiscal policy decisions that will be made in the near future.

This is a mistake. Substantial reductions in tax rates will improve the economy's performance. Economists may disagree over the amount of additional growth that will be generated when tax rates are reduced, but one would be hard-pressed to find a credible economist who would say there is no effect. Likewise, one would find even stronger agreement that the economy will grow faster if lawmakers reduce the tax code's bias against savings and investment. This is why elimination of the death tax will result in additional economic output, particularly if the dramatic reduction in compliance costs and substantial improvement in the efficiency of investment are included in the estimate.

Tax policy is important, but it is not the only economic policy variable that deserves attention. Social Security reform could have profound consequences on future economic performance. The current system, a pay-as-you-go, tax-and-transfer scheme, reduces employment and lowers national saving. If America does what so many other countries have done and shifts to a system of personal retirement accounts, the impact on the economy's long-term performance would be quite significant.

Finally, no discussion of economic growth would be complete without addressing the size of government. Regardless of whether it is financed through taxes or borrowing, government spending represents a transfer of resources from the private sector to the public sector. If government spends that money in a way that generates a sufficiently high rate of return, the economy will benefit. If the rate of return is below that of investments in the private sector, however, then the rate of growth will be slower than it otherwise would have been. Unfortunately, most analyses indicate that the vast majority of government programs have low rates of return. Thus, if lawmakers can reduce the size of government-or at least limit its growth to 4% annually-this could free up resources that could be more efficiently used by the productive sector of the economy.

What does all this mean? If tax rates are lowered and the death tax is repealed, the economy will grow faster. This will enable more families to climb the ladder of opportunity. More important, for purposes of this committee, it will mean that tax cuts will not result in nearly as much foregone revenue as static forecasts suggest. My colleagues at The Heritage Foundation estimate that roughly half of the lost revenue will be recaptured as a result of improved economic performance. In simple terms, if a tax cut results in more income to tax, then there will be some level of revenue feedback. Similar "supply-side" estimates have been produced by economists at Harvard University and the American Enterprise Institute.

The third question is how best to use the surplus. This is the dominant debate on Capitol Hill, but it actually is a greatly overblown issue. Whether or not we have a surplus or a deficit is not nearly as important as whether we have a tax code that rewards productive behavior. It is likewise not as important as whether we can modernize the Social Security system. And it is not as important as whether we can impose some greatly needed discipline on the spending side of the budget.

In short, deficits and surpluses do not have much impact on the economy's performance. Self-proclaimed debt hawks asset that fiscal balance is important because interest rates will remain low, yet there is virtually no empirical evidence for this proposition. Indeed, the evidence actually suggests both fiscal balance and interest rates are dependent on the economy, not vice versa. In other words, a healthy economy will generate the tax revenues that balance a budget, but a healthy economy also will create attractive investment opportunities, and this will tend to bid up interest rates.

Moreover, changes in our fiscal balance are dwarfed by the sheer magnitude of international capital markets. Can anyone seriously believe that a $50 billion-$100 billion annual shift in the U.S. fiscal balance will have a noticeable impact on interest rates when more than $2 trillion changes hands every day in world financial markets?

Having issued caveats as to why this is not the right question, let me now suggest the best way to use the surplus. Lawmakers should focus on policies that will produce the greatest benefits for the people. This suggests both tax cuts and Social Security reform.

Tax cuts, more specifically lower tax rates and a reduction in double taxation of income that is saved and invested, will improve the economy's performance and therefore create more opportunities for families to prosper. Indeed, because certain tax cuts have significant supply-side effects, the amount of tax relief can be much larger than the package proposed by the Administration. Remember, the $1.6 trillion figure is based on a static revenue estimate and the actual revenue loss will be far less than that amount.

Social Security reform is another desirable use of the surplus, though it should happen even if there were no surplus. Simply stated, the current system faces two crises. The first crisis is the gigantic long-term deficit. According to Social Security Administration figures, the inflation-adjusted deficit between 2015 and 2075 is a staggering $21.6 trillion. The other crisis is the fact that Social Security is an increasingly bad deal for workers. They are required to pay a record level of taxes into the system, but the benefits they are promised upon retirement are very meager.

America should learn from countries like Australia, Sweden, Chile, and England. Workers should be allowed to shift some portion of their payroll tax burden into a professionally managed personal retirement account. These private accounts would enable today's workers to build a substantial nest egg that will provide a secure and comfortable income upon retirement.

An important component of any reform plan, however, is that current retirees and older workers should be given every penny of benefits that currently are promised. This guarantee could be fulfilled even if we did not have a surplus, but the extra money certainly will make this commitment easy to discharge.

Some would argue that the surplus should be used to reduce the national debt, which leads us to the final question. More specifically, is government debt a problem? The answer is yes, but not for the reason most people usually cite.

America's national debt is a minor irritant. At just over $3 trillion, it is a small fraction of our annual income. Indeed, compared to other industrialized nations, our national debt is inconsequential. And the burden of debt will keep falling even if we don't redeem a single bond-so long as the economy continues to grow. The national debt today, for example, is much bigger than the debt that was built up during World War II. But because our economy has expanded so much in the last 50+ years, the burden of the debt-measured as a share of GDP-is only one-third of its post-World War II high.

The real debt problem facing America is Social Security's unfunded liability. The program's long-term deficit is more than $21 trillion, roughly seven times bigger than the official national debt. This is the debt that threatens the well-being of future generations. And this is why Social Security reform is the issue that debt hawks should champion.

Critics complain that shifting to personal accounts will use up some of the surplus and therefore make it harder to pay off the debt. This is akin to not removing a tumor for fear of leaving a scar. Social Security reform may use up some of today's surplus, but the long-term reduction in the program's unfunded liability makes this one of the most effective investments that lawmakers can make.

Social Security reform is like refinancing a mortgage when interest rates drop. Yes, there may be some up-front costs, but the long-term savings will dwarf the short-term expense. This is why it is so misleading to talk about the "cost" of transitioning to a system of personal accounts. If lawmakers considered the total impact on government finances, Social Security reform is a big money-saver.

Thank you for the opportunity to discuss these important issues, and I look forward to answering any questions.

Chairman NUSSLE. Thank you, Mr. Mitchell. Mr. Bartlett.

STATEMENT OF BRUCE BARTLETT

Mr. BARTLETT. Thank you, Mr. Chairman.

I would just like to make three brief points. First, I believe that the estimated revenue loss that we keep hearing about, and which keeps getting inflated every time I hear it, is way, way too high. Because all these estimates are so-called static estimates, they assume that the tax cut that is being considered will have no macroeconomic effect on the economy—no effect on GDP growth, no effect on productivity, no effect on anything.

I think this is a very unreasonable assumption. The House of Representatives also believes this. Six years ago, the House voted to allow the Joint Committee on Taxation to take into account macroeconomic effects in its revenue forecast, upon request. For reasons I don't know, no one has ever asked them. They've hired new economists, they've done research on this matter precisely for this purpose. And I believe now is a very good time to do this.

I do not know what figures they will come up with. I don't know what the figures would be. I do know that there are some published estimates. The Heritage Foundation, which Dan represents, believes that the faster economic growth resulting from this tax cut will recoup almost half of the static revenue loss, with the loss being less than $1 trillion over 10 years.

Recently, Martin Feldstein, using the National Bureau of Economic Research model, estimated that about 35 percent of the revenue would be recouped. This is a very standard estimate. You can get it out of any textbook. Basically any textbook will tell you you'll get back about 35 percent from faster consumption and therefore faster economic growth. That doesn't even take into account any supply side effects.

Therefore, I think the static revenue figures we've heard here are absolutely a minimum of 35 percent too high. If the committee wanted to make an assumption of 25 percent, I think that would be extremely conservative and well within the bounds of what is acceptable in academic theory. I append to my testimony a long list of articles in prominent academic journals that point out almost universally that dynamic scoring, that does take into account macroeconomic effects, is feasible. There are of course questions about it. But I think that this is a very good time to institute this for budgetary purposes.

Second, I'd like to make the point that I believe that the baseline revenues which we are all discussing are way, way too low. For reasons I don't understand, both the CBO and OMB are estimating that over the next 10 years, Federal revenues will grow at a rate slower than GDP. This is simply contrary to all evidence and all logic. Since 1963, Federal revenues have risen about 4 percent faster than GDP. Since 1986, they've risen 18 percent faster than GDP.

And since 1993, they've risen, I believe, 37 percent faster than GDP.

I think a very reasonable assumption would be that some of the post-1993 bulge in revenues was due to one-time factors. So if you simply stick with the post-1986 trend, we're looking at 18 percent more revenues—revenues growing 18 percent faster than GDP—over the foreseeable future. If you calculate it out, this gives you about $2.1 trillion of additional revenue in the baseline than is currently being projected.

Now, that's more than enough to pay for this tax cut. And you'd still have exactly the same amount of revenue that is currently being forecast without a tax cut.

Lastly, I would point out to people who worry, I think excessively, about the potential risks of enacting a large tax cut such as this, much of this discussion in effect implies that we only do a budget once every 10 years. So we worry, I think, very, very excessively about things that are going to happen so far into the future they are absolutely not worth thinking about. The history of this Congress is that when there's a need for additional revenues, it has not shown any resistance to enacting tax increases.

Over the last 20 years, there have been 15 major tax bills that have been passed into law. And of those, only four were tax cuts, and two of them were trivial, and one was very small. Only the 1981 tax cut was substantial.

So I would say that this means there really is no need for a trigger mechanism. If there is some reason why additional revenues are needed in the future, Congress should simply pass a tax increase at that time. Thank you.

[The prepared statement of Bruce Bartlett follows:]

PREPARED STATEMENT OF BRUCE BARTLETT, SENIOR FELLOW, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. Chairman, there are three major points I would like to make this morning regarding the budgetary implications of President George W. Bush's proposed tax cut.

First, the estimated revenue loss from it is too high, because the published estimates do not take into account the macroeconomic impact of the tax cut.

Second, I believe that the baseline revenue forecast is too low, meaning that the impact of the tax cut on the surplus is too high.

Third, the tax cut is being treated as if it will be a permanent feature of our tax system for all time. In the event that budgetary or economic circumstances change, it can be changed in the future.

SCORING TAX CUTS

As this Committee well knows, the impact of tax changes on aggregate revenues is highly uncertain. I believe that a key reason for this is that the revenue estimators use static scoring methods that ignore the macroeconomic effect of tax changes. Use of dynamic scoring, which is permitted under House rules, would give a more accurate estimate of proposed tax changes.

The basic issue is this. Large tax cuts, of the sort currently being proposed, stimulate economic growth. There is really no debate about this in the economics profession. The only question is how much will growth be stimulated. Clearly, there is great disagreement about this, owing mainly to inadequate statistical techniques for measuring different sorts of tax cuts. For example, a tax rebate and a permanent tax rate reduction of equal dollar size on a static basis will have very different effects on growth, both in the long- and short-term. But it is very hard for existing macroeconomic models to capture these effects.

In recent years, there has been considerable discussion of tax scoring methodology in prominent academic journals. Almost all agree that dynamic scoring is feasible,

although there are important questions still to be resolved about how to do it and when. (I append to my testimony a bibliography of academic research on dynamic scoring.) But the basic point is undeniable that the tax cut currently under consideration by Congress will raise growth by some degree, thus reducing its net revenue loss.

In a recent study, the Heritage Foundation, utilizing the well-respected WEFA econometric model, estimated that faster economic growth will recoup almost half the static revenue loss (www.heritage.org/library/cda/cda01-01.html). Over a 10-year period, the static revenue loss is estimated at $1.8 trillion. But this loss falls to $939 billion once faster growth is taken into account.

The Heritage estimate is probably a little on the high side, I admit. But it is very common for economists to get about 35 percent revenue reflow from a tax cut of this type. For example:

• In 1981, Richard Musgrave, dean of American public finance economists, told the Joint Economic Committee that the Reagan tax cut would recoup 30 to 35 percent of the static revenue loss.

• In 1996, Lawrence Chimerine, chief economist of the Economic Strategy Institute, wrote that "credible evidence overwhelmingly indicates that revenue feedback from tax cuts is 35 cents per dollar" (Washington Post, 7-23-96).

• Just a few days ago, Martin Feldstein, Harvard professor and president of the National Bureau of Economic Research, found that the Bush plan would only lose 65 percent of its officially estimated revenue loss (Wall Street Journal, 2-16-01).

I don't know what the correct reflow assumption is, but I know with certainty that it is not zero. Ideally, I would like to see the Joint Committee on Taxation and the Congressional Budget Office work together to come up with a dynamic estimate. Six years ago, the House amended its rules to allow such an estimate to be made, but in all the years since, no one has ever asked. I think now is the time. Even if the JCT comes up with an estimate more conservative than those cited above, it will still give a better picture of the impact of the tax cut on budget totals than we have now.

BASELINE REVENUES

The failure to use dynamic scoring inflates the budgetary size of the proposed tax cut. But from the point of view of this Committee, the absolute budgetary levels are also of concern. In this respect, I suggest that the baseline revenue forecasts, both from CBO and OMB, are underestimating future revenue growth. Hence, even if the tax cut loses as much revenue as the static forecast projects, revenues may still rise by a greater rate than projected. In short, there may well be more revenue available for a tax cut, debt reduction and spending growth than currently assumed.

Historically, revenue growth has closely tracked nominal GDP growth. Since 1963, for every one percent rise in nominal GDP, revenues have risen by 1.04 percent. Since the Tax Reform Act of 1986, the elasticity has been slightly higher at 1.18 percent. Since the 1993 tax rate increase, the elasticity has grown still more to 1.37 percent. In other words, since 1993 federal revenues have increased 37 percent faster than GDP. That is the reason why revenues as a share of GDP have risen from 17.6 percent in 1993 to 20.6 percent last year.

Given this highly consistent trend, broken only by recession periods, it is very odd that both CBO and OMB are projecting future revenues to rise by less than the growth of GDP. Over the next five years, CBO estimates that nominal GDP will grow 5.2 percent per year on average, whereas individual income tax revenues are projected to grow only 4.7 percent per year. In other words, CBO expects revenues to grow 10 percent more slowly than GDP will grow over the next five years. OMB is even more pessimistic about revenue growth, stating that it projects revenue growth "to lag GDP growth throughout a multi-year period to a degree generally experienced only during recession."

Both CBO and OMB base much of this pessimism on an anticipated decline in capital gains realizations, owing to the fall in the stock market. However, the principal reason why revenues have historically grown faster than GDP is because of the progressive nature of the tax code. Although the personal income tax is largely indexed to inflation, it is not indexed for real economic growth. As real incomes rise, workers are pushed up into higher tax brackets in the same way inflation used to. Thus as long as there is real GDP growth, we will still get bracket creep.

A reasonable approach to forecasting revenues would leave out the recent revenue bulge resulting from exceptionally large capital gains realizations. But I think that the post-1986 trend for revenues, in which they grew 18 percent faster than GDP, is far more likely than the excessively conservative forecasts of OMB and CBO. On this basis, the federal government can expect $2.1 trillion in additional revenue,

over and above that presently estimated, between now and 2011. That is more than enough to pay for President Bush's tax cut and still run surpluses as large as currently projected without the tax cut.

FUTURE RISKS

The foregoing analysis indicates that President Bush's proposed tax cut is easily affordable. Nevertheless, some members have expressed concern that unforeseen events might alter that view. They suggest that the tax cut should be subject to some sort of trigger mechanism. If budget surpluses don't emerge as expected, the tax cut would be canceled.

I think the trigger idea is utterly unworkable. The principal economic benefit of lowering marginal income tax rates is so that people will change their behavior in ways that will increase work, saving and investment. For example, someone might seek additional education or training in response to the prospect of keeping more of their future income. Adding a high degree of uncertainty to whether legislated lower tax rates will emerge defeats this purpose.

Of course, future tax rates are always uncertain to some degree. Congress can and does change rates and other features of this tax code from time to time. This is another reason why triggers are undesirable. In the event that economic or political circumstances change in the future, Congress can always pass new tax legislation, raising revenues if necessary.

Some would suggest that this is unrealistic, because it is easier to cut taxes than to raise them. However, this view conflicts with the experience of recent history. According to a recent Treasury Department study (www.ustreas.gov/ota/ota81.pdf), there have been 15 major tax bills since 1980. Of these, 11 were tax increases. Ronald Reagan, the arch tax cutter, signed into law 6 of them, including the Tax Equity and Fiscal Responsibility Act of 1982, one of the largest tax increases in history. And of the 4 tax cuts, only the Economic Recovery Act of 1981 was significant.

Therefore, I would suggest that raising taxes is not nearly as difficult as it is painted. True, many of these tax increases occurred as the result of tense budget negotiations. But in most cases, the tax increase portion of those budget packages was their least controversial element. Of course, there are exceptions, as in 1990 and 1993. But the point still holds that Congress has shown a willingness to raise taxes by large amounts in recent years, when it felt that budget circumstances warranted it. Those who favor a tax trigger implicitly assume that Congress cannot or will not do the same in the future.

CONCLUSION

I believe that the proposed tax cut is affordable and necessary. Without it, the tax burden will rise from a level that is already extraordinarily high by historical standards. I believe it will help improve the performance of the American economy in future years, and is appropriately designed both in size and structure.

APPENDIX

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Chairman NUSSLE. Thank you very much, Mr. Bartlett. Thank you to all the witnesses for their testimony.

Let me begin the questioning first with Mr. Gale. I want to begin by clarifying something and really correcting something. I recognize that you work in a think tank and fortunately or unfortunately that's the kind of environment that makes this environment look like the real world.

But here, I think being accurate, being direct is extremely important. You stated that the President was proposing to pay down $2 trillion in debt. That's certainly correct. That's more debt repayment than has ever been achieved by any country in the history of the world, but certainly that's more debt paid down over a shorter period of time than in our Nation's history.

Then you suggested though that there was an additional $574 billion that was being generated largely by the Social Security surplus that the President was proposing to use for any purpose at all. That's wrong. That is not accurate. The President's budget is explicit that those funds can only be used for Social Security. Now, you may disagree and we may all have disagreements about how they would be used to modernize or strengthen Social Security. But to suggest that they're being put in the budget to be used for any purpose simply is not correct.

I would begin by asking you, given that those funds are being set aside, the Social Security funds, $574 billion, they cannot be used

to pay down debt without incurring significant penalties. What would you propose to do with those funds?

Mr. GALE. Well, first, as a point of fact, my understanding is that the money is not being used to pay down debt, this $574 billion, what we're rounding to——

Chairman NUSSLE. As I just stated, because we would incur significant premium penalties if we tried to do so.

Mr. GALE. Well, OK, it's my understanding it's not being used to pay down debt and that the money is ending up in this so-called reserve fund of $842 billion.

Chairman NUSSLE. No, let me be clear, that is not. That is a separate reserve fund, $574 billion, Social Security surpluses, that's being set aside in its own reserve fund to be used for Social Security.

Mr. GALE. All right, well, my——

Chairman NUSSLE. What would you propose to use those funds for?

Mr. GALE. There's a number of things we can do with those funds. The simplest thing is to note that State and local governments currently hold $3 trillion of private assets, including $2 trillion of equities. That is 10 percent of all private equities in this country are held by State and local governments.

Chairman NUSSLE. Held by governments or their pension funds?

Mr. GALE. Their pension funds, but they are not self-directed funds. They are invested by boards of trustees on behalf of workers. Workers do not get to choose where these things go. They're defined benefit plans.

These funds earn market rates of return, less than 2 percent of them——

Chairman NUSSLE. That's fine, so you think one use would be for the Federal Government to buy equities, to buy stocks, to buy private assets that are out there?

Mr. GALE. That's correct. The other——

Chairman NUSSLE. I think that's a good idea, but that's certainly a legitimate point you make. But you would want to do that through the Social Security system, right? You're not saying to spend that for something other than Social Security?

Mr. GALE. Right, to invest it in order to address future Social Security needs. That's a way of cordoning off the funds in a way that they can't be spent.

Chairman NUSSLE. So you're with the President here, set aside the funds, use them for Social Security?

Mr. GALE. Well, no, the President, the budget says the administration is philosophically opposed to investing these funds in private assets, even though the State of Texas invests $20 billion on behalf of its workers.

Chairman NUSSLE. They're not supporting buying private assets, and again, I don't want the Government out there buying Microsoft stock or GE stock and to suggest that this is going to be insulated from political influence I think is a misnomer.

Mr. GALE. If you'd let me finish my——

Chairman NUSSLE. Insofar as setting aside the funds in a reserve and using those funds for Social Security, you're for that, correct?

Mr. GALE. I'm absolutely for—let me be clear. The President, I have a feeling the administration wants to pull the same kind of switch on Social Security as it's trying to pull on Medicare, which is, it's going to try to use the $600 billion surplus there left over to fund the privatization plan, which is different from setting aside the money to pay down future revenues. It's the same deceptive budgeting that they're trying to do on Medicare.

Chairman NUSSLE. I'd like to maintain a decent tone, I think this is a substantive discussion. I'm not questioning your motives in putting forward your proposal for getting the Federal Government into the stock market, and I don't think you should question the administration's motives or intentions in setting aside these funds. I don't think the administration has done anything for anyone here, Democrat, Republican, Independent, observers, to come in and suggest that the whole budget's a ruse and it's part of a bait and switch. I just think that sets the wrong tone for looking at what is a serious opportunity with significant surpluses to do good things.

Mr. GALE. I agree that this is a serious opportunity. Paul O'Neill has testified in Congress, I don't know if it was this committee or a different committee, I don't know if it was House or Senate, but he testified in Congress he was unwilling to commit that that $600 billion was going to be held to pay future Social Security liabilities under the existing system. That's about as authoritative a measure as you can get in terms of what the administration's economic policy is at the current time.

I agree, it's very difficult to understand what the administration's policy is. But that's largely because they're trying to push a tax cut through before they've even sent up a budget that has all the details, as Mr. Greenstein has pointed out. So I agree this is a serious debate. But I don't think my comments were at all out of line in terms of what the administration's budget is absolutely proposing.

Chairman NUSSLE. The administration's budget is not proposing to spend that money on anything other than Social Security. And everyone knows that the administration supports conceptually some very bold and progressive reforms for Social Security. And we can agree or disagree with those reforms. But I don't think it's fair to misrepresent the very clear statements of the budget.

Let me talk about tax relief. You talked about a $2.5 trillion tax relief package. You know what reconciliation is, I take it, you probably understand the process better that me or other members of this committee, given your extensive work in the budget. The way reconciliation is written into our budget resolution, it will contain a statement in the President's budget proposal, and if we pass a resolution that largely follows that, it will allow for a tax relief package up to $1.6 trillion, correct? That's the way the reconciliation language is written in the budget resolution, up to the amount, up to $1.6 trillion.

Given that fact, and that that's the only way we can protect the tax package from a filibuster in the Senate, explain to me the series of events or the conspiracy that will go on once we've passed that reconciliation number to allow this $2.5 trillion package to move through the Senate.

Mr. GALE. Well, I don't think it's necessarily a conspiracy. But let's say the tax cut is $1.6 trillion over 10 years. There's an interest cost associated with that which according to the administration's budget is almost $400 billion. That's not technically part of the tax package, but that should be included in the total cost of the surplus. And the tax package, if it includes the provisions of H.R. 3, will leave a whole mess of unfinished business, namely that 36 million taxpayers will be on the AMT as of a decade from now. That's one out of every four taxpayers.

Chairman NUSSLE. I'll get to that point. I definitely want to ask about the AMT. But also on the interest costs, you've seen the President's budget proposal and submission, I'm sure. It includes the anticipated interest costs, even under static scoring, that would occur because of any additional spending or tax relief, correct?

Mr. GALE. No, the $1.6 trillion number doesn't.

Chairman NUSSLE. No, not $1.6 trillion, his budget proposal does. It comes to $417 billion over the 10-year period.

Mr. GALE. Right.

Chairman NUSSLE. OK. Let's talk about income distribution a little bit. You sort of talked about weighting the tax relief to upper-income earners. I, just for the record, want to get some figures here. If you take the top 10 percent of wage earners in this country, what share of personal income do they represent?

Mr. GALE. I'm not sure what share of personal income they represent. I can tell you what share of taxes they pay.

Chairman NUSSLE. Well, I want to know how much money they're making first.

Mr. GALE. I don't have that in my testimony. I'd be happy to provide that in written follow-up.

Chairman NUSSLE. If you could. I believe it's approximately 45 percent of aggregate personal income in this country. What share of the income taxes do they pay on that income?

Mr. GALE. What share of total income taxes?

Chairman NUSSLE. What total income taxes do the top 10 percent of wage earners pay in this country?

Mr. GALE. According to CBO data, they pay 63 percent of income taxes and 49 percent of total taxes.

Chairman NUSSLE. But 63 percent of the income taxes, but their share of personal income is only 45 percent. Now, I would just ask you in general terms, do you think that's a pretty fair share of the personal income tax burden?

Mr. GALE. In a progressive tax system, you expect, almost by definition you expect high income taxpayers to pay a higher share of the taxes than of the income that they——

Chairman NUSSLE. Right, so 45 percent of the income, 63 percent of the taxes. Is that roughly where you would want it to be, or would you rather have them pay 75 percent of the taxes, 85 percent of the taxes? Does Brookings or do you personally have a goal for the progressiveness in the tax code if it's not progressive enough already?

Mr. GALE. Brookings doesn't take institutional positions on any issue. If we want to talk about the progressivity of the tax code, and——

Chairman NUSSLE. But you are arguing that this tax relief package is too heavily weighted toward the wealthy, which suggests that you do have a position on the progressiveness of the code.

Mr. GALE. OK, I just said Brookings doesn't, I didn't say I don't have a position. And I'm trying to get to my position, if you'll let me finish.

Let's go with your number that the top 10 percent earn 45 percent of all income. I don't have that number at my disposal, let's go with that. They pay 49 percent of all Federal taxes. They paid 63 percent of income taxes, but 49 percent of all Federal taxes. They would get a larger share of the Bush tax cut than the proportion of all Federal taxes that they pay.

Let me put it differently. The proportion of the Bush tax cut that goes to the top 10 percent is bigger than the proportion of total Federal taxes that they pay. So that will make the system less progressive. Now, it might make the income tax itself more or less progressive, depending on how you calculate it. But the income tax is a progressive, is the most progressive part of the system, other than the estate tax.

So if you cut income tax levels generally, you're making the whole system less progressive. It's that emphasis on the whole tax system, rather than just the income tax, that is so important. When the President says that Americans are facing record tax burdens, that includes the payroll tax and three-quarters of families pay more in payroll taxes than in income taxes.

So if the President were really concerned about reducing the tax burden on the typical American family, he wouldn't have proposed the tax cut that he proposed.

Chairman NUSSLE. Mr. Greenstein, I want to talk about AMT. You talked about the AMT and that again, regardless of the fact that it will include a reconciliation number up to a certain level that will, and only that level will be protected as a bill moves through Congress, you suggest that, well, there's another $300 billion in AMT changes that need to be made. Are you suggesting that we should include changes to AMT in the tax relief package that we move through the House and Senate?

Mr. GREENSTEIN. Two answers. First, yes. I do think we should include AMT relief. I've thought that for several years. We urged the Clinton administration in its budgets to go farther in proposing more. We all know this is a problem that has to be addressed.

But Mr. Chairman, let me make another key point. I recognize that AMT reform will probably not be done this year. Might be next year, might be 2 years from now. My point is, we have a projected budget surplus for the next 10 years. We have to leave room in it for the AMT cost. And the argument that because it won't be in this year's reconciliation bill, we can ignore the cost when adding up how to dispose of the projected surplus I think is not responsible budgeting.

The cost of fixing the AMT, which probably will not be done this year, is, according to the Joint Tax Committee, increased by $292 billion over 10 years by H.R. 3. Therefore——

Chairman NUSSLE. And you've taken a position in favor of that $300 billion modification to the AMT? Is that your personal posi-

tion or you're saying the Center for Budget and Policy Priorities has supported AMT reform?

Mr. GREENSTEIN. The Center has supported and continues to support AMT reform. I don't know that we've looked at it in enough detail to have a specific AMT reform proposal. I do think the single biggest problem is probably that this big exemption amount is an index for inflation. If you index that for inflation that would solve a lot of the problem.

Chairman NUSSLE. I would ask you to submit just for the record any position papers from the Center on reforming the AMT. I don't follow all the work that you do and I'm sure it's a lot of good work. But I am unaware of the Center having taken a position, a clear position for AMT reform prior to this——

Mr. GREENSTEIN. Mr. Chairman, since you're questioning my veracity, could I respond to that?

Chairman NUSSLE. Oh, no, I'm saying I'm aware of it. If you could submit a policy statement.

Mr. GREENSTEIN. I don't know that we have a formal position. We have said it in prior Congressional hearings, we have said it in the press. We have said it in meetings on the Hill. We have said it to the Treasury and OMB——

Chairman NUSSLE. Terrific.

Mr. GREENSTEIN [continuing]. And White House officials during the Clinton administration. We have been very consistent on this.

Chairman NUSSLE. And just for the record, if you could submit a reference to prior testimony before this committee——

Mr. GREENSTEIN. I'll see if we have something in paper. It's mostly been—I don't know that we have, we probably have something and I'll find it and submit it.

Chairman NUSSLE. Terrific. Finally, let me talk a little bit about forecasting and error rates, because you presented some interesting information there. You referenced an error rate of plus or minus $1 trillion over a 10-year period. What 10-year period were you using as a reference there?

Mr. GREENSTEIN. Years 2002 through 2011. These figures come right out of the chapter, they're based on the data in the chapter on uncertainty in the new CBO report issued in late January that covers 2002 through 2011.

Chairman NUSSLE. So that's a prospective assessment of what the——

Mr. GREENSTEIN. I'm sorry, Richard is correcting me. The 2011 figure is a 5-year total from the CBO report, and it's 2002 through 2006.

Chairman NUSSLE. But it's a prospective assessment of what the error rate could be, as opposed to a look-back to the 1970's or to the 1980's or to the 1990's and saying, gee, our forecasting varied in the 1990's by $1 trillion.

Mr. GREENSTEIN. No, to the contrary, what CBO did is, it took the entire period for which it has done forecasts for at least a 5-year period. And it said, what was our average error in the fifth year during this period. And it expressed its average error for the fifth year as a percentage of GDP. That translates into errors over this 5 year period as a whole.

They estimated the average error over a 5-year period and in the fifth year. If you simply take their average, the average error, if we have the same error in the next 5 years that they've been off on average for their whole history of doing 5-year forecasts, it would be $1.1 trillion in either direction, too high or too low.

Chairman NUSSLE. Let me talk briefly about averages. It was something alluded to by Mr. Bartlett. Do you know what the average, the historic growth in revenues has been over the last 50 years?

Mr. GREENSTEIN. I don't have the specific figure, but I would say that most economists I know would not at all agree with Mr. Bartlett's assessment that there is a standard estimate that revenues would grow by this amount.

Chairman NUSSLE. No, but there is an average. There's an historic average which is about 7½ percent.

Mr. GREENSTEIN. I don't have the specific figures.

Chairman NUSSLE. It is 7½ percent nominal growth in revenues per year. In fact, it's surprisingly consistent. If you go to any 10-year period during the last 50 years, you come up with an average annual nominal revenue growth rate of between 7 and 9½ percent. Do you know what the revenue growth forecasts are in the current budget submission over the 10-year period?

Mr. GREENSTEIN. I don't have the specific percentage in my head, but I know, Mr. Chairman, that one of the things that's been taken into account is that one of the driving forces in revenue growth in the last few years has been huge surges in capital gains taxes as a result of the big increases in the stock market, and that there is a strong reason to believe, given how high the price-to-earnings ratios are, and how high the market already is, that it won't grow at the same rate in coming years and that one would therefore have to assume a lower rate of growth in capital gains taxes during this period.

So we can't simply look at long-term averages. We also have to consider the events of the most recent period. I am not an expert on revenue forecasting, but I do——

Chairman NUSSLE. But your point is a very good one. It's the same point that Alan Greenspan made. So I think you're in pretty good company there, that there might be something unusual about the revenue growth we've seen over the past 3 or 4 years. But——

Mr. GREENSTEIN. There's a larger issue here which CBO points out in its report. That is the big unknown is the rate of productivity growth. We've had a higher rate of productivity growth in recent years, and no one really knows to what degree it's permanent. CBO and OMB have made a certain judgment about how much of it's permanent in their forecast. They could be too high or too low.

The point is that CBO points out that this forecast has a higher degree of uncertainty, this budget forecast, than most, because of the degree of uncertainty regarding the productivity growth rate estimates.

Chairman NUSSLE. I understand that. At the same time, I think that any observer would be hard-pressed, given the productivity growth rate recently, and currently, and the argument of economists that that productivity rate has seen a structural increase, to

then argue that the next 10 years will bring a lower revenue growth rate than we have ever seen in our modern economy.

Now, I'm not arguing for a wildly optimistic revenue growth rate. But I do want to drive home the point that the revenue growth rate forecast in this 10-year budget is about 5 percent per year. That is a full 2 percentage points below the historic average of the last 50 years. I apologize for taking so much time, and at this time yield to Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman.

Do we have a vote? What is that, the 10-minute bell? Let me take a few minutes, then we'll come back.

With respect to the AMT, Mr. Chairman, I would simply point out that the Center doesn't have to endorse the AMT reform in general or any specific form, other than to say that when it confronts 20 million taxpayers, there's likely to be clamor for significant change. I think that's a political fact that they can express their judgment upon.

I share that judgment. I think you would, too, when we go from 2 million people to 30 million people affected by the AMT, being extended benefits under the code that are then taken back, we'll change it.

Chairman NUSSLE. And if you would yield on that, I don't disagree at all. I simply wanted to point out the process issues of trying to include that in our reconciliation instructions for the Senate, if the number is $1 trillion or $1.6 trillion, any modifications need to be made within that number, and it wouldn't be right from a process standpoint to assume that we could easily layer the AMT reform that you talked about and that Mr. Greenstein has talked about on top of it.

Mr. SPRATT. Let me also clarify something else that you were questioning Mr. Gale about. If you look at the Blueprint for New Beginnings, page 12, it says, after achieving all these goals, $1.6 trillion in tax cuts, roughly $1.4 trillion in projected surpluses will remain. The President proposes to use some of these and the additional needs as a contingency to reserve is ultimately an insurance policy. The surpluses may not be as large as projected. Farm conditions could require additional resources. More money may be needed for national security.

To get to $1.4 trillion, which they're claiming as a cushion fund and a contingency reserve there, you have to include the Social Security, some of the Social Security surplus. There's no other way you can add it up.

If you turn the page to page 14, the $1.4 trillion at the bottom of the page becomes a $1 trillion reserve. The President's budget recognizes there are inherent uncertainties in making 10-year projections. In deference to this, it sets aside a large $1 trillion reserve. Once again, by my arithmetic, to get to $1 trillion, you have to include some of Social Security and all of Medicare.

Then on page 185, there's a table, Table S1. We talked about it yesterday. The contingency fund there is not identified to any particular purpose, just a general contingency fund, is $842 billion. Yesterday the chairman opened the hearing by saying there was a lot of angst in your party over the fact that the administration was advocating the inclusion of the Medicare surplus, Medicare HI

trust fund surplus, in some kind of a contingency fund. He wanted it made clear that the HI surplus could not be used for anything but Medicare. And the witness who was there is in charge of the Medicare program as the Secretary of HHS. And he said absolutely not, only Medicare.

Well, if you back out the surplus, $526 billion, which Mr. Greenstein does, and Mr. Gale does, you're down to a contingency fund of just $316 billion. There are a lot of other things that would have to be taken into account. So if there's confusion, it's not because we're politicizing the issue, it's engendered by this particular blue book. Mr. Gale.

Mr. GALE. Thank you for bringing it up. The text on page 12 that Mr. Spratt referred to is precisely the motivation for my written testimony and the discussion I was having. I didn't have access to that, to the written text, while we were talking before. But that's precisely the language in the President's budget that leads me to the conclusions that I mentioned.

Mr. SPRATT. Thank you very much.

Have you voted?

Chairman NUSSLE. I haven't. What I would suggest, and I'm sure you have other questions you'd like to ask and there are other members, so what I would suggest is that we recess and come back and then we'll continue with your questioning.

So the committee will be in recess, subject to the vote on the floor.

[Recess.]

Mr. GUTKNECHT [assuming Chair]. The committee is back in order. Mr. Spratt.

Mr. SPRATT. Listening to the four of you testify, I thought there may have been one strand of agreement, when it came to looking at the budget long term, longer than a 10-year horizon. Mr. Mitchell, you or Mr. Bartlett I think used a figure of $21 trillion as the deficit in Social Security alone. I'm not really sure what the number represents. The number I've always used is $3.1 trillion as the present value of the unfunded liabilities for benefits promised today.

Where does your $21 trillion come from?

Mr. MITCHELL. That's an inflation adjusted figure, taking the Social Security Administration's forecast between now and 2075.

Mr. SPRATT. For all benefits?

Mr. MITCHELL. Looking at all promised benefits compared to projected revenue collections, taking the annual deficits that begin around 2015 through the 2075 year period. You add them all together, they come up to some enormous number well over $100 trillion. But you adjust it for inflation to today's dollars, you come up with $21 trillion. You of course put it in present value terms, you can get it down lower than that. I've always thought the inflation adjusted dollars was the most accurate, because Government doesn't budget using accrual accounting, so the present value concept wouldn't really have much value.

Mr. SPRATT. Well, let's just use $3.1 trillion. That number has some validity, it's used by lots of people. If we used accrual accounting and if we had a $3.1 trillion liability fund funded benefit, which we now could see and recognize, accrual accounting would

require us to begin booking it right away. Our accountants might let us get away with incrementally booking it so that over a period of time we would cover that.

But if that were true and if we had accrual accounting, we wouldn't have a surplus, would we?

Mr. MITCHELL. Well, I confess, I don't know whether we'd have a surplus with accrual accounting. I do know that obviously you would recognize the long-term obligations of the Social Security system and in some sense, I'm very tempted to go down that route, because it would show that Social Security reform is a savings, not a cost. But on the other hand, I'm also concerned that people might be tempted to play games by reclassifying Government consumption expenditures as investments. There might be opportunity for shenanigans that, well, to be perfectly honest, both parties would want to engage in, depending on which programs they were supporting at the given time.

Mr. SPRATT. But, Mr. Greenstein, would you agree with that, that if we were to accrue the liability for the unfunded present value of future benefits that we would have a marginal surplus, certainly nothing approaching $5.6 trillion in the unified budget?

Mr. GREENSTEIN. I don't know what the figure would be precisely over the next 10 years. If you had a longer time frame than 10 years, you would clearly see return to deficits.

I'm reminded of a phrase that Gene Searly of the Urban Institute uses. He says we're on an island of surpluses in a sea of deficits. We came from deficits, we're going back to deficits. The island looks considerably larger than it did a year ago. It's still an island.

Mr. SPRATT. I appreciate your reminding me who said that. I plagiarized it this weekend and didn't know who I was supposed to attribute it to, so I claimed it for myself. I'll thank Gene Searly for it.

Getting back to the point, though, I'm simply saying that when you recognize the liability for Social Security and you recognize the liability for Medicare in some form, there's a lot of talk of reforming it, but there's no way around the fact that medical costs are going up faster than other costs, and the demographics are there, they're not going away for a long time to come. Both of those factors means substantial liabilities for the future. If you factor in those liabilities, we have a lot less surplus than we think we have, and therefore, doesn't that mean, doesn't that suggest to you that we ought to deal with those long-term liabilities before we declare a surplus? And, if we can indeed pull off the kind of alchemy that you're talking about, with private accounts, and wipe out this huge liability, then we can go back and dispose of the remaining surplus.

But shouldn't that come first?

Mr. MITCHELL. I would have no objection to doing Social Security reform before tax cuts or doing tax cuts before Social Security reform. I don't think they're necessarily linked. But if it's alchemy, we should bring all the alchemists from all these other countries around the world that have successfully done it and do it as quickly as possible. I'm glad that the President in his address before Congress stated that he has every intention of moving forward on this issue.

Mr. SPRATT. Mr. Greenstein.

Mr. GREENSTEIN. They're inextricably linked. And I think the reason they're inextricably linked is that Congress cannot pass, I don't see how Congress can pass Social Security reform or long-term Medicare financing reform unless it either engages in budget gimmickry to an extraordinary degree or transfers significant funds from the non-Social Security, non-Medicare surpluses into those programs.

Take the proposal to take 2 percentage points of the payroll tax and put it into individual accounts. If that was the only thing you did, insolvency would come in 2023 rather than in 2037. Obviously there would be some Social Security benefit reductions linked to setting up individual accounts. But the President has said that no one who is now elderly or nearing retirement would have those Social Security benefits touched.

While if you look at the numbers, in order to avoid insolvency in Social Security, you do 2 percent in individual accounts. If you don't touch benefits for anybody 55 years and over, you have to have, for example, average Social Security guaranteed benefit cuts for people age 30 today up around 50 percent. And even after you factor in the individual accounts, it would be a net reduction, using high rates of return that people like Martin Feldstein use, which may be too high for what you get from the stock market for the individual accounts. You'd still have a 20 percent benefit reduction.

Now, Congress isn't going to accept that. That isn't going to happen. So the only way to fit the numbers together is to have some transfer from the rest of the fund. Whether you do individual accounts or you don't, or you do Social Security long-term solvency the traditional way, either way, you couldn't put together something you could pass, because of the benefit cuts that would be involved, unless you lubricated, softened the reform by having some transfer from the rest of the budget so the benefit cuts wouldn't be too deep.

The same is true in Medicare. Breaux-Frist, Breaux-Thomas, all these things, I forget the numbers, 70 percent, 75 percent of the long-term shortfall in Medicare is still unaddressed. Even if you raise the eligibility age to 67 and do things like that.

So if Congress is to take tough actions that will be controversial in Medicare and Social Security, to restore long-term solvency, in order to have that not be so controversial you can't possibly pass them, you're going to have to have as part of that package some transfer which suggests to me, you know, do that first, figure out how much of a transfer we need. I'm not talking about doing just a transfer. I'm in favor of some tough reforms in both programs.

But to consume the whole non-Social Security, non-Medicare surplus on a tax cut and not have resources left to do as part of that transfer I think at the end of the day could end up meaning that we go another bunch of years without restoring long-term solvency to either program.

Mr. SPRATT. Mr. Gale.

Mr. GALE. I agree that they are inextricably linked, both for policy and for economic reasons, they being Social Security and Medicare reform on the one hand and tax cuts on the other hand. One of the commonly heard arguments in favor of tax cuts goes along the line of, it's the people's money, give it back to them, we're over-

charging them because we have a surplus. All of those arguments omit the fact that the Government has promised more in benefits to the American public than the Government has agreed to collect from the American public.

So yes, it's the people's money. But which people? The next generation or this generation? If you give the money back to people this generation, then you're making the problem for the next generation more complicated. So an emphasis on the long-term financing issues is crucial to understanding how much money is available for a tax cut.

Mr. SPRATT. Mr. Mitchell, Mr. Bartlett.

Mr. MITCHELL. I would just make the point that yes, in all likelihood, if we reform our Social Security system like so many other countries have done, there probably will be a general revenue transfer to help facilitate that process, or to lubricate it, as Mr. Greenstein said. But if we don't reform Social Security, we'll have to make a much bigger general revenue transfer into the program to make up for that giant unfunded liability that currently exists, on the assumption, bringing political realism into the equation, that we're not going to cut people's benefits by 35 percent or increase payroll taxes on low income workers by 50 percent.

So the question is, if we're going to use some general revenue at some point in time for Social Security, do we do it in a way that makes it, that creates a stronger, better system. And does that have anything to do with tax cuts? Absolutely not. Countries have privatized their Social Security systems when they've had surpluses, they've privatized their Social Security systems when they had deficits. They did it not because it was a fiscal issue, but because it was a way of guaranteeing workers a better, stronger retirement system, and helping their economies by switching from a tax-and-transfer entitlement scheme into something based on private savings, which every economic theory that I know of, even Marxism, they all agree that capital formation, savings and investment, is the key to rising wages over time.

Mr. SPRATT. Mr. Bartlett.

Mr. BARTLETT. I don't have anything to add to that.

Mr. SPRATT. Mr. Mitchell, my only response to your response is that the question is, which comes first. If you have the tax cuts first and not enough is left over to begin to lubricate or facilitate the transition to Social Security and Medicare reform, what do you do? You're back into deficit, aren't you, and you're defeating your purpose? You're borrowing to prevent borrowing.

Mr. MITCHELL. I would refer back to my testimony. I don't think we should worship at a shrine of a surplus or a balanced budget. Let's say for some reason we had no surplus today. It would still make sense, as I said in my testimony, to run a shortrun deficit to reform Social Security in order to both achieve all the long-term fiscal savings and also of course, let's keep in mind, to create a better system for today's workers that will give them more security in their retirement.

And of course, we just talked about accrual accounting. If we had accrual accounting, it would show that this kind of reform was actually something that reduced aggregate present value deficits for the Government. So we can't keep switching back and forth be-

tween cash budgeting and accrual budgeting, depending on which point we want to make.

Mr. SPRATT. Thank you very much for your testimony, for your coming here today and for your patience. Let me yield to other members for questions.

Mr. GUTKNECHT. Mr. Bentsen or Mr. Price, either one. Mr. Bentsen, if you have questions, go ahead.

Mr. BENTSEN. Thank you, Mr. Chairman.

I want to go back to what you were talking about with Mr. Spratt and sort of walk through the math on this. First, Mr. Mitchell, I think what I hear you saying is similar to what Martin Feldstein and others have said in their proposal to reform, we'll just issue new debt to get us over. That's obviously one way to do it, of course, the debt's not free, there's a price to pay for that, both in terms of actual dollars as well as the associated macroeconomic costs.

But this is something we've tried to sort of discuss in our hearings. Since none of you either are elected officials or serve in a publicly elected administration, you have a lot more leeway to say what you want, and not to think that others who have testified wouldn't have absolute candor, because they might be concerned with political issues or controversy, just as Members of Congress might not have such candor. Of course, that would never happen.

If we look at the long term issues, and you look at CBO's numbers, on its face if we do nothing, and we could pay down all the debt, forgetting the question of what's callable and non-callable, what's redeemable and non-redeemable, by, I think 2030, we start to see a dramatic uptake in our debt to GDP. Now, of course, that number backs up to 2020 the more of the projected surplus that you use.

We have surpluses in Part A of Medicare and surpluses in, which is the Hospital Insurance trust fund, as you know, and we have surpluses in Social Security. We expect those to grow for some time and then to start to be drawn down.

If you take those moneys and use those moneys for anything other than the long term benefit that they are promised to, aren't we in effect double counting those moneys? Because ultimately, you have to make those up. The only way, if we're not double counting, is the only way to avoid that by replacing those moneys somewhere else, either through benefit cuts or payroll taxes, or additional debt on top of that? Is that a fairly correct theory?

Mr. MITCHELL. I guess I think we're double counting in the current system. No matter whether we have a lockbox or not, regardless of whether the Social Security surplus is used for more spending, for tax cuts, or used to pay down debt, none of that changes the fact that at the end of the day, all that happens with the Social Security surplus is that the Social Security trust fund gets Government bonds, IOUs that simply represent a claim on future taxpayers.

This is not real savings. It's not like a State and local pension system where they buy private assets.

Mr. BENTSEN. I see where you're going. Let me back up and use my simplistic sort of banker's mentality on this. Assuming that you have an indenture and you have a flow of funds of where they go,

these surpluses are invested in interest bearing Government securities and correctly in the future, the Social Security trustees are going to go to the Treasury window and they're going to present these bonds, and they're going to say, we want our cash. More likely than not, the Treasury is going to say, fine, here's your cash, while at the same time, they'll roll the bond into the public market.

But the money is encumbered. The instrument represents real dollars and real interest that under the indenture of the Social Security trust is encumbered for payment on future benefits. I don't think anybody has yet denied that. The point is, if you spend that money on anything else but those future benefits, and legally you would have to make that up, but forgetting the laws, think of the laws of economics or the laws of finance, the laws of mathematics, don't you also have to make it up? I mean, you're taking a dollar from one pot and putting it in another.

Mr. MITCHELL. No, but what happens with Social Security is that the payroll taxes automatically get credited to the Social Security trust fund. If we don't have enough of a benefit obligation that year, that money then automatically is going to go for something else.

Mr. BENTSEN. I understand all that. And they get a certificate against the dollars. I think that muddies the debate, though, when you say, well, it's spent on something else or whatever. I understand you to say that's a claim against future revenues of the Government.

But the fact is, that claim is in effect a monetary instrument encumbered against future benefits. Whether it's cash or a bond, it's still encumbered.

My question is, if you spend that cash or that bond on anything but future benefits, don't you have to make that up somewhere else?

Mr. MITCHELL. Under current law, all that matters is that the Social Security trust fund gets credited with a bond. What actually happens with the surplus cash after that doesn't change the size of the Social Security trust fund, it doesn't change the fact that, as you point out, Social Security will present those bonds to Treasury when they begin to run deficits, and that Treasury of course will redeem those bonds, either by raising taxes, or more likely just by rolling them, as you said, into the debt held by the public.

But it's not going to affect the size of the trust fund or any of the underlying mechanism and operation of Social Security, how that surplus money is then disposed of. I mean, the whole lockbox concept is simply saying, we want to make sure that surplus is spent to buy down debt.

Mr. BENTSEN. No, I'm not talking about the lockbox. The lockbox is, I think, somewhat of a gimmick, myself. But there's a legal obligation and there's a mathematical obligation. If there's $500 billion that is for future benefits, whether it's sufficient or not, there is that $500 billion. If you take, say you take $250 billion of it away, don't you have to make up that $250 billion in one of a number of ways, higher taxes, additional debt on top of the $500 billion debt that's out there, or benefit cuts? I don't know if anybody else wants to comment on that.

Mr. MITCHELL. All I would say is, that's exactly what happens under the current system. And nothing——

Mr. BENTSEN. Well, I guess my point is, if that's exactly what happens under the current system, but then you reallocate some of that obligation, don't you make it worse by the amount you reallocate?

Mr. MITCHELL. It wouldn't matter whether you spend the money, cut taxes with the money. The point is that the Social Security trust fund still has this claim through this Government bond on future revenues from the Treasury Department. The only way that could actually be changed is to say that the Social Security surplus from now on is going to be invested to purchase private assets.

Mr. BENTSEN. The Chairman is indulging me, I guess maybe—let me rephrase it this way. If you transfer the claim, if you say the trust fund is a claim, and we're going to use part of the claim, rather than for future benefits, we're going to use it to privatize the system in some way. Then you have to make up the deficit in that claim.

Would that be correct? Does that make sense?

Mr. MITCHELL. I suppose one could design a reform plan that did that, and presumably, if it occurred that way, it would be accompanied by some general revenue transfer to hold them all harmless.

Mr. BENTSEN. Well, let me try one more time, Mr. Chairman, if I might. Larry Lindsay, the President's Chief Economic Advisor, whatever his title is, but de facto Chief Economic Advisor, talked about the idea of taking $600 billion of the projected Social Security trust fund and using that to privatize Social Security. He thus is taking $600 billion worth of claims or obligations, claims against future obligations, and using it for another purpose, albeit within the system, but using it for another purpose.

So don't you have to make up that $600 billion some way?

Mr. MITCHELL. Yes, I understand the point you're making now. Yes, of course you would, and that's what people mean by talking about the general revenue transition financing to make the system work.

Mr. BENTSEN. So it would be through general revenue or what else?

Mr. MITCHELL. It would be through general revenue, borrowing, reductions in other Government programs, that's something lawmakers will have to decide, as they've done in all these other countries that have made the reforms.

Mr. BENTSEN. Anyone else want to comment on that?

Mr. GREENSTEIN. That's precisely the point. This is precisely why the tax cut is too big and we shouldn't be doing it now. We need to figure out how much money we need to transfer to Social Security. Whether it's for a transition to individual—it is in individual accounts that give you a higher rate of return. I think this is pretty clear in the economics profession.

Two things give you higher rates of return, advance funding, so the money earns interest, it could earn interest in the trust fund, it can earn interest in individual accounts, and a diversification of investments. You can do it through individual accounts, you can do it through allowing the trust fund, through an independent board, to be able to invest in index funds.

Things that give you the higher rate of return and the advance funding and the equity investment, you don't have to do either through private accounts, you can do them for private accounts. I think doing through private accounts is preferable, low administrative costs, better guarantees for the beneficiaries. But that's another discussion.

But the point is, is you want to go to advance funding to ease these long-term liabilities and to be able to get higher rates of return, you have a transition issue and you have to get the money from somewhere. And if there's no money left in the general fund, because it's all gone for a tax cut, then you either can't proceed with Social Security reform or you're going to proceed by virtue of doing substantial on-budget deficits. Those are the choices.

Mr. GALE. It might help, it might not, to think about a family that's trying to plan for their retirement. They have a mortgage that they're trying to pay off, and they have assets that they're saving. If the family raised its mortgage debt and put the loan proceeds in the retirement account, it would not be correct to say that its wealth went up, because it now has a bigger liability on the mortgage side. This is just another way of making the exact same point that Mr. Greenstein is making and that you are making, which is if you take the money out of one pot and move it, you haven't increased the total amount of money they're saving for retirement. You've just shifted it from one set of claims to another set of claims.

Mr. BARTLETT. I think one of the important things to keep in mind here, if we're going to talk about the long-term sustainability of Social Security, is that it is currently unsustainable. I mean, changes in the law will have to be made at some future date, because current tax rates are insufficient to pay benefits, all the benefits that have been promised. So there's already a fundamental disconnect. We've made a promise for which we have not provided the funding, and now we're concentrating solely on the promise element of it, when the promise was in effect fraudulent to begin with.

We don't have a funded system. The analogy between the Social Security trust fund and a private trust fund held by a responsible financial institution I think is a flawed analogy. And I think also that it's important to remember that benefits formulas have been changed many times in the past. The Supreme Court has even ruled that you don't have a right to Social Security benefits.

A few years ago, for example, we increased taxes on Social Security benefits, which had previously been untaxed. So I think that treating some of these numbers out into 75 years as if they can never be changed for any reason whatsoever is extremely unrealistic. Obviously, changes will have to be made, very substantial changes.

I think everybody understands that there's going to be a tradeoff of some kind in terms of those people who move into a more privatized system will give up future benefits. If you do all that on a present value basis, it can work out. The problem is, you have different sizes of cohorts and things of that sort, so that the cash flow isn't the same every year.

So getting from here to there, in other words, is a very, is a difficult political and accounting problem. But it's not an insurmount-

able economic problem. If you could just sort of throw all that accounting stuff out of the way, it would be a lot easier to design something that would work. I think most economists would say that there's nothing wrong with floating some new debt to pay to get rid of another kind of debt. I mean, people refinance their mortgages all the time, and people don't say that that's phony baloney. You obviously save something in the process, or you wouldn't do it. And that's part of what I think is going on here, is the idea of in effect, refinancing the Social Security debt into one that is more manageable under a different set of rules.

Mr. BENTSEN. That is true as long as it's an economically beneficial refinancing, and not one that costs you more or is equal.

Mr. BARTLETT. Of course.

Mr. GUTKNECHT. Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman.

I want to thank the panel this morning. I appreciate all of you being here. I'd like to pick up on Mr. Spratt's search for possible common threads of agreement, even though you've disagreed on many things, and I suppose on most of the major questions confronting us, as to the optimal size of a tax cut and the fairest distribution of the benefits.

In terms of budget process and what we're going through in this chamber today, is there any one of you that would want to say it's sound procedure to vote through the major portion of this tax cut before we have a budget? Is there anybody who would wish to defend that process or that procedure?

Mr. BARTLETT. Well, before I walked in here, I was handed a sheet of paper that was prepared by the staff of the Budget Committee that indicated that you're operating under the current budget. That is, the one that was passed last year, that for the current fiscal year you're in. So there is a budget.

Mr. PRICE. Do you think that's a credible claim? I'm aware that is the legal claim that's been made: that we're actually operating as the budget law intended, and not just the letter of the law, but the principles of sound budgeting. Do you think that's a credible claim, that we're doing all this under the fiscal 2001 budget resolution and therefore it's just fine?

Mr. MITCHELL. I would agree that perhaps this is not what the drafters of the Budget Act envisioned would normally happen. But I think that to simply note that this is an unusual step doesn't in any way indicate that there's something irresponsible about taking a step in terms of tax relief that is part of an overall budget framework that's been presented and is going to be digested throughout the year.

Mr. PRICE. But you seem to be suggesting there might be some burden of proof on proceeding in this way.

Mr. MITCHELL. I just think it's an unusual step. That doesn't make it irresponsible or wrong or reckless in any way.

Mr. PRICE. Well, if it's unusual, what might justify it? What do you think is the justification?

Mr. MITCHELL. I think the justification is that many lawmakers are concerned about the state of the economy and want to move quickly on tax relief.

Mr. PRICE. And this tax package has a reasonable chance, you think, of turning the economy around?

Mr. MITCHELL. I've always preferred to think of tax policy in terms of what's going to help the economy's longrun performance. But having said that, I think the sooner you can cut tax rates and improve people's incentives to work, save and invest, the sooner you're going to realize some of the benefits. So if anything, I think that the majority is being too cautious and too slow with its tax rate reduction package.

Mr. PRICE. All right. I wonder if anyone has a different view? In light of what we all know is awaiting in the Senate, it just doesn't seem to be a credible claim that violating the procedures in this way meets any kind of burden of proof in terms of what budget law requires and what sound budgeting procedures require.

Mr. GREENSTEIN. There were two justifications just offered. One was, we're operating under last year's budget resolution, and the other is that the economy needs an injection, the sooner the better. I think both of those fall apart very quickly upon close examination. If we're operating under last year's budget resolution, this tax cut busts it. It is much larger than the amount of the tax cut that was allowed under last year's budget resolution. My understanding——

Mr. PRICE. And would be in total violation of any kind of pay-go rules or pay-go standards?

Mr. GREENSTEIN. It would be in violation of the pay-go rules, it's in violation of the budget resolution. My understanding, it's going to the floor with a waiver of the revenue floor in last year's budget resolution.

Mr. PRICE. So the notion that this is kind of flying under last year's budget resolution is really a fig leaf if by that resolution you mean the explicit constraints imposed on revenue reductions?

Mr. GREENSTEIN. Precisely. And with regard to an injection into the economy, this tax cut provides in 2001 a tax cut equal to 5/100ths of 12 percent of GDP. I think it would be pretty hard to find anybody who would argue that you get any noticeable stimulative effect from a tax cut equal to 5/100ths of 1 percent of GDP.

Mr. PRICE. Let me move on to Mr. Gale and some questions about the distribution of the benefits of this tax cut. Secretary O'Neill, in an appearance before the committee last week, derided what he called advocacy statistics, with explicit reference to a couple of our witnesses this morning. But speaking of selective statistics, the administration has said that the average benefit for taxpayers under the Bush tax cut plan would be $1,600.

Now, going back to statistics 101, I wonder if the mean here is the figure that gives us the best picture of how the average American would be affected, or the greatest group of Americans would be affected by this tax cut. Mr. Gale, what percentage of taxpayers would actually get that $1,600 tax cut or more? And then could you instruct us maybe on the difference between the mean and the median and tell us what the median figure is?

Mr. GALE. Sure. Thank you. The mean of course is just the average of all the tax cuts. The median is what the typical person or the 50th percentile, the midpoint in the distribution, would get. According to the estimates that I've seen and view as reliable, up-

wards of 90 percent of families would get less than the $1,600 that the so-called typical family would get.

Mr. PRICE. So 90 percent of the taxpayers would be below the $1,600 mean figure?

Mr. GALE. That's right, including about 95 percent of households in the bottom 80 percent of the distribution. So almost all households in the bottom 80 percent of the distribution would get less than $1,600, and about half of households in the bottom 40 percent of the distribution would get nothing from the tax cut. And in the top 1 percent, the estimates are in the 20's or 30's of thousands of dollars per year.

Mr. PRICE. What would the median taxpayer receive? Do you have that figure?

Mr. GALE. The median taxpayer would receive about $400 in tax cuts.

Mr. PRICE. So you're looking for the figure whereas many taxpayers would get that or more as would get that or less.

Mr. GALE. Right.

Mr. PRICE. Then you're looking more at the $400 range, rather than $1,600, is that accurate?

Mr. GALE. It's on that order. Twenty-seven percent of taxpayers would get no tax cut. And in the bottom 40 percent of the distribution, the average tax cut is about $100.

Mr. PRICE. If you want to refine those figures for the record, I would appreciate it.

Mr. GALE. Sure. I'd be happy to.

Mr. PRICE. But I think that gives us the picture.

Mr. Chairman, if I could ask one last question here, since we've had a rather discombobulated session this morning. I would like to go back to Mr. Mitchell and his quote that the national debt is a minor irritant. I think those were the words you used. Do you regard $200 billion plus a year in interest payments on the publicly held debt as a minor irritant in terms of other uses to which those funds might be put in terms of either public or private investment? And picking up on your conversation with Mr. Bentsen, quite apart from the technicalities of how the Social Security trust fund works and how those obligations are going to be met, isn't it true that when the cash flow reverses, as the baby boomers retire, and if general funds have to be used to make good on those obligations that the trust fund holds, wouldn't we be in a stronger position to meet those obligations with those interest payments being off our collective backs?

Mr. MITCHELL. I guess it depends on what your long term goal is. Simply paying down debt today so we can borrow it all back and then trillions of dollars more in the future doesn't strike me as a very feasible or fiscally prudent plan. On the other hand, if we use some of the money today to restructure our program so it will be much stronger in the future, then I think there's a lot more merit to that approach.

Now, obviously, referring to the first part of your question, if we had somehow never run any deficits in the past and had no debt and didn't therefore have $200 billion of interest payments, of course that would be wonderful. But I suspect it was probably well worth the cost to win World War II, to win the Cold War, and

many of the other things that we wound up incurring debt for. Then again, some of the expenses I'm sure weren't very valuable.

The point I'm simply making is, that at the end of World War II, our national debt was over 100 percent of GDP. Now it's down around what, 30 to 35 percent of GDP. And if we do nothing, don't pay down a single penny of debt for where we are now, it will fall even further just because our economy will grow, and the difference between the numerator and the denominator will cause that to happen.

I'm simply saying that we don't want to be so myopically focused on that one statistic that it prevents us from undertaking other economic policy reforms that will strengthen our economy in the future.

Mr. PRICE. Well, I understand, and I think every member of this committee would express huge relief at the fact that we're now dealing with surpluses rather than deficits, and we are systematically bringing down the debt. Both parties are committed, as you know, to using proceeds from the Social Security surplus for that very purpose. There's a lot more agreement on that than the rhetoric sometimes indicates.

But I also think that not a single member of this committee, and not just for political reasons, would describe the current publicly held debt as a minor irritant. Nor would we describe the third largest item in the Federal budget, namely debt service on that debt, as of minor importance. It seems to me to continue to reduce that debt, to get that interest burden off of our back, for whatever purposes, is a worthwhile objective. We have an obligation to assure ourselves, as we debate this tax cut and the budget resolution eventually, that we're providing for the disciplined, systematic reduction of that debt.

Would you disagree with that?

Mr. MITCHELL. I guess I'm speaking in relative terms and you're speaking in absolute terms. I think the national debt we have today is minor compared to a national debt of over 100 percent of GDP. Now, obviously, $200 billion is a lot of money. I'd like to have it. I'm sure lots of people would like to have that money used either for, as you said, returning it to taxpayers or spending it on other Government programs. But in relative terms, which was the context that I was using, our national debt is not a significant economic impediment, especially when you compare the situation we're in to the other industrialized nations of the world, many of them who have debts well in excess of 100 percent of GDP.

And also, speaking again in relative terms, the national debt, the official national debt I think is a minor problem compared to the implicit debt of the Social Security system, which as I mentioned earlier, is seven times as large as the official national debt. So again, I'm speaking in relative terms. I'm not saying that in absolute terms it's not unfortunate that we're spending $200 billion in interest on the debt.

Mr. PRICE. I see. Any other witnesses have a comment?

Mr. BARTLETT. Congressman, I think that this whole issue of debt paying off has gotten really blown out of proportion. I mean, if a corporation decides that it wants to make an investment, it might float debt or it might float equity or it might decide to take

money out of retained earnings. There's no value judgment placed on one versus the other. It's simply what makes sense at a given moment in time.

I think that the implication that we should use all the money that is coming in over and above what the Treasury needs to pay its bills, solely for one exclusive purpose, is like telling your constituents, don't buy a new car, don't buy any new clothes. Pay off the mortgage on your house before you do anything else, because that's the only thing that you should be spending your money on.

I think that that makes no sense, and I think it equally makes no sense to pick this one particular purpose that could be used for the current cash surplus of the Government, when there are other things it could be used for. You mentioned spending money for various projects. I'm sure there's things we could probably agree upon. And I think tax reduction is one of them. I think the main benefit of paying off the debt is that we free up these interest payments and don't soak the taxpayers for them.

So I think that it's something that's desirable, but it has to be looked at in context, rather than elevating it above everything else.

Mr. PRICE. I understand your point. I also think as we conceptualize this and think about giving taxpayers their money back, we also need to understand this debt is also a shared obligation on the part of the American people. Surely we ought to have that same attitude about benefiting taxpayers, but also meeting the responsibilities of the citizens in this country to take care of these accumulated obligations.

My time has expired. If one of the others has a comment, we'd be glad to hear it.

Mr. GALE. I just wanted to respond to two things that Bruce said. One is the idea that Treasury has enough money to pay its bills and it has money left over. The only reason we think that is because we're not accounting for these long-term liabilities that we're talking about. In fact, again, to emphasize it, if the Government kept its books like a business it would show these huge unfunded liabilities in its pension and retiree health programs and would not think of itself as wallowing in cash.

The other thing, Bruce used a family example, which I think is a good way of thinking about these things. But I would give a slightly different family example. The United States right now is sort of like a middle aged family that's in its peak earnings years, but has saved nothing for retirement. So if that family gets a bonus, the question is, should they blow that bonus on a vacation or should they put it away and start setting their retirement accounts right?

And put in that context, I think the responsible thing to do, no question, is to save the funds. It's not a matter of just having excess cash around and maybe we buy a car, maybe we go to a nice dinner. The problem is that we have a current cash flow surplus for a few years, that's the island of surplus that Mr. Greenstein mentioned. Then we have these retirement issues looming on the horizon. So a responsible family would do what a responsible government would do, which would be to put that money away.

Mr. BARTLETT. Can I add something to that, just briefly? I think part of the Social Security debate here is not whether we should

save the money or blow it on a weekend in Vegas, but whether we should put the money into a passbook savings account that gives us 3 percent or put it into the stock market where you can get 10 percent over a long period of time. I think that's really a lot of what the debate here is. It's not just whether you save, but how you save and what is the most appropriate way to save for the particular purpose you're saving for.

Mr. GREENSTEIN. If I could just add a quick point. If you look at the GAO and CBO long-term forecasts, they both warn us that under the current policy path, even if we don't do a tax cut or any spending increases, that eventually, when the baby boomers retire, deficits return, debt rises as a percentage of GDP and it eventually reaches levels that are not sustainable for the economy and would cause serious economic damage.

Now, it's true that that isn't at a level today that causes economic damage. But the forecast is that it will get there.

Now, it seems to me that if you see that on the horizon, you want to be doing things now to ease that problem on the horizon. One of them is paying down as much debt as you can now to get that debt-to-GDP ratio as low as you possibly can, knowing that whatever we do on Social Security and Medicare, when the boomers retire, that ratio is probably going to go back up.

Mr. PRICE. Thank you very much. Thank you, Mr. Chairman.

Mr. GUTKNECHT. Thank you.

Mr. Mitchell, my understanding is you need to leave. I have some questions, but if you do need to leave, I think we promised you to be out of here by 11:30. If you need to leave, please feel free to do so.

Mr. MITCHELL. Well, it's a meeting with a Congressional staffer where several other people are going to be at as well. As much as I think I probably would add to the discussion, they'll say the same thing I would say anyhow. So I don't know that there's a crisis in me being late for that meeting.

Mr. GUTKNECHT. I just wanted to respect your time. Let me ask, first of all, this has been a great discussion today. I've really enjoyed listening to all the different vantage points. You've provided us with a lot of things to think about.

Let me go back to the issue that's here today, and Mr. Greenstein, I'm not sure if you're aware of what our resolution provided for last year for tax relief, the budget resolution that we're currently operating under. Are you aware of what number that is?

Mr. GREENSTEIN. Yes. My understanding is, Richard was informing me that it was $150 billion over 5 years.

Mr. COGAN. As it was passed last year, it was $150 billion over 5 years.

Mr. GUTKNECHT. But then wasn't there also a provision within that budget that allowed for an update in July and August, and that CBO update would be included in that resolution, isn't that also correct?

Mr. COGAN. At the option of the chairman, the increase in the forecast CBO provided for last July, when they made their estimate, could have been added to, subtracted from the revenue to allow a larger tax cut.

Mr. GUTKNECHT. Right. Maybe we should invite you up to the table. Instead of making you do that, Richard, which I'm not interested in making you do, I think the bottom line here is that the budget resolution of last year permitted a tax cut over 5 years of $284 billion. Certainly, yes, there were prerogatives that were allowed to the Chair, they were extended last year. And so there is a $284 billion technical, now again, whether or not people determined that that is in the best interests of our country or whether that's in the best interest of the budget is a judgment decision that people have to make.

But the parliamentarian, just so we're clear, Mr. Greenstein, the parliamentarian disagrees with your position. CBO disagrees with your position and suggests that not only is this current tax cut is smaller than that amount that was allowed for in that budget resolution, but it does in fact fit within last year's budget.

Now, I'm not arguing the point with you, you suggest that we should do a budget first, this year, first, that's fine, that's your opinion. But there is a technical issue here that we do have to follow, at least for the purposes of this budget. The rulings by the officials who are in charge of the budget and in charge of the rules of the Budget Act and in charge of the rules of the House disagree with you.

Mr. GREENSTEIN. Mr. Chairman, I believe my answer would have been correct yesterday. Richard informs me that in the last 24 hours, a mechanism was used under the budget resolution to adjust the revenue floor. I was not aware of that when I mentioned it earlier. But the general point I'm making still fits.

Mr. GUTKNECHT. And I respect your opinion on the general point. I just wanted to make sure that at least for the record's purposes, that we were correct on that, and that you were at least aware of that.

Mr. GREENSTEIN. I have been made aware that the adjustment just occurred in the last 24 hours.

Mr. GUTKNECHT. Well, that, there's nothing unusual about that type of procedure being used throughout many Congresses ad infinitum.

One other thing that I just wanted to ask, you had mentioned that the tax cut was too big, because you needed to have, you were suggesting that at some point in time there will be transfers that are needed in order to deal with some of those other looming problems. I think there was general agreement, I would agree that those looming problems are Social Security and Medicare, at least two big ones. There are some others, I think Ross Perot described them as crazy aunts in the basement that you're in the attic that you have to deal with. But those are the two most prominent members of the family that we know that are out there that we're going to have to deal with.

What size or how much of that tax cut would be needed, are you suggesting? All of it would be needed? What size of a transfer are we talking about here, how big of a hole is in Social Security?

Mr. GREENSTEIN. It's hard to know until we actually get into Medicare and Social Security. We did an estimate last year in which we looked at the question, if you were to close 70 percent of the long-term hole in Medicare and Social Security through other

means, and I do not think Congress can agree on things that will close 70 percent of the Medicare hole through other means, but if one heroically could, and you only needed to cover 30 percent of the hole through transfers, you'd need about $500 billion over 10 years. In reality, my guess is probably somewhere between $500 billion and $1 trillion.

But I think that's not the only problem in terms of the size of the tax cut. Mr. Chairman, I cannot believe that over the next several years, Congress is going to agree on a Medicare drug benefit that only costs $153 billion over 10 years. For that level, you probably can't even cover 50 percent of drug costs until out-of-pocket costs are $11,000 or $12,000 a year. You're going to inevitably end up with a larger drug benefit than that. You're going to inevitably, even if it isn't this year, fix the AMT issue. We don't have a price tag yet on national missile defense.

So when we add all of those pieces together, of which perhaps the biggest one is the needed transfer, I think the numbers simply don't add up unless we're lucky and the surpluses keep growing. But we don't know at this point that they will.

Mr. GUTKNECHT. But the number for Social Security you would put at somewhere between $500 billion and $1 trillion?

Mr. GREENSTEIN. Yes.

Mr. GUTKNECHT. Add to that what would be your estimate with regard to Medicare?

Mr. GREENSTEIN. I would—now, this may be phased in. You know, the Clinton proposal last year was about $350 billion over 10, when you looked at the percentage of drug benefits that covered. I'm not making a judgment of how big I think a drug benefit should be. I think at the end of the day, and it may take several years to get there, I would guess you're talking about a drug benefit that ultimately is going to be at least $500 billion over a 10-year period.

Mr. GUTKNECHT. So that may be as much as $1.5 trillion of needed transfers during that period of time.

Mr. GREENSTEIN. Clearly, we need to make some Medicare reforms as well, without question. But even factoring those in, if you're covering the drug benefit cost and then you're doing reforms, assuming that we would only need $500 billion to $1 trillion in transfers assumes significant and controversial Social Security and Medicare reforms.

Mr. GUTKNECHT. So under the budget that you would construct, and under that scenario, the tax cut is not only too big, but it's nonexistent. It would be pretty difficult to envision any, and there are those who are suggesting that while $1.6 trillion is too large, that in fact there's a whole other party that is suggesting that we should do it at $900 billion. Nine hundred doesn't fit, according to your calculations. That would be irresponsible. Sounds like we're all being irresponsible, according to your, which is fair, if that's what you're telling us.

Mr. GREENSTEIN. There's a question of the perfect being the enemy of the good. If we were totally responsible on this one, I prefer a tax cut of probably around $500 billion. But basically, given these big unmet needs, 900 is better than 1.6; 1.2 is better than

2.0. We're not going to deal with all of these things right now. But I think it is a very serious concern.

And yes, in my view, even $900 billion is larger than would be desirable, but less undesirable than $1.6 billion or $2 billion or $2.5 billion.

Mr. GUTKNECHT. What has changed in your opinion over the last 5 years, 10 years, 15 years, 20 years? I mean, the issues involving Social Security and Medicare as far as an unfunded liability have been there for quite a while. I mean, I don't recall, and I'm not challenging you, maybe you did, and maybe others did. But I don't recall anybody running in here before and saying, don't increase spending because we've got an unfunded liability out there, don't increase the welfare programs because we have an unfunded liability out there, don't increase children's health care because we have an unfunded liability out there. Don't increase the deficit, because we have an unfunded lability out there.

For years and years and years, in fairness, both sides have been putting forth priorities which arguably could eat into, depending on the economics, eat into that future unfunded contingent liability that is out there. So while I respect that you and many others would come forward today and suggest that, what I would hope that we maybe could do, because I think part of this is politics on our side, certainly, we put forward a plan that we believe in, others put forward a plan that they believe in, what I would like to focus on is, what are some of these long-term liabilities. You mentioned two huge ones today, Medicare and Social Security.

I would invite the others on the panel, because we will be later this year holding a hearing on some of these unfunded liabilities and what we should do 2, 5, 10, 20 years out in order to deal with them. Aside from the context of today's debate of juxtaposing those with tax cuts, which is interesting but I think as we all hear the debate on the floor, it's the train already left the station on that issue.

What other unfunded liabilities would you propose need to be added to the mix for us to discuss as a budget committee as we're looking at that horizon? I'll start with you, Mr. Greenstein, and we'll move down the aisle for comments.

Mr. GREENSTEIN. I think it's the things I—it's Social Security and Medicare. Then there are things that, I don't know if you'd call them an unfunded liability, but we know the political system will address them, so we need to leave room for them. A Medicare drug benefit, AMT reform, some form of continuation of payments to farmers, which isn't included in the budget.

Mr. GUTKNECHT. If I could interrupt, that horizon may be next week. I'm talking about what is on the horizon, and I'm very serious about the question. I understand the—let's get the politics out of here for just a moment. What is 10 years out that's going to come up and bite us? Social Security and Medicare is obvious. We've been hearing about that for 20 years. What haven't we heard about yet, or what aren't we even considering to address? We're going to address agriculture and we're going to address prescription drug benefit. But what haven't we even been talking about?

I had a gentleman mention to me, for instance, that some of our nuclear waste and hazardous waste is an issue that has a 10-, 20-

year horizon that we aren't even talking about yet. And part of my question is, what else do you see out there that has that kind of horizon?

Mr. GREENSTEIN. I think one that we're all starting to talk about is AMT. I think another, which I hesitate to mention, because my level of knowledge in it is pretty limited, but there's increasing evidence that the global warming problem is real. Some of the changes that may be needed to deal with it may entail various kinds of cushions in Government expenditures of some sort, or Government tax breaks of some sort. I'm not an expert on exactly what we ought to do on that front.

I'd also note on the unfunded liability front, you know, at the time after the 1983 Social Security Commission, it was thought that solvency had been restored for 75 years. Now we're both getting closer to the boomers' retirement, and we have newer and better figures, so we all realize this is more of a problem.

Just in terms of what various of us said in the past, just as a brief point for the record, I'd note that for example, in 1995 at a press conference our Center held, we said we thought the most responsible budget before the Congress then was neither the Democratic budget, the Clinton budget, the Republican budget, but was rather the Blue Dog budget. I got no end of grief from the Clinton White House for having said that at the time. But I think we've been talking about these issues for a while.

Mr. GUTKNECHT. Mr. Gale.

Mr. GALE. Thank you. I certainly would second everything Mr. Greenstein just said and just add a couple more possibilities to the list, with the emphasis of course that these are prospective issues.

One is that Medicaid spending is projected to rise faster than the rate of inflation. That in conjunction with Medicare and Social Security is projected to eat up an increasing share of GDP over the next 50 years.

Mr. GREENSTEIN. Particularly because of long term care.

Mr. GALE. Right. And the CBO and the GAO outline those projections very clearly. A second issue may be Government pensions, that's pensions for military and civilian workers, which again, in the current budget, the assets of those funds are included but the liabilities are not.

And the third issue, I'm not certain about this, but I would speculate that we probably haven't been doing enough to maintain the physical infrastructure of the country and roads and bridges and things like that may need to be thought about in terms of being built up.

I also want to mention two things. One is, I think that's a great question to ask, and I'm glad that we're having this conversation in the context of a discussion also of the tax bill, because the two are linked. But also, the main thing that's different between now and 20 years ago or 30 years ago is that the baby boomers are about to retire. In these demographic patterns, where you're dealing with these things, 10 years is not that long of a time.

So I think the main issue is not a day-to-day urgency, nothing's going to happen this week or next week if we don't fund this immediately, but the problem is getting much closer, the leading edge of the baby boom turns 62 in 2008. In the years after that, we will

have many, many more people that are of retirement age. So I think that's the main difference between now and 20, 30 years ago.

Mr. GUTKNECHT. Mr. Mitchell.

Mr. MITCHELL. Well, first, let me give the caveat there are plenty of issues I don't know anything about, like nuclear waste. So whether they're big, long-term problems, I'm the wrong person to ask. In terms of sort of the traditional fiscal policy issues, I think there's widespread agreement, even among the diverse opinions on this panel, that demography is driving much of this, Social Security, Medicare, Medicaid, those are all really demographic problems. I think it appears there is some agreement that advance funding is the way to go. And I think Mr. Bartlett raised the appropriate question, do you want a 3 percent passbook savings account by having in effect the Government owe the money to itself, or do you want advance funding in the sense of defined contribution accounts that individuals control?

Mr. GUTKNECHT. Mr. Bartlett.

Mr. BARTLETT. Just to add something new to the list of what's been discussed, I'm becoming increasingly concerned about the contingent liability of all the Government sponsored enterprises. The debt of Fannie Mae and Freddie Mac is just exploding. It's just going through the roof. And although they always make these arguments that, oh, they're private, everybody in the financial markets knows that there's an implicit Government guarantee of their debt. There's a serious moral hazard problem. If everything goes along fine, that's great. But there's always risk of some sort of financial problem that would make the S&L problem a few years ago seem trivial by comparison.

I would certainly urge the committee, at the very least, to pay much, much more attention to these off budget contingent liabilities than I think has been the case.

Lastly, I would just like to agree with Mr. Greenstein that the cost of any prescription drug benefit that Congress passes will, by definition, be vastly larger than anybody estimates, because it's going to change people's behavior. I think that also, the recent history suggests that the greatest breakthroughs in the areas of medical technology are mainly in the drug area.

I think the prospect of having more money available to pay for prescription drugs will certainly drive the drug companies to produce more drugs, more expensive drugs. And given the testing process—we all know it costs $500 million to bring a drug to market—I think that the consumers will change their behavior. The drug companies will change their behavior. Everybody will change their behavior so as to take advantage of whatever benefit Congress enacts.

I believe it's potentially a black hole of Government revenues for which there is absolutely no bottom. Frankly, I would urge you not to step into that hole, but I guess political factors may overwhelm my judgment in this area.

Mr. GUTKNECHT. Well, I want to thank you, because part of what I'm considering doing, and I've talked to Mr. Spratt about it, and I don't want to put words in his mouth, but I think he shares some interest in this as well, and that is that the committee, over the last 20 years, has been a committee that has dealt with today's

budget, the here and now. Balance was the grail that everybody was searching for. I guess we got it now, finally, at least under some definition of balance.

But the point is that now that we've achieved the here and now, we have a responsibility, we're really the only committee that can do a good job of looking at the horizon and saying, what's coming up from a situation in our country that's going to come and bite us at the Federal level, from a fiscal policy standpoint. That's part of the reason that this year, when we get through with the here and now budget, we want to lift our sights a little bit and look at that horizon.

So I appreciate the list that you're giving us. That's part of the outlook that I was hoping you would give us today. If you have additional thoughts or ideas about that horizon, issues that you think we should pay attention to, I would appreciate it. Because I believe that that can be an exercise that can be done in a very nonpartisan, just American, patriotic way. That's not an issue, I mean, the politics of here and now, we'll deal with that. We'll have our tax cut versus whatever debate and we'll have that out as we're having today.

But whether or not hazardous waste or whether or not the AMT or whether or not global warming or whatever it might be is out there, and from a budgetary standpoint maybe something we need to pay attention to is yet an issue that Congress is not really trying to address. I think this is the committee that needs to at least begin to approach that.

So I appreciate the exercise of at least giving me some of those ideas. I appreciate your testimony today and thank you for your indulgences all the way until noon.

Unless anybody else has anything else, the committee will stand in recess until 1:30, where we will continue the Members Day hearing panel. Thank you.

[Whereupon, at 12 noon, the committee was recessed, to reconvene at 1:30 p.m. the same day.]

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