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UNITED STATES MONETARY AND ECONOMIC POLICY

Wednesday, April 30, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to call, at 10:00 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Leach, King, Lucas of Oklahoma, Paul, Gillmor, Ryun, Manzullo, Ose, Biggert, Miller of California, Hart, Capito, Tiberi, Feeney, Hensarling, Murphy, Brown-Waite, Barrett, Harris, Frank, Waters, Maloney, Gutierrez, Velazquez, Watt, Hooley, Carson, Sherman, Meeks, Lee, Inslee, Gonzalez, Capuano, Ford, Hinojosa, Lucas of Kentucky, Crowley, Israel, McCarthy, Baca, Matheson, Miller of North Carolina, Emanuel, Scott, and Davis.

The CHAIRMAN. The committee will come to order. Today's hearing is on U.S. economic and monetary policy, and we are honored to be joined again by the Honorable Alan Greenspan, Chairman of the Federal Reserve Board of Governors. Before we get started the Chair has a few housekeeping announcements.

First, pursuant to the Chair's prior announcement in the rules of the committee, opening statements will be limited to the Chair and ranking minority member of the full committee and the Chair and ranking member of the Subcommittee on Domestic and International Monetary Policy, Trade and Technology for a total of 16 minutes evenly divided between majority and minority. All members' opening statements will be made part of the record.

Secondly, in an effort to permit all members an opportunity to question Chairman Greenspan, for purposes of questioning the witness under the 5-minute rule, the Chair will first recognize majority members who did not get an opportunity to question Chairman Greenspan at his last appearance before recognizing other members. The Chair will recognize minority members based on the list submitted by the ranking minority member. The Chair recognizes himself for a brief opening statement.

Good morning, Mr. Chairman, and welcome back. First of all, I would like to thank you for your generosity in agreeing to come back to the committee and continue the round of questions for members who weren't able to speak with you in February. Second, let me offer my congratulations on the President's comments last week that he would reappoint you to another term as Chairman when your term expires next summer. I am sure I speak for the entire committee when I say we appreciate the strong and steady hand you have exerted in the control of monetary policy.

A great deal has happened in the 10 short weeks since you testified before this committee. On February 12, when you were last here, the war on Iraq seemed certain but its length and outcome were certainly less so. Today we know that the war was quick, the dictator was ousted and a free Iraqi people are on their way to a new and more democratic government. Back in February, the economy's fundamentals looked good, but uncertainties about the war and energy prices made it difficult to predict an economic turnaround. Now with those issues out of the way, the consensus is for gradual but steady recovery.

Of course, Mr. Chairman, as you know, there are plenty of things that can throw the recovery off track; namely, the continued weakness of the global economy and, as yet unknown, the facts of the SARS epidemic. That is why I believe it is so important to enact the President's jobs in growth program. It is important to note that the President isn't seeking a short-term stimulus. Instead, Mr. Chairman, the President is seeking long-term restructuring of the Tax Code of the sort that you have tended to favor over time and that you embraced in your February appearance. I am particularly interested in the dividend tax cut and its benefits to investors for the capital markets and for corporate governance. As to the other parts of the President's jobs in growth package, you have always said, Mr. Chairman, you believe that tax predictability is important and that in general the lower taxes are and the less government spends, the better, and I certainly couldn't agree more.

Mr. Chairman, I think most in this room would agree that there is no better time to cut taxes than during an economic slowdown. It is a little harder to reach into the wallet but now is when it really counts.

In closing, I think the early indicators are moving in the right direction and that the economy may finally be ready to rally. Since the war we have had indications that consumer spending is up, the market seems to be recovering, and just yesterday we learned that consumer confidence took its biggest jump since March of 1991.

Again, Mr. Chairman, I thank you for your consideration in returning to the committee, and I now yield to the ranking member, the gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. I join the Chairman in extending our appreciation to Mr. Greenspan for giving us this return engagement to accommodate this large number of members and also I have had a longtime interest in trying to rebut stereotypes. And Mr. Greenspan, I mean this quite seriously, for you, given where you are, what you have done, your age, your health, for you to be continuing as if none of this was of any moment and that the only important thing was doing your job really is an important lesson that I hope other people learn from. So I appreciate not just what you do but the way in which you do it. And I apologize for making a big deal out of something which I am congratulating you for not making a big deal out of, but I do think that needed to be said.

When you were here last time, you were asked and will be asked again about one central question, which is what is the relevance of a deficit, an ongoing deficit, an increasing national debt to our economic performance. We have had a great deal of debate back and forth about the role of the deficit. When I first got into politics, deficits were considered to be a bad thing and they were used as weapons against people held responsible for them. In the 1990s, a consensus appeared to have emerged in a bipartisan way that deficits should be brought down, that the debt should be brought down, and surpluses were a good thing particularly in normal economic times, particularly in good economic times and we were making progress in bringing it down. There was some general sense this contributed to the climate in which long-term interest rates could be lowered.

We are now in a reverse situation. We are in a situation in which the national debt is climbing back up again. You noted when you were here before us last time that we will begin to run into a problem in the teens of this century with regard to the demands of Medicare and Social Security. Many of us believe that this is directly relevant because the question is do we get to that point with a very large debt or have we begun to bring that debt down. They are not two separate entities. But what happens leading up to that period in terms of the debt has a lot to do with our capacity to deal with it. And in particular, we have this public policy issue, which is whether or not at this point it is appropriate to substantially reduce Federal revenues. I say substantially reduce, because quantity has become a new issue here. And I have to say as a liberal I am used to people saying oh, we don't value money enough and people have said you treat a couple of billion of dollars as if it is nothing. Well, I guess in that category now I am officially a piker because the President of the United States has just announced that $350 billion is, to use his technical economic term, itty-bitty. If $350 billion is itty-bitty, then I guess I have more ability to talk about money than before.

And I assume, by the way, and I look forward to seeing this graphically represented, there is this group, the Club for Growth, or the Clubbers for Growth, who have begun to put pressure on Republicans who dare dissent and having accused Senator Voinovich and Senator Snowe of French leanings, I can just imagine what they will do with itty-bitty. I look forward frankly to seeing the next commercial in which Senators Voinovich and Snowe are in yellow polka dot bikinis. I guess I really don't look forward to that, but it may happen. So when we have the President announcing that $35 billion a year, $350 billion over 10 years is itty-bitty then I am worried. Unfortunately, you know, to quote another former Senator, an itty-bitty here and an itty-bitty there and pretty soon you are talking about a lot of itty-bitty. And the question we have for you is what is the impact of this.

Now I was interested to note the study from Mr. Laubach which does argue what many have argued that there is a correlation between increasing national debt and interest rates, and I would be interested in your evaluation. I realize that not everything is official and one of the things for which we value the Fed is the first rate economic research you turn out, and not everybody agrees with everything but this seems to me to be pretty persuasive.

Finally, let me say here is what worries me. I think we are in the midst of bait and switch. We have had people who argued that deficits were a terrible thing suddenly changing their position. Indeed, I am reminded of—unfortunately he is French, Henry of Navarre, who became Henry IV of France. When he was the heir to the French throne, he was told that as a Protestant he could not become the King of France so he converted, and when asked about that said Paris is worth a mass. Well, we have had people, we have the Secretary of the Treasury, the Chairman of the Council of Economic Advisers-to-be, the Chief Economic Advisers to the President, there are people who historically have been critical of deficits. And I suddenly find now that their past criticism of deficits has somewhat changed. And I wonder whether the modern version of Paris is worth a mass has become Washington is worth a deficit. And I wonder why people would have changed.

What I am afraid of is this: If they haven't really changed, if it is bait and switch, that people are now pooh-poohing the deficit because they want to get a tax cut. But the real reason for the tax cut is not to be stimulative. As the chairman said, it is not aimed at short-term stimulus. The real reason is they want to reduce the revenues of the Federal Government because philosophically they don't think it is a good idea to have a country in which there are program expansions. And once they have succeeded in getting a tax cut, a double itty-bitty, and have increased the deficit, they will return to their previous deficit professions and try to use that as an argument for reducing Social Security benefits, for further cutting Medicare and for making other cuts.

I appreciate again your willingness to come here and I look forward to your evaluation of this important issue with the interactivity of deficits and interest rates.

The CHAIRMAN. The gentleman's time has expired. The gentleman from New York, Mr. King.

Mr. KING. Thank you, Mr. Chairman. Mr. Chairman, it is a pleasure to have you here. I commend you on your quick recovery and on your stamina. I am going to make a very brief statement, but I look forward to the questions today. I look forward to your statement. And if you could cover certain areas, one of which Chairman Oxley touched on in his opening statement, the economic impact, the potential economic impact of having a quick victory in Iraq to the extent that that is going to restore investor confidence, that perhaps is going to bring in businesses that were on the sidelines waiting to see what was going to happen with the war, the positive impact, if any, that will have on the economy; also on the decrease in energy, decrease in oil prices, the impact that will have on the economy as far as putting more money into people's pockets, the stimulative effect that that could have in the short term and perhaps even the long term.

On a negative aside, I would be interested in the impact that the financial crisis that State and local governments are facing, what that will have on the overall economy as to whether or not Federal policy or national policy could be enough to bring it forward or whether or not that is going to be a permanent anchor on overall economic growth, the fact that there are so many large deficits being faced by local governments which are going to cause tax increases in some cases, layoffs in another, combinations of both in others and the negative impact that will have.

Also following up on what Congressman Frank said, I am obviously on the other side of this issue. I would be interested to the extent that you could address the long-term impact of tax cuts as far as actually increasing revenues, providing long-term growth and restructuring that is, I believe, necessary to the long-term growth of the economy.

With all of that, all of us look forward to your testimony, and again I want to commend you on making such a quick recovery and being here. I think some of us could have used your condition—if it was me I would probably use it as an excuse to take 6 weeks off and tell my constituents how sick I was and how they should pray for me. But as I said you are an inspiration to all of us.

The CHAIRMAN. The gentleman's time has expired. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for being here today. Your appearance before this committee is extremely timely. Just yesterday, Treasury announced that it will need to borrow $79 billion this quarter, a startling reversal of more than $100 billion from recent projections. This is just another step in the massive fiscal reversal the Federal Government has experienced in the last two years. Today, using the administration's own estimates, the deficit is forecast at $304 billion for 2003, in contrast to the $236 billion surplus the President inherited when he took office. When the costs of war and rebuilding Iraq are factored in, the forecasts are even bleaker. In the short term, deficits may be acceptable if they are forecasted on getting the economy moving.

Unfortunately, the Congressional Budget Office macroeconomic analysis of the President's budget found little economic benefit from his financial and tax plan. CBO did note the impact on the deficit of the President's budget, a staggering $2.7 trillion through 2013. Independent economists at the IMF issued similar findings recently, saying of the economic plan and tax cuts, and I quote from the IMF, if enacted in full, they will significantly worsen the medium term fiscal position, unquote.

Perhaps the most unfortunate aspect of this deficit growth is that the administration's plan is overwhelmingly backloaded and not focused on putting people back to work today. This is an exceptionally serious problem as unemployment is close to 6 percent nationally. In my home city it is 8.8 percent. And nationally for African Americans it is 10.2 percent. These numbers, as you know, only cover those who are looking for work, not the growing number of people who are underemployed or who have given up looking for work, nor does it include the 100,000 reservists who have gone to the Gulf and will come home to reclaim their jobs.

I hope you will address the impact of the administration's economic tax plan on job creation, and I also look forward to your comments on inflation. Inflation appears to have fallen below the Fed's implicit target, specifically a measure that I know that you watch closely. The deflector for personal consumption expenditure has dropped to .9 percent, very close to zero. I hope that you will express your level of concern with this number and what changes and tactics or strategy the Federal Reserve is contemplating to deal with it.

Again, I thank you for your service to our country and I thank you very much for being with us today.

The CHAIRMAN. Gentlelady's time has expired. We now return to the distinguished gentleman, Chairman of the Fed, Mr. Greenspan.

STATEMENT OF THE HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Mr. Chairman and members of the committee, I am pleased to have this opportunity to update you on the developments of the U.S. economy since mid-February, when I presented the Federal Reserve's semiannual monetary policy report.

At that time, I noted that the economic expansion over the preceding year had been modest. Spending by households had contributed importantly to the gains in economic activity. The Nation's strong underlying productivity performance was providing ongoing support for household income. That rise in income combined with low interest rates, reduced taxes, and the availability of substantial home equity had spurred solid gains in consumer spending and a robust advance in residential construction.

In contrast, although the contraction in capital spending appeared to have slowed, we had yet to see any convincing signs that a sustained pickup in business spending was emerging. Moreover, heightened geopolitical tensions were adding to the already considerable uncertainties that had clouded the business outlook over the preceding three years. The general climate of caution in the business sector was manifest in a number of ways, including restrained hiring, reluctance to invest in new capacity, and aggressive actions to maintain low levels of inventories.

In late February and early March, the risks and uncertainties surrounding the economic outlook intensified as the range of possibilities for the timing, duration, and economic consequences of the impending war in Iraq appeared to widen. In financial markets, a greater sense of caution among investors seemed to bolster the demand for Treasury and other fixed-income securities at the expense of equities. The price of crude oil moved up as did the prices of gasoline and home heating oil and consumer confidence sagged further.

After picking up in January, payroll employment and manufacturing production turned down again in February and March. When the onset of the war became imminent, financial markets rallied and the price of crude oil dropped back. Market participants seemed buoyed simply by the elimination of uncertainty about the timing of the start and hence the end of hostilities, although still a significant amount of unease inevitably remained about the way the war might progress and how severely it might disrupt oil production and economic activity.

In such an environment, we had little ability to distinguish temporary changes from more persistent shifts in underlying economic trends. For that reason, the Federal Open Market Committee at its March 18 meeting refrained from making a determination about the balance of risks with respect to its long run goals of price stability and sustainable economic growth. At the same time, we stepped up our surveillance of economic developments. As part of that surveillance, we received virtually continuous information from commodity and financial markets. The price of crude oil is now well below its peak of early March as the potential for serious supply disruptions in world oil markets has diminished. Broad equity indexes remain well above their lows of mid-March and have been boosted most recently by incoming information on first quarter earnings that market participants appear to view as generally positive.

In contrast, six weeks after the beginning of the war, we have only limited readings on broader economic conditions and that information has been mixed. Households appear to have become somewhat less apprehensive about the economic outlook in recent weeks, though reports from businesses have not exhibited a similar improvement in tone. Consistent with this, the persistent high level of new claims for unemployment insurance suggests that firms may still be finding it possible to meet their customers' tepid increases in demand with a leaner workforce.

Going forward, some further unwinding of the economic tensions that have been associated with the situation in Iraq seems likely. As that occurs, the fundamental trends shaping the economic outlook should emerge more clearly.

As I indicated when I met with you earlier this year, I continue to believe the economy is positioned to expand at a noticeably better pace than it has during the past year, though the timing and extent of that improvement remains uncertain. Fundamentally, the long run growth potential of the economy remains solid and the enhanced flexibility inherent in that trend imparts resilience against shocks of the kinds that we have experienced in the past few years.

Unfortunately, the future path of the economy is likely to come into sharper focus only gradually. In the interim, we will need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

As you may know, the consensus of economic forecasters is that a material rebound in economic activity will develop in the second half of this year and certainly a number of elements should be working in that direction. The recent improvements in financial markets that I noted earlier, if maintained, would seem to suggest a turnaround in capital spending. In this regard, the ongoing decline in risk spreads in corporate bond markets so far this year is an encouraging development. To be sure, spreads remain high by historical standards but the constraint imposed by last fall's huge run-up in risk premiums now appears to have been put largely behind us.

In addition, businesses should see some relief from the pressure on profit margins that had developed in recent months as energy prices rose sharply. An improvement on this front could be a positive development for capital spending. A modestly encouraging sign is provided by the backlog of orders for nondefense capital goods, excluding aircraft, which has been moving up in recent months. Households, too, are likely to welcome lower energy bills and a continuation of favorable conditions in mortgage and credit markets.

As you know, core prices by many measures have increased very slowly over the last six months. With price inflation already at a low level, substantial further disinflation would be an unwelcomed development, especially to the extent it put pressure on profit margins and impeded the revival of business spending. The balance of influences on inflation and economic activity will be among the subjects of discussion by the Federal Open Market Committee when it meets in six days.

Mr. Chairman, I look forward to your questions.

[The prepared statement of Hon. Alan Greenspan can be found on page 71 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman. And let me recognize first the gentleman from Iowa, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. Mr. Chairman, could you comment on the reasons and implications of weakening exchange rate of the dollar vis-a-vis the Euro. And secondly, has the Fed done any studies or are you prepared to comment on the economic implications of the spread of disease, particularly AIDS and SARS?

Mr. GREENSPAN. Mr. Leach, as I think I have indicated on numerous occasions, we in this government have a special agreement amongst us that stipulates that any comments with respect to the exchange rate be left to the Secretary of the Treasury as our general spokesman. And as much as I would like to comment, I am obligated not to and I apologize.

Mr. LEACH. Do you have the same rule with the NIH on disease?

Mr. GREENSPAN. No. And therefore I am fully able to expose to you my lack of knowledge on a lot of these issues. There is not terribly much I can add to the issue of AIDS. That is a fairly well understood and very devastating process, and it is clearly doing extraordinarily unfortunate and negative things to a number of areas in the world, especially in Africa.

The SARS issue is more recent, more uncertain and more difficult to pin down, but we know certain things. We know it has had a very major negative impact on air transport obviously, vacations, all aspects of the type of holiday parts of our economy, if I may put it that way, which rests on travel and visits. Since a fairly significant part of Southeast Asia does rest on travel and tourism, it is beginning to have some effect specifically in Hong Kong, to a lesser extent in Singapore and China, but it is pretty much contained in that area. As you know, the World Health Organization just recently indicated that Vietnam has contained SARS. There is very little evidence that outside of the tourist-related aspects of the economies in Southeast Asia that much has been impacted.

You have to remember that there are one-and-a-quarter billion people in China and even though the numbers on SARS are large, they are clearly just a negligible part of the total at this stage. But it is clearing having some modest effects.

Our concern would largely be the fact that in the manufacturing area, because we have just-in-time techniques fairly sophisticatedly tied into many of the production operations in Southeast Asia, that if the production part began to be eroded by absenteeism or other issues which would contain production, it could feed back into the United States through the just-in-time processes. To date, there is just no evidence of that. Apparently, production is being maintained and we see no backing up in any significant way of supply lines in the United States.

Mr. LEACH. Thank you, sir.

The CHAIRMAN. Gentleman yields back. The gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Chairman Greenspan, the questions I am going to ask you I am going to make them based on the role that I play in the House Small Business Committee, and I want to take advantage of your presence here to help me understand the President's stimulus package. He is proposing an enormous stimulus package, the centerpiece of which is a dividend tax cut for large corporations. During previous testimony before Congress, you stated that you support the principle of the repeal of the dividend tax. One of the many problems I have with the dividend tax cut is that it offers no relief to millions of small businesses that are organized as S corporations, partnerships and individual owners who will see no benefit from the repeal. The dividend tax cut is going to create a tremendous incentive to put your investment dollars into companies that can issue these tax cut free dividends.

Mr. Chairman, can you explain how investment dollars will not be shifted away from small and mid-sized firms to these large corporations who benefit from the repeal of the dividend tax cut?

Mr. GREENSPAN. Well, Congresswoman, I think it is important in the context of the President's proposal to recognize that there is not only a significant reduction or in fact, depending on how one ultimately decides this, the potential full elimination of the double taxation of dividends, but there are also significant cuts in marginal tax rates. So far as Subchapter S corporations owners are concerned, that clearly is a far more significant factor for them than would be the issue of elimination of the double taxation of dividends, although obviously I am certain that owners of Subchapter S corporations are significant holders of common stock.

I must say to you, Congresswoman, I am a very strong supporter of expanding the scope of Subchapter S corporations, because in a sense that also eliminates the double taxation of dividends. That is in fact what a Subchapter S corporation does. So in that regard, owners of Subchapter S corporations have already had the double taxation eliminated. And I would hope that we could expand that particular form of organization, because as I am sure you are more aware than I, a major part of economic growth in this country comes out of small business, certainly the vast proportion comes out of small business. Anything we can do in that regard to enhance expansion of small business I think is in the national interest without question.

Ms. VELAZQUEZ. Small businesses represent nearly 99.7 percent of all businesses. Small businesses employ collectively more than half the private sector workforce and generate about three-fourths of net new jobs each year. In addition, these firms also generate more than half the revenue of all U.S. Firms. As Congress continues to consider the size of the final tax cut package, it is unlikely that both the dividend tax repeal that large businesses favor and the accelerated income tax cut and expensing provisions that small businesses favor will both pass. If you had to choose which of these provisions will better stimulate domestic economic growth, which one would you choose?

Mr. GREENSPAN. I would choose to abstain from answering that question. First of all, I will not and hope I don't have to be pressed to get into answering details of the President's package. But these are complex issues and there are a lot of different analysts who come up with different judgments, and I think the second panel will be glad to address that in some detail. In fact, you will probably not be able to prevent them.

Ms. VELAZQUEZ. Mr. Greenspan, I am tired of hearing all the time when people want to lecture us about our economy how great small businesses are for our economy, that they are the fuel for the engine of our economy and they are the ones who take us out of recession, but when it comes to the final package I just want to make sure that those provisions that are going to help small businesses who will stimulate economic growth will be there.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlelady's time has expired. The gentleman from New York, Mr. King.

Mr. KING. Chairman Greenspan, in your statement and other economists seem to feel that the economy is growing stronger and especially in the second half of this year we should see more growth. Let me ask two questions, one involving national and one international, as to what could be the impediments to that growth and see what your response is.

One is that no matter how strongly based our economy is, how far forward can we go if overseas economies continue to be weak, particularly Western Europe and Japan? And secondly on that line, especially Japan, how tied to our economy is Japan? How tied is Japan's economy? Are we—as far as talking about large scale long-term growth, is there an opportunity for Japan to do anything more, because there is economic malaise there that seems to have been going on up for a better part of a decade.

Secondly, on the domestic front, one of the strong points of our economy consistently in recent years has been the housing market and the housing starts. With local and State governments faced with budget cutbacks or budget problems, that is inevitably going to result in property tax increases. How will those property tax increases impact on housing starts and on the housing segment of the economy?

Mr. GREENSPAN. First of all, if you look across the spectrum of major economies in the world, we are clearly the most resilient and potentially the most productive of all. There is no doubt that we depend upon and have gained very significantly from international trade and obviously that is determined to a substantial extent by the general level of economic activity in the world at large. So clearly, if Europe and Japan are weakened, it will impact on us. But we are still very substantially a self-contained economy and we have huge markets here, indeed everyone wants to come here as you well know. So I would think that yes, residual weakness in Europe and Japan will have a negative effect but not a very large one.

Far more important is the apparent underlying, still unexploited, fairly significant capital investments with potentially significant profitability over the longer run, which I mentioned here on numerous occasions and specifically did so last February. That outlook has not changed and, if anything, it is something that is far more important to project in the longer-term U.S. outlook than anything else that is going on elsewhere.

To be sure, Japan is having very considerable difficulties. They have had them for quite a long period of time. That underlying trend is already built-in, if I may put it that way, to our relationship with them in an economic sense. I am not going to say it is discounted, but we have adjusted to that particular state of affairs. So I am not terribly concerned about the international impact on the American economy as such.

So far as the housing issue is concerned, it is certainly the case that it just remains continuously buoyant. Mortgage interest rates have been kept down quite significantly. There is still significant refinancing going on even though it is clearly off some of the astronomical peaks that we have just seen, but it is pretty viable. And housing starts and sales and existing home sales all continue to look reasonably good. To be sure, if you raise property taxes, it will have some effect, but my impression is that the order of magnitude of the types of changes that are likely to occur are sufficiently small as to probably be lost in the rounding with respect to the viability of home construction and its importance to the American economy.

Mr. KING. Thank you.

The CHAIRMAN. The gentleman yields back. The Chair now recognizes the gentlelady from Indiana, Ms. Carson.

Ms. CARSON. Thank you, Mr. Chairman, for being here and I am glad to see you are on the rebound. Hope you continue to do that. I have a very quick question here and I know that you said you don't want to get into defending the President's tax package and if it is one of these questions, I will yield back. The President has now equated tax cuts with jobs and called for a first round tax cut bill of at least $550 billion. The recovery is now through 2013. Given that I represent Indianapolis, where we experience a high rate of bankruptcies, high rate of home foreclosures, high rates of unemployment, probably one of the highest segments around the country, I am wondering if you could feel free to say whether or not you believe that in fact the stimulus in terms of job recovery, the $550 billion tax cut.

Mr. GREENSPAN. Well, Congresswoman, I haven't changed my view from where I was at this committee in February. I am in favor of the elimination of the double taxation of dividends. In fact, I am very strongly in favor of reducing taxes on capital per se on the grounds that I believe it slows the economy and effectively undercuts income growth through all areas of the income distribution.

So in general, I strongly support those types of tax cuts which remove burdens off capital. But as I also indicated in February, and indeed as I indicated back in September, I was very much concerned that the budget rules—which had been, in my judgment, surprisingly effective, specifically PAYGO and discretionary caps—were being essentially allowed to lapse and that I strongly supported their continuation, which in my recollection, was due to terminate in the House on September 30, and I strongly advocated continuing those.

Now if they had been continued, if I were testifying on a particular project, I could be strongly supportive of certain types of tax cuts, as indeed I am but in the context of PAYGO and a recognition of the necessity to contain what I perceive to be a trend toward increasing budget deficits. And that left me with the conclusion that we needed to curb spending far more significantly than we did. In my judgment, that type of package would, over the long run, be conducive to a better degree of economic growth and one would presume that at least part of that would be reflective in a significant increase in job creation.

Ms. CARSON. I yield back, Mr. Chairman.

The CHAIRMAN. Gentlelady yields back. The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman. I have a couple of questions regarding the Fair Credit Reporting Act. You have stated that the FCRA national standards ought to be made permanent because, among other things, limits on the flow of information among financial market participants or increased costs resulting from restrictions that differ based on geography may lead to an increase in the price of or reduction in the availability of credit. In light of the important role that consumer credit has on the economy, could you explain whether such limits or information flow or increased costs would have a positive or negative effect on the economy?

Mr. GREENSPAN. Well, Congressman, we have a really extraordinary consumer credit market. It has become unbelievably complex and sophisticated. It was not that many decades ago that most small bankers, and most bankers were small bankers, pretty much knew the credit capability of those to whom they lent and they had pretty sophisticated ways of controlling credit risks and those markets worked.

But as we got ever larger and more sophisticated, it was no longer possible for each individual borrower to be readily evaluated in that old-fashioned way. And what occurred was the development of a rather extensive credit bureau-type system which collected information on the credit characteristics of various different borrowers and set up the capability of being able to judge individuals more or less on the basis of their credit records.

There have been a lot of complaints about inaccuracies and all of that and I am fully aware of that, and I think efforts are being made to minimize that sort of problem. But there is just no question that unless we have some major sophisticated system of credit evaluation continuously updated, we will have great difficulty in maintaining the level of consumer credit currently available because clearly without the information that comes from various credit bureaus and other sources, lenders would have to impose an additional risk premium, because of the uncertainty, before they make such loans or indeed choose not to make those loans at all.

So it is clearly in the interests of consumers to have information continuously flowing into these markets. It keeps credit available to everybody, including the most marginal buyers. It keeps interest rates lower than they would otherwise be because the uncertainties which would be there otherwise will not be there. And as I have indicated previously to a similar question the last time I was here, I think it is terribly important that we continue forward in this type of credit evaluation process.

Mr. GILLMOR. I think you answered what my second question is, how that might lead to a reduction of the ultimate sharing of risks and rewards. Where do you think the likely market impact of State imposed restrictions on prescreen offers of creditor insurance and in particular would consumers in rural or underserved areas have less access to creditor insurance or pay more?

Mr. GREENSPAN. I have been in favor of national standards here for reasons which are technically required. If you have very significant differences State by State, it would be very hard to maintain as viable a system as we currently have.

Mr. GILLMOR. Thank you, Mr. Chairman.

The CHAIRMAN. Gentleman yields back. The gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. Mr. Greenspan, the study that was done by Thomas Laubach, if I pronounced it correctly, in March and I understand it is not officially endorsed, but his conclusion is that there is a four or five basis point increase in long-term interest rates in response to a percentage point increase in the debt to GDP ratio. That is in his conclusion on page 13. As I look at CBO's official statements here, in 2013, the end of our 10-year projection, according to CBO, on the baseline, the percentage ratio there was to be 16.8 percent. That was the baseline. Their estimate based on the President's submitted budget is 32.2 percent. That is an increase of 14 points. Now using Mr. Laubach's formula, that becomes about a .6 percent increase, about 60 basis points, between 56 and 64 percent. We are not in an area of exactitude and I realize the President's budget was not enacted or adopted, but it is a close approximation. Do you think that is a plausible estimate of the effects of the President's budget as opposed to the baseline?

Mr. GREENSPAN. Congressman, I can't comment on the specific calculations, but I can comment on the study itself. I thought it was an exceptionally good study. It is interesting because in years past it has always been difficult to infer the impact of what deficits did to interest rates, and the reason for that is there was a tendency to use as the interest rate involved either the 10-year Treasury note or in some cases the 30-year bond. Now what we know about interest rates is that a 10-year note, for example, is effectively a weighted average of a whole series of short-term rates between zero or one day and 10 years and that with the business cycle inducing very significant movements in short-term rates, what tended to happen in periods of recession when deficits went up, you would find that the 10-year note went down contrary to what one would expect.

What Laubach did, which a number of economists do for other reasons, was essentially to endeavor to smooth out the business cycle and the short-term rate impact on the 10-year Treasury and effectively ask what is the impact on that part of the Treasury note, as I recall it, that is essentially five-year interest rates five years from today. And somewhat to my surprise, it came out far more robust as the relationship indicated that the greater the deficit, the greater the long-run interest rate.

Mr. FRANK. In other words, your sense, deficits affect long-term interest rates if anything has been strengthened since you were last here because you found in Mr. Laubach's study a more robust relationship than people might have expected?

Mr. GREENSPAN. The difference between his analysis and previous ones, which had difficulty finding that relationship——

Mr. FRANK. I think this is very relevant and it is a current issue. There are people who have denied that there is any deficit long-term interest relationship. I was interested in reading Mr. Laubach's paper. I skipped over the regressions. I will do those later. But he does quote another very distinguished economist who is saying the interest rates effects of deficits depend on how persistent those deficits are assumed to be. Now of course we are talking about deficits as far literally as the eye can see under rules. And the economist he is quoting is Martin Feldstein. So the consensus of deficits here seems to be a strong one. I appreciate that and I think that is a very important point.

We are talking about stimulus. We have had a significant increase in unemployment with all of the social distress that complicates everything else. You discussed how trade policies become harder when people are more afraid of losing their jobs and health care. You say here that you begin—you see the economy perhaps getting better. My question is how much short-term stimulus do you think we need right now, especially given your view that there was a trade-off between increasing that debt ratio and interest rates? What is your sense of how much short-term stimulus we ought to be enacting right away?

Mr. GREENSPAN. Well, that is an ongoing question in the sense that we already have a significant amount of stimulus in place. I mean, clearly, as of now we have got a fairly large government expenditure trend and clearly low interest rates. Obviously, I have said in the past, and my belief is that it is very difficult to fine-tune fiscal policy for short-term stimulus purposes and I have tended to be strongly supportive of the employment and fiscal policy for long-term structural growth issues and leave monetary policy to be applied in the short run. If it turns out that, contrary to my expectation, we somehow can fine-tune fiscal policy in timing and in content, I would change my mind but I have seen no evidence that that is the case, although I do admit that the 2001 tax cut did turn out to be extraordinarily well-timed from the point of view of the economy, but I don't think we can count on that generally.

Mr. FRANK. You would not be wanting to repeat that and especially given that we have the deficit interest rate impact?

Mr. GREENSPAN. Yes. My view is that clearly we still have room in monetary policy if we choose to move and if stimulus was required. So I still have not essentially changed my view about what the appropriate balance is between——

Mr. FRANK. Mr. Chairman, just a second, I would like unanimous consent to introduce into the record the study by Mr. Laubach that Mr. Greenspan and I were discussing and maybe want to pause so that the journalists can run out and call in the fact that he said there is room for reducing monetary policy.

[The following information can be found on page 115 in the appendix.]

Mr. GREENSPAN. That is not news. I have said that on many occasions.

The CHAIRMAN. The gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman. I represent Rockford, Illinois, which in 1981 led the Nation in unemployment at 24.9 percent. We have a 25 percent manufacturing base. Our unemployment now is at 11 percent and it is going right through the roof. The manufacturing orders and the manufacturing output—the figures that the Fed uses do not reflect the percentage of imported parts that are going into manufactured items as they are completed in the United States. Those figures simply do not exist with the exception of bonded matter going to Mexico under NAFTA and the NAFTA content on automobiles. And continuing is the fact that the Defense Department, particularly the Air Force continues to grant massive waivers of the Berry amendment and the Buy America amendment that has allowed, for example, the Russians to dominate our titanium market and destroy tens of thousands of jobs related to nickel and titanium and the people who fabricate those, especially in the State of Pennsylvania and Ohio. In fact, Ingersoll, 122 years old company in Rockford, Illinois, went bankrupt last week, and one of the reasons is that Northrop Grumman decided to send a contract to Spain as opposed to keeping it in the United States for the U.S. Portion of the production of the Joint Strike Fighter with NATO, and Spain is not a member of that seven nation consortium.

My question to you is this. As I read the Fed figures, it does not indicate the hollowing out of American manufacturing and the systematic destruction of tens of thousands and now 2-1/2 million jobs of manufacturing that are never going to come back. Does the Fed have any way to try to have new studies to indicate the true nature of the loss of manufacturing jobs so that we can state that the recovery in this country will not start until we restart and reestablish our manufacturing base?

Mr. GREENSPAN. Well, Congressman, I think one of the problems in a statistical sense is that the share of manufacturing in the total gross domestic product is not changing all that much. What is occurring is extraordinary productivity gains in the manufacturing area, which has to a very large extent accounted for—as you point out—the dramatic decline in jobs. There is no question that open borders and international trade create huge degrees of competition throughout the system and very specifically in a number of areas to which you alluded. But overall, as I indicated earlier, the net effect of general trade has been very advantageous to the United States for the post-World War II period.

Mr. MANZULLO. I am not talking about trade. What I am talking about is the fact that there is a coring out of our domestic manufacturing industry that the trade figures do not—I have lost 19 percent of my manufacturing jobs in the past year-and-a-half. That is 10,000 jobs.

Mr. GREENSPAN. I understand that.

Mr. MANZULLO. It is not really trade related.

Mr. GREENSPAN. It is in a sense that there is a very significant shift in the capital structure in the United States from industry to industry and the consequence of that are the types of numbers to which you allude. I don't want to get into the national security aspects of some of the issues that you raised, but that is a different type of issue when we get to how that is handled. That is more a DOD issue.

Mr. MANZULLO. I wish it was yours because the Air Force doesn't understand.

Mr. GREENSPAN. The bottom line is that we at the Federal Reserve endeavor to adjust our policies to maximize long-term economic growth in the economy as a whole and we cannot and should not endeavor to implement policies which differentiate or endeavor to differentiate various different aspects of our economic structure.

Mr. MANZULLO. And you are doing a super job at it, and thank you for coming.

Mr. GREENSPAN. Thank you very much.

The CHAIRMAN. Gentleman from Illinois Mr. Gutierrez.

Mr. GUTIERREZ. Mr. Chairman, yesterday, we received Treasury's final rule regarding section 236 of the U.S. Patriot Act, which provides guidelines for financial institutions to identify their customers. Section 326 states, and I quote, "if the customer is a non-U.S. Person and does not have a U.S. Taxpayer identification number, the bank may obtain an identification number from some other form of government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard."

As I interpret the rule, financial institutions could have the flexibility to accept government-issued IDs such, as the Mexican Government's matricular consular card that allows Mexican nationals currently under FDIC rules and others to open up bank accounts in the United States.

Given the fact that we have estimated, depending on whose estimate, Mr. Chairman, 6, 7, 8, maybe 10 million undocumented workers in the United States of America, and given the fact that just days prior to September 11 people forget that President Bush and President Fox were discussing a way of regularizing the economic activity of Mexican nationals in the United States, and given that this makes up the fifth pillar of the Mexican economy, that is remittances back to the United States, and if you bank, you know, you and I want them to have the same rate as you and I would at a beach in Acapulco with our ATM card versus a Western Union or Monogram, which sometimes fluctuates as much as 16 or 17 percent fewer dollars than the Wall Street, what do you think of the idea of using the Mexican Government's consular card and other consular cards, and is the Fed ready to join the FDIC and others in supporting the use of the Mexican consular ID card as a form of identification?

Mr. GREENSPAN. Congressman, I am familiar with the particular issues which you raised, but my general view, at least with the state of my knowledge now, is that I was not able yet to be exposed to the complexity of the choices and the alternatives because these are very complex issues, especially as they have arisen subsequent to September 11. I would prefer to go back and take a look at some of the details of the arguments here and perhaps respond to you in writing to give you a more informed view than I could at this particular point.

Mr. GUTIERREZ. It is very fair. Thank you very much. We would just like you to look at it because it seems to me that, you know, when we listen to the Justice Department and we listen to others, it is at one moment we are talking about regularizing a work force, and we are passing all—we are spending all of this money and passing all of these laws so that we can find out the activity of everyone, and it just seems to me that a very simple way of identifying, having a picture and fingerprints of millions of people in the United States you would not otherwise be able to get, and so, therefore, in terms of national security issues it seems that this is the way to do it. And I called the IRS, and the IRS really does not care. They just want them to pay their taxes. I am sorry, Mr. Chairman, that's all the IRS. I talked to Social Security, and they said, well, just make sure they do not put any dependents down. So when I talk to them about undocumented workers, even our Federal Government said, oh, do not worry, Congressman, just send their applications in, and we will give them a tax ID number, and then they can go with the matricular consular and open up their bank accounts. So obviously our Federal Government is taking their tax dollars in and even allowing them to submit income tax returns.

A second question, Mr. Chairman, in 2002 you remarked that the ABA conference, and I will quote you, "the use of credit scoring models, whether turnkey models purchased from providers or proprietary models developed in house, has taught bankers sometimes through costly experience the value of continually updating the database on which the model operates," end quote. I would like to get your opinion as to whether there is value in providing customers, particularly mortgage applicants, information about their credit score. I mean, not limiting it just—limiting it to just handing over a number, but providing sufficient explanation of the rationale for the key factors that influenced the mortgage applicant's credit score, the date of the score, the source of the score. Will not disclosure of this information also help in updating the databases by consumers who are, in my opinion, in the best position to ensure the accuracy of the information? Also, does not the lack of information put consumers who are shopping for a mortgage at a disadvantage, especially when banks advertise APRs for only the best-qualified applicant, a near perfect score?

Mr. GREENSPAN. Well, in general I just want to say that over the years we have developed a really quite extraordinary mortgage market, which has been in the last year exhibited in the form of a huge interaction of the American public with our mortgage system. We have had, as you know, a huge number of refinancings, very substantial cashouts, and millions of transactions, which in general, I think, has helped both homeowners and the economy in general.

There is no question, however, that it is crucially important that individual borrowers be fully cognizant of precisely what they are doing and various choices that they are making. And having looked at some of the detailed data and material available in the mortgage processing area, I hope we can sharpen it somewhat better if we can make it clearer in many cases.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. It is great to have you here. I am glad you are well and life's treating you good.

I really appreciate the gentlewoman's comment regarding small business and your concerns, and I applaud that. However, I continue to hear arguments against tax cuts for those in the upper income tax brackets; yet those are generally the brackets where small business owners fall within if they are doing a reasonably good business. If they do not, they are generally not providing many jobs, and I think we need to do what is necessary to encourage consumer spending, to promote investment, both individual and business, and if people do not have a job, we need to do what we can to create more jobs.

But I am convinced if people do not have cash in their pocket, they cannot spend it. They can continue to go into debt, and many will go into debt regardless. They will use credit cards or whatever. But I know you do not want to defend the President's tax package, and I am not asking you to do that, but as you notice, Congress is unwilling to cut spending, so we keep spending, deficits grow, and things do not seem to change in Washington. But I think we need to look at what the market impact might be on the economy with the President's new package in place, and can you respond to that?

Mr. GREENSPAN. I cannot specifically, because that would get involved in certain elements of the program. As I said, Congressman, I find much to support in the President's program, provided it is matched by cuts in spending, because——

Mr. MILLER OF CALIFORNIA. That is the key with cuts and not spending for——

Mr. GREENSPAN. Let me tell you why it is, and it does rest on the issue of whether deficits, or expectations of long-term structural deficits, which is the more important question, affect long-term interest rates.

Indeed, there are powerful reasons to suspect that, for example, the elimination of the double taxation of dividends and significant cuts in higher marginal rates will elevate long-term productivity in the country. If, however, in the process you get significant increases in deficits which induce a rise in long-term interest rates, you will be significantly undercutting the benefits that would be achieved from the tax cuts, and therefore, I have concluded all along and continue to conclude that it is very important for us to maintain the degree of fiscal restraint over the years ahead, because it is only under those conditions that I think we can create a fiscal policy which significantly assists in acceleration of economic growth, which we will sorely need as we move beyond this particular decade and run into the very large increase in baby boomer retirements.

Mr. MILLER OF CALIFORNIA. It seems rather disingenuous on our part, hearing what you have said, to say on the one hand we need to stimulate the economy, we need to create more jobs, yet, on the other hand, we are unwilling to cut spending. I mean, we tried to do that this time, and it pared way back from what we were even trying, which was minimal, I believe, in this budget.

On the other hand, being in the development industry for probably 30 years myself, I am still doing some investments in that, and having many friends in there, I am convinced that they invest money if they have it. And if you look at the upper brackets, and if a person is paying State income taxes and such, he is probably paying 50 percent plus other user fees and taxes that you locally pay. So when you are taking 50 percent out of the pocket of a business owner that they would otherwise put back into their business through job creation or investment—because there is no sense, as you know, putting money in a bank today and getting a percent and a quarter interest—they are going to find a better source for their funds, and that is generally investing it in something that they will make a profit on, and that in and of itself creates a job.

It's difficult for me to accept the fact when some say, well, we need to provide jobs, we need to do what we can to get people back to work, yet we are unwilling to do our job by cutting spending, because it creates the deficits if we provide tax cuts, and yet the only way I see we are going to get job creation moving in this country is to put more money in the economy, and that is by allowing people to keep more of their money by not just giving them a grant, but say keep more of what you earn; thereby you are able to invest that back into your business.

Would you comment on if we were willing to cut spending from the Federal perspective and provide tax cuts to people, would that not be more beneficial to the economy?

Mr. GREENSPAN. Oh, indeed. I have argued that over the years.

Mr. MILLER OF CALIFORNIA. I hope my friends on the other side of the aisle are listening very closely because I hear other things than they think they hear. Repeat that again. I want to make sure everybody heard that.

Mr. GREENSPAN. I have argued before this committee on numerous occasions that curtailing deficits and at the same time lowering taxes on capital is a major way to expand economic growth in this country and increase the incomes of all Americans eventually in the process.

Mr. MILLER OF CALIFORNIA. I agree with you.

The CHAIRMAN. The gentleman's time has expired.

The gentlewoman from Oregon Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chairman, and thank you for being here. I thank you for helping keeping the interest rates low. It's allowed me to refinance my house, as well as many other people.

I am go going to ask you a couple of questions, and one is I am very concerned about jobs and job creation. I think most people here are. I come from a State where we have the highest unemployment rate at 7.6 percent, so I am very interested in what is going to help create jobs for people. And we all know what happens when people do not have those jobs.

I am troubled by a seeming conflict of some numbers. I sit on the Budget Committee, and in March we were talking about the President's tax relief package, and they were talking something like 190,000 jobs would be created with this. More recently, a month and a half later, we are now talking about 1.4 million jobs created with this same amount of money. Do you have any explanation for why that may have changed so dramatically from 190,000 job creations to 1.4 million?

Mr. GREENSPAN. No, I do not, but I want to point out that there is a very important issue that I alluded to in my prepared remarks, and it is that productivity has really been impressively strong, especially in recent quarters when this economy has been weak, and what that has meant is that, as I put it in my prepared remarks, businesses were able to meet increasing demand, although weak increases, with an ever lesser work force, which is another way of saying that output per laborer has gone up significantly.

So part of the weakness in the labor market is the numerical consequence of this really quite strong and, I must say from a long-term point of view, highly desirable improvement in productivity. So we are going to need to get economic growth rising at a pace sufficiently in excess of the rate of growth of productivity in order to get the job market to be far more viable again, and most people's forecasts, in fact, imply that. If you look across the spectrum of most economic analysts, even though they and we do not see the immediate effects of the end of the Iraqi war, and we cannot, obviously, because it is too soon, most people have got fairly strong increases in demand and enough to cause a marked increase in the level of employment.

But it is going to require more than historically has usually been the case in getting increased growth in the GDP because the productivity growth is so impressive.

Ms. HOOLEY. So you think the productivity growth—I mean, we have just lost—in the last 22 months we have lost 450,000 job. Is that because of productivity?

Mr. GREENSPAN. We have no evidence that the GDP has been going down in the current quarter, for example, although its growth is very low, but clearly a very significant part of the loss in jobs reflects the fact that economic growth is being very closely matched by growth in output per hour, leaving very little room for significant increases in jobs.

I think that will change. I think this is a temporary phenomenon, and that as we get into the second half, and a number of the positive forces again begin to emerge, I think that is going to change, and that has been a view which I think a very substantial proportion of economic forecasters now hold.

Ms. HOOLEY. Mr. Chairman, one of the things that I think all of us are looking for are, in fact, how do we stimulate the economy, what is the best thing we could do, what is the best thing we can do short term? So if I ask you to put together a package, or ask you if there was something in the President's budget that would provide the most immediate stimulative impact for jobs, because for the people of my State and, I think, across the United States, that is what people are interested in right now, how do we make sure we can create jobs? What would that one piece or one thing be that would have an immediate stimulus impact for job creation?

Mr. GREENSPAN. That is an exceptionally difficult question to answer in general, and I do not want to get into it because it will, I am certain, get me more involved in discussing the relevant choices in the programs which the Congress has now got to address, and I don't have anything more to add to that than I did back in February.

The CHAIRMAN. The gentlewoman's time has expired.

The gentlewoman from Pennsylvania Ms. Hart.

Ms. HART. Thank you, Mr. Chairman.

Thank you, Chairman Greenspan, for coming back to visit so quickly, and I am glad to hear you are doing better healthwise.

I had a question specifically, actually two questions, regarding the Check 21 Initiative, and I understand that the legislation that is being considered by our committee has been supported by the Fed.

Mr. GREENSPAN. Are you talking about Check 21?

Ms. HART. It still is supported by the Fed; is that correct?

Mr. GREENSPAN. Indeed.

Ms. HART. Okay. As you know, it would greatly expand the ability of financial institutions to move checks through the payment system electronically without the need to have actually the cancelled check itself move through the system. But there is a portion of the bill regarding expedited recredit language that I am especially interested in. It is included in our proposal on the basis that the compliance burdens would outweigh the benefits of the recredit. I understand the Fed's position on that has changed, and I am——

Mr. GREENSPAN. That is correct.

Ms. HART. I am interested in why the Fed believes the current protections under the existing check law are sufficient to ensure that consumers are not adversely affected by legislation if the recredit provision was removed, and what would happen if the expedited recredit provision were extended to cover all checks?

Mr. GREENSPAN. We originally included that, as you know, in our early recommendations with respect to check truncation legislation. Subsequently, on evaluation in far more detail, it turns out that most, almost all, of the protection that one would envisage from that provision is already fairly conclusively achieved under current law, and that it was our conclusion, having reviewed this in more detail, that indeed the additional costs of compliance that the new provision would impose exceeded by any measure we could find the benefits over and above the protections currently in the law.

So we have chosen to alter our proposal on the grounds that we think that it is more balanced, and indeed, as we all hopefully do when we find out that we can do something better, we change, and we did.

Ms. HART. I thank you for that explanation.

Also, on the check truncation issue, can you share with the committee the images that the check truncation would provide to the domestic banking system? Some have indicated, not the members of the committee that is, but others who have testified have indicated, that they are wary of the legislation because they believe it will result in confusion with the elimination of the original check, possible double use of the original check and the image check. I am interested in your view of that. Is there a reasonable concern attached to that concern about the creation of substitute checks and the technology associated with check imaging?

Mr. GREENSPAN. I think not. I think we have reviewed all of the potential things that can go wrong in a system of that nature, and

I do not want to say to you that we know for certain that upon enactment various things will or will not happen, but from everything we can see, those are not concerns which we think are of significance.

Ms. HART. I thank you for that as well as I yield back.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

One thing where I guess we will just have to agree to disagree, Mr. Chairman, is the assumption that private sector spending is good, it stimulates the economy, and public sector spending is bad and must be cut back. It would seem to me that purchasing as a society one more school bus than we have today creates the same level of expenditure, the same stimulus as if as a society we buy one more of those new $300,000 Mercedes Maybachs. But I guess we will have to agree to disagree. Apparently if we can just make sure that one more very rich individual buys one more $300,000 Mercedes, that is going to help the economy.

But, Mr. Chairman, there is in your statement, there is an implied criticism made—almost an attack, by the more explicit statements by my friend the gentleman from California Mr. Gary Miller—in which, it has almost become the joke or cliche where the serial murderer sends in a note saying, “stop me before I kill again.” What we seem to be hearing from the other side is, “stop us before we waste again.” I would hope that in a city dominated by Republicans and a White House that has promised not to spend a single penny more than is necessary, that we wouldn’t need to have to undermine fiscal responsibility on the tax side in order to get an OMB that actually limits us to necessary expenditures.

So, Mr. Chairman, I will ask you to consider a parallel universe, a hypothetical situation in which there is a government dominated by people who want to avoid unnecessary expenditures, and they have eliminated all the unnecessary expenditures, and they will not make any unnecessary expenditures. Those expenditures are fixed. In other ways this parallel universe is just like our own. Should that hypothetical United States run a $200 or $300 billion deficit, or should it have tax laws to bring in as much revenue as those necessary expenditures, every one of them signed by a President dedicated to eliminating every unnecessary expenditure?

Mr. GREENSPAN. Mr. Sherman, your hypothetical example would require about 55,000 footnotes to get it into a measure with which I could deal.

Let me, however, just address, I think, an important point that you are making about the source of spending and whether or not it matters where you spend. First of all, I do not think anybody would argue that a school bus is not necessary, and that one does that. But we are talking about long-term economic growth and standards of living of the American people, and that at root is what we are really all about. It is important to discuss how you distribute it in certain aspects, but if it is not there to distribute, you do not have anything.

All of the evidence suggests that what creates economic growth is capital investment and incentives to innovation, and that investment in those types of assets does indeed increase long-term economic growth, whereas other expenditures will not. And I do say to you that the real criterion is not whether it is government or nongovernment, it is the question of whether it is investment or noninvestment.

Mr. SHERMAN. Mr. Chairman, with my limited time I just want to underline that comment. We are underinvesting in education, we are underinvesting in infrastructure, and we are told that here in Congress that if we can just give millions of dollars, hundreds of thousands of dollars, to the richest in our society, they will go out and spend it, and that will be good, and at the same time we are cutting expenditures on so many aspects of education.

I gather from your comment that investing in education may be just as helpful to an economy as private sector investments, and, of course, our colleagues on the other side of the aisle preach the importance of not a private sector investment so much as private sector spending.

Mr. GREENSPAN. I think it is a question of fact, and you have to demonstrate that a particular type of capital investment or innovation increases productivity and long-term growth, which is easy to do. The difficulty is endeavoring to trace various different types of educational expenditures into economic growth, a relationship which one would assume has got to be there because clearly the quality of the education of your work force has got to be relevant to what you have got.

So I think the question is a question of fact; I mean, what is the evidence as best we can infer? But I would emphasize that the question is essentially consumption versus investment as the statement number one.

The CHAIRMAN. The gentleman's time has expired.

The Chair would announce there is a vote on the floor of the House. The Chair would indicate we will keep going, and I will be relieved in the Chair hopefully soon, but in the meantime we will keep going, recognizing the Chairman has to leave by noon. And with that, we will recognize the gentleman from Florida Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman.

Mr. Greenspan, thank you for being here today, and just very quickly, to follow up on my colleague's immediate question, you indicated that the ideal thing is to eventually—in terms of growth production is to stimulate capital investment and incentives to innovate. Without the 50,000 footnotes, in general over the U.S. Economy history and over the world economy history, which sector has been more efficient in investing in those two items, the private sector, a free market, or the public sector?

Mr. GREENSPAN. It has been my experience that it is clearly the private sector that has done so. I indeed remember that there has been an endeavor in this society to move a good deal of public services into the private sector on exactly that premise.

Mr. FEENEY. Thank you, Mr. Chairman, because I think that undermines the argument that a lot of us are making.

Now I have a very specific question and then a general question, if you can, that I am going to leave you with. And the specific question relates to the Basel Accords and the rulemaking regarding our unique banking system. We have been getting some mixed signals in terms of how the Fed intends to react to the rules that have been promulgated in Switzerland by the international regulators, and I guess the specific question, if you can answer it, is whether or not the Fed would be prepared to take on some major sections of the rules being promulgated as part of the Basel drawing board if it becomes clear that they will not work well here under our American banking system.

Secondly, and then I will end up here, the debate has focused on whether deficits matter, and I don't remember anybody saying that deficits never mattered at any time. But I was thrilled to hear you say earlier today that the recipe for long-term success is to cut spending and to cut tax rates on capital, and I think I was using your words, it will raise the income of all Americans, which is certainly something we would all aspire to, and is not the more significant ratio, as opposed to what the temporary debt or deficit is on any given year, even the more significant ratio be the rate of spending as a percentage of gross domestic product.

And I say that because the way to pay for that spending is one of three ways that I know of. You can either print money by fiat, which has some negative implications for inflation; you can borrow money, which is deficit spending, which potentially crowds out some private sector borrowing; or you can raise tax rates by doing exactly the opposite of your suggestion we need to be doing in terms of encouraging capital bottom line. Any one of those three ways to deal with the level of spending has some adverse consequences at any given time. One way will be more or less adverse for the economy as a whole than the other two.

Mr. GREENSPAN. Well, Congressman, you can preempt private resources by spending, taxes, regulation, guarantees, a whole series of mechanisms in which you move private resources into the public sector. Clearly the ratio of federal outlays to GDP is a measure of the degree of shifting of resources that are going on, but you have to distinguish between the issue of what the interest rate is, which exists either in very heavy preemption or very light preemption, and the issue of deficits and finance. In other words, it is possible to have a fairly high ratio of spending to GDP and low interest rates.

The problem is that if you have a very high ratio of spending to GDP, history suggests that economic growth suffers as a consequence, but that can occur with high or low interest rates, and I say that the deficit interest rate relationship while I do not deny is not partially related to spending as a percentage of the GDP obviously, but I think is more appropriately thought of as a separate issue, related but not the same thing.

Mr. FEENEY. And because of the response to the Basel rulemaking on banks.

Mr. GREENSPAN. We have been very careful in the rulemaking to be highly cognizant that it has to be consistent with rules in the United States which are effective for us. We have gone through very detailed analyses of what we call Basel II, and as best we can judge, these are rules which will clearly be effective in the United States and not burdensome, in fact less burdensome and more effective than the previous sets of rules.

It has certainly been our view that we would not in any way agree to a set of Basel II rules which would serve to the detriment of the American financial system.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Texas Mr. Gonzalez.

Mr. GONZALEZ. Thank you very much, and welcome back, Chairman Greenspan. And we do have a vote, so I am going to try to abbreviate everything, including your answer. I am going to attempt to, because I have been here five years—and to be honest with you, Mr. Chairman, I will ask something, and later it's like law school, you are not sure what happened after the professor turned you around, and you are going to be limited to the choices of answer. And what would be the appropriate size of the tax package currently being considered by Congress? I am not going to give you the perfect choice of the three. It is just going to be the best under all circumstances. It will not be the Greenspan answer that will take into consideration everything that should be taken in consideration, because Congress is not going to do that, but we are going to arrive at a figure, so you have a chance under the circumstances today.

Congress is going to make a decision on one of these. Which would be the most appropriate in the way of the size of the tax package being considered: A, $728 billion; B, $550 billion; or C, $350 billion?

Mr. GREENSPAN. None of the above.

Mr. GONZALEZ. There is not a D.

Mr. GREENSPAN. Look, I am not going to answer that question, Congressman. I do not have a vote in the Congress, you do. You have to answer that question.

Mr. GONZALEZ. But we rely on people with tremendous knowledge and expertise, and you fall in that category. And I know that you defer to us all the time, but the truth is we do not make these decisions independent of opinions by individuals such as yourself.

Mr. GREENSPAN. Congressman, I appreciate that, but there are certain questions which I do not think are appropriately answered A or B if A or B is not the way they should come at them, and I am not going to get involved in what I think is a very complex set of issues with a simple conclusion because I don't know what a simple conclusion is.

Mr. GONZALEZ. But the end of the process, you are going to end up with one of the process—Congress is going to end up with one of these numbers.

Mr. GREENSPAN. Yes, I understand that.

Mr. GONZALEZ. So you could render an opinion relatively speaking as to which number would best serve the economic interests of this Nation.

Mr. GREENSPAN. I cannot answer it in the context in which you put the question, Congressman. I am sorry.

Mr. GONZALEZ. And quickly because I want to, Martin Feldstein in today's Post—you probably have read the article about the CBO's analysis of dynamic tax analysis or the valuation. And I will read the paragraph, then I will ask the question.

The good feature of the CBO analysis is that it distinguishes the short-term demand-side effects of the President's plan from the longer-term supply-side effects. This distinction is important because the ability of any tax cut to raise GDP in the short term by stimulating demand depends on the Federal Reserve's response to the tax cut. There are times when the Fed responds by raising interest rates to prevent an increase in demand because it fears the resulting rise in inflation. But the Fed is now eager to see stronger growth and would not take any such offsetting action.

So it's the last sentence, obviously, but the Fed is now eager to see stronger growth and would not take any such offsetting action, and so again we will go, A, you agree with that analysis, or, B, you disagree?

Mr. GREENSPAN. You father was kinder to me, Congressman.

In general I thought that was a thoughtful piece, but I cannot respond, obviously, because six days from now we have a Federal Open Market Committee meeting, at which we will be discussing a lot of these various things.

Mr. GONZALEZ. Mr. Chairman, in a very serious way, we cannot spend ourselves, government cannot spend itself into prosperity. Nor can it tax-cut itself into prosperity. Somehow we really have to start bridging the differences and come to what is prudent government spending, which is investment, because if dynamic scoring works on the tax side, it should work for the expenditure side, as Brad was alluding to. If you spend a dollar on education, what is its return? If you cut taxes by a dollar, what is its return?

So we really do need your advice and counsel, and maybe it will not be given to us in this particular forum, but I do look forward to maybe some private discussions with you. Thank you very much.

Mr. GREENSPAN. Thank you.

Mr. GILLMOR. [Presiding.] The Chair recognizes the gentleman from Massachusetts for questions.

Mr. CAPUANO. Thank you, Mr. Chairman.

Thank you, Chairman Greenspan, for being here again and for coming back as you said you would. I think you would be happy to know that since you started speaking, though the market is down, it's up about 46 points from the time you started speaking, so keep going. Do not stop.

Deficits in and of itself mean nothing to me. The consequences of deficits means a lot. The consequences of deficits to—the short-term consequences of deficit is increased interest payments, increased debt interest payments. We are fortunate at the moment to have low interest rates, fortunately to you, and hopefully you will keep them that way in a few days, but one thing at a time. But it does bother me that over the last two years we have had the largest increase in publicly held debt back to—I don't know how far back, at least back to the mid-1980s.

Publicly held debt has increased almost $559 billion, just publicly held. Government-held debt has also increased $423 billion. That is the largest increase we have had since actually 1990, 1991.

Now, if my memory serves me correctly, the last time we did this in those early 1990s, the result in the economy was not very good. It took a big dip, lots of tax cuts, lots of spending cuts, lots of problems all across the economy. It concerns me. It concerns me that I have not heard more from people such as yourself as to what to do about the deficit, how to deal with the deficit.

For the sake of discussion, we had a roll call at the end of last year whether to utilize or to discontinue temporarily, I guess, or permanently at the time, the use of the PAYGO rules, which I always had problems with on some levels, but I also thought they kept us disciplined in a crude way, but they worked. Yet I didn't hear a word from the Fed or very many other leading economists. That was troubling.

I would like to see you and others speak out more forcefully not just about the deficit, which is a concept, but about specifically what this Congress should be doing relative to that deficit. If you believe tax cuts are necessary, fair enough, but would that also—if you really do believe deficits are problematic, that would then, I think, lead to no other conclusion other than much deeper cuts in spending. There is no other way.

So I guess at some point I would like to hear more specifics on that from you or from others, because we do listen to you. We do not always agree with you, but we do listen, we take into consideration, and I actually agree with your concerns about deficits. But again, I am not really terribly worried—I guess I am a little bit worried about what happens five and ten years from now, but right now I think we need an economic stimulus of some sort. We will disagree on some levels as to what that could be, what that should be, but no matter how you work it, increasing the deficit is going to lead to more debt, which can lead to higher interest payments, which is going to hurt the economy probably in the short run, but certainly in the long run.

And I would like to hear you be more specific on that as we go along. I am not silly enough to think that you are going to do that now, but as time goes, certainly as other votes come up on things like PAYGO rules or whatever, they might be—if not tax cuts, fair enough, I understand you want to leave that to us, but there are some things I think that should be a little bit more aggressive on speaking about.

I do not want to talk about productivity. We have had this discussion pretty much every time you come. I agree with you on the issue of productivity. I actually like the fact that you tied part of the increase of productivity to the lack of job creation. I think you are 150 percent correct. But an increase in productivity does not help the guy who is out of work. They need a job. To get back to that, I particularly look at the last quarter's increase in productivity, very, very small; very, very small. If I am reading it correctly, it is .3 percent just in the last quarter of 2002.

Mr. GREENSPAN. It is higher in the first quarter.

Mr. CAPUANO. Okay. Good. If that is the case, if it is lower or if it is a little higher, then it is back up into the 5 and 6 percent range yet?

Mr. GREENSPAN. No. The fact that it is increasing at all in this context is telling you that there is an underlying structure which is favorably disposed in that direction.

Mr. CAPUANO. I agree with that. That is good to hear. But if that is the case, we should have at least stopped losing jobs in theory if they aren't tied together, and if there is a delay factor in that connection, how long is that delay? In your testimony I believe you said that—you did not say, but you attributed to others that we hope there will be a recovery in the next half of the year. Does that include jobs, or is this continuation of a jobless recovery?

Mr. GREENSPAN. No. I think it includes jobs.

Mr. CAPUANO. So you think the jobless rate will go down; jobs will start being created in significant quantities?

Mr. GREENSPAN. The unemployment rate had in it, in the last month, a fairly significant increase in the number of people who still want a job, but are not activity seeking one, according to the definition of the Bureau of Labor Statistics. So it is a question of the unemployment rate coming down from a level of measured joblessness, which includes the standard definition, plus those who, although they are not as actively seeking a job as previously, nonetheless would still be willing and desirous of taking one.

Mr. CAPUANO. Also has an increase in the level of people who have had the longer-term unemployment as well.

Mr. GREENSPAN. That is correct.

Mr. GILLMOR. The gentleman's time has expired.

The gentleman from Texas Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman Greenspan, before I left to go for a vote, I heard at least one Member announce or articulate that he thinks the difference between the two parties is a fundamental disagreement between whether private spending or government spending is somehow equivalent, I think, with respect to economic growth. Certainly for those who long for state-dominated economies, you can no longer look to the Soviet Union as a model, but certainly Cuba and North Korea and several other regimes on the face of the planet do have state-dominated economies.

Do you have an opinion on the difference in economic growth between State spending and private spending?

Mr. GREENSPAN. Well, indeed that question came up, I presume, while you were out of the room, and I indicated that the evidence strongly suggests that economic growth from investment in the private sector is greater than that in the public sector, and indeed I argued further that the indication that that is apparently the case has moved numerous municipalities and even states to move a good number of previously government-funded services essentially into the private sector in a more direct way.

So I have—I am clearly of the opinion and have stated so that I strongly support private investment over public investment as an issue increasing the rate of growth in our economy.

Mr. HENSARLING. If I have listened to your testimony carefully, obviously you have a concern about budget deficits. But for budget deficits, I understand in your testimony that you are an enthusiastic advocate of eliminating the double taxation on dividends. Is that correct?

Mr. GREENSPAN. That is correct, Congressman.

Mr. HENSARLING. There was questioning earlier about the impact of lowering rates on small businesses. I believe it was your observation that lowering marginal rates is favored by small business. Do you believe that lowering marginal rates, assuming that such a move would be definitely neutral, would have a positive effect on the economy?

Mr. GREENSPAN. That is correct.

Mr. HENSARLING. Okay. We also heard a characterization about the tax relief being proposed, whether it was itty bitty or not. I do not want to get into the characterization business, but if I have looked at the numbers carefully in the budget that was recently passed, we are proposing $28 trillion of spending over the next 10 years. It seems like the relevant number today of tax relief is $550 billion over the same 10-year period. So if I am doing the math correctly, that is roughly 2 percent assuming that the tax relief promotes no economic growth whatsoever.

So when once asked why Willie Sutton robbed banks, he said, the money was there. If we wanted to be focused on deficit reduction, it would appear to me that perhaps 98 percent of the problem might be on the spending side as opposed to the 2 percent on the tax relief side. So if Congress is to get serious about deficit reduction do you have an opinion about whether restraining the growth of government spending or tax relief would be a preferred method, or for purposes of economic growth would you be indifferent between the two?

Mr. GREENSPAN. Congressman, I have testified before this committee many times over the years that I strongly support constraint on the expenditure side, which I think has a chronic tendency to press on our revenue resources, and that unless we contain expenditures, it will be very difficult to maintain balanced budgets.

Mr. HENSARLING. I believe earlier in your testimony you advocated returning to PAYGO and discretionary caps. Are there other government growth restraint measures that you advocate at this time?

Mr. GREENSPAN. One which I raised, I believe implicitly in February, is the recognition that we have a set of laws in place on entitlements specifically related to retirement, which includes, of course, Social Security and Medicare amongst the major items, which, because of the huge demographic changes which are inevitable starting next decade, creates more excess claims on federal revenues than I think we are capable of creating. So that it is not too soon to begin to evaluate the impact of what that will mean, and I do not get the impression that we are moving sufficiently expeditiously to address that problem.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. GILLMOR. The gentleman from Tennessee Mr. Ford.

Mr. FORD. Thank you, Chairman Greenspan, for coming. Let me jump right into it, Chairman.

I know you have talked a lot about the taxes, and you don't want to comment on tax cuts and the impact they may have, but the reality is that is what we are dealing with, and you have come in the middle of a time in which the country is focused on what we are going to do on tax cuts or not.

I happen to be for a tax cut. I take issue with what some of you said regarding the 2001 tax cut. I can't figure out how it helped as much as you claim it helped. It certainly didn't help people in my district as much, but that's perhaps another conversation.

With regard to the lack of help that we are proposing to provide for hospitals and schools, particularly through State aid, I'd asked you this question before because I am not as smart as you, I don't know math as well as you, but I couldn't understand how you reconcile the fact that States are faced with these growing budget shortfalls and by law are required to balance their budgets. Yet our stimulus package here, the President's growth plan—and I have done the math in his growth plan just by—I did do that—that for $726 billion, the President has promised it will create 1.4 million jobs. Now if the math is right, that's $519,000 per job to create under the President's plan. So I guess I have a few questions.

One, is there a more cost-effective way to create jobs? Number two, as we all know, and you know it far better than me with your economist background, it seems to be a procyclical aspect to State budgets. When the economy is good, they do really good. When it is bad, they have to raise taxes or cut services, which worsens the situation.

Wouldn't it be in our interests in terms of creating jobs and helping to put us back on a trajectory that you played a role in with the former President to help this thing grow to figure out a way to help the States avoid undermining what we do here at the Federal level, whatever the tax cut may be? And two, isn't there a better way to cut taxes to create the things that you talk about wanting to do in terms of growing this economy, in growing jobs?

I am opposed to double taxation. I think tax reform should take place, but if we are going to do something, we ought to reform the AMT before we go about doing some of the things that this President has proposed doing.

I know you are reluctant to talk about it, but you kind of talk around it. I understand there have been some developments in the last few days about appointments and reappointment, but I want to know directly and specifically, Mr. Chairman, how can we say to States and Governors across this country, balance your budgets, balance your books, cut services, raise taxes, but then allow a President—when you have talked incessantly about debt and that being a problem, how can you come before this committee and suggest that in any way, without responding in any way, that building and piling up more debt—when States cannot do it, when they are forced to raise taxes and cut services, I don't understand how you reconcile that.

Mr. GREENSPAN. Because I am not advocating piling up more debt.

Mr. FORD. Won't the President's plan do that?

Mr. GREENSPAN. No. I am saying in the context of PAYGO and discretionary caps implicitly a very significant reduction in the implicit deficit that would be otherwise indicated.

Mr. FORD. Should we not be helping the States, Mr. Chairman?

Mr. GREENSPAN. Well, that is another question. I mean, remember——

Mr. FORD. I know. It is what I am asking. Should we not be helping the States as a part of the stimulus plan?

Mr. GREENSPAN. Congressman, I am not going to get involved in the specifics of these programs, as I said at the beginning. It is an endless conversation which I don't——

Mr. FORD. I am trying to narrow it down. We helped the airlines, and I thought that was the right thing to do, the two packages we provided for them, including Northwest Airlines, which has a hub in my district. That being the case, would it not be smart, consistent with what you want to accomplish, Mr. Chairman, that we provide some assistance for hospitals, for schools, responsibilities that State and local governments primarily have? Would that not be intelligent and wise and something that we could do that would comport with this growth package?

Mr. GREENSPAN. I don't think I can effectively deal at the detailed level. All I can suggest is what I think is important on a macro level, and that is where I have been all morning, and I hope to continue to stay there.

Mr. FORD. Would it not be, in your estimation, a better tax cut, or should I say better and more effective way to help put money in people's pockets, perhaps a payroll tax which 80 percent of Americans pay, would that perhaps be a better way, consistent with what the Business Roundtable and others have called for, to ensure that we can grow jobs and grow this economy, and would that not be cheaper than the $519,000 per job that the $726 billion tax cut package the President has promise will create 1.4 million jobs?

Mr. GREENSPAN. I am not going to respond, and the reason I am not going to respond is that this gets into issues of tax cuts for encouraging consumption and tax cuts for encouraging investment, and as you well know, as I have said previously, I am very strongly on the side of tax cuts for investment because you do not basically increase economic growth by inducing consumption.

Mr. FORD. You have also said that you are opposed to big debt and growing deficits, and it seems to me that we are moving rapidly in that direction.

I know my time is up. I would like to enter into the record, Mr. Chairman, if I can, in light of the letter in response to Chairman Baker's comments about congressional oversight and study of the role of government-sponsored enterprises in our economy. I know that great steps have been taken by both Fannie Mae and Freddie Mac, voluntary ones undertaken, to comply with the whole range of things, and eight concrete steps that they have taken. I would like to submit that to the record, Mr. Chairman.

Mr. GILLMOR. Without objection.

[The following information can be found on page 64 in the appendix.]

Mr. GILLMOR. The gentleman's time has expired. The Chairman has to depart. We have made a commitment to him to get him out. If we could let me recognize Mrs. Capito and Mr. Israel, but ask both of you to be as concise as possible so we can get the Chairman on his way.

The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman. Thank you for your presentation. My concern is the high cost of health insurance that is occurring all across the Nation, and many businesses aren't able to reinvest in capital and other things because of the raise in the health insurance premiums. Where do you see this in the long term? And also, I think it will—another strain on the economy will be if businesses drop their health insurance coverage, it creates more uninsured, again causing another economic strain. I would just like to hear your comments on that.

Mr. GREENSPAN. Congresswoman, a really difficult problem we confront is the fact that our technologies in the medical area are improving so dramatically, they are creating the availability of significant new medical services, which in the context of a third-party payment system which is subsidized, creates an inordinate amount of demand for medical services of all types, and that inevitably spills over into medical insurance costs, and it spills over into the difficulties that a number of companies are involved with.

So the issue is a very difficult one which I don't think is resolved other than by considering how we approach our total medical services system and how we finance it. And I doubt very much if we can solve problems individually without looking at the fact that, you know, we have got 14 percent of the GDP going to medical services, and my suspicion is more than that, in the total proportion of employment, and that means a very significant part and a growing part of the economy devoted to health care, which is very important for the American people and is very important for us each individually. But it does not produce goods and services, and we have to make these very difficult trade-offs.

Mrs. CAPITO. Thank you.

Mr. GILLMOR. The gentleman from New York.

Mr. ISRAEL. Thank you, Mr. Chairman. I will try to be as brief as possible.

Mr. Chairman, in your testimony you note that the persistent high level of new claims for unemployment insurance suggests that firms may still be finding it possible to meet their customers' tepid increases in demand with a leaner work force. I think that is a rather prosaic way of describing job losses. Guy comes home, says, honey, good news and bad news. The bad news is I have been laid off. The good news is that the firm is finding it possible to meet our customers' tepid increases in demand with a leaner work force.

I would like to focus on that issue. We created the Temporary Emergency Unemployment Compensation Program in March of 2002 and extended it in January, 2003. The Labor Department reported last week that new applications for unemployment insurance hit 455,000 in the week ending April 19. There are now fewer jobs in the labor market than at any point in the current slowdown. 365,000 workers exhausted their regular unemployment benefits in March, and the number of exhaustees has increased for 24 straight months.

Statistics go on. Percentage of workers beginning to receive unemployment benefits who subsequently exhaust those benefits without finding work was at the highest level ever recorded in February.

There are some who say that the best way to help workers who are falling off the cliff is to cut taxes on people who are furthest away from the cliff. There are others who say the best way to stimulate the economy is through unemployment compensation, that every dollar we provide in unemployment compensation is necessarily a dollar invested in the economy because when workers don't have jobs they dramatically scale back their purchases. A dollar in unemployment compensation helps increase those purchases.

So my question to you is, as a matter of immediate economic stimulus, what is a more useful tool? Is it providing another extension after May 31 of emergency unemployment compensation or is it not providing that extension and instead sticking with some of the tax reduction proposals that are on the table?

Mr. GREENSPAN. I think the crucial issue gets to the failure to distinguish in a lot of these conversations between stimulus to capital investment which, ultimately over the long run, increases everybody's standard of living and, two, short-term stimulus to consumption which will raise the level of activity almost by definition and short-term employment but does nothing over the longer run. And that is a very difficult trade-off which Congress has got to make because if you do nothing other than short-term stimulus, you will end up with economic growth slowing down.

Mr. ISRAEL. Mr. Chairman, on May 31 temporary emergency unemployment compensation will end. Is it important for the economy for us to extend that program?

Mr. GREENSPAN. I frankly have not given that much thought and I couldn't give you an informed answer.

Mr. GILLMOR. The gentleman yields back. Mr. Chairman, with your indulgence I would like to have one Republican ask one question and one Democrat ask one question and not take the full time.

The gentlelady from Florida, Ms. Harris.

Ms. HARRIS. Thank you, Mr. Chairman. Very quickly, welcome, Mr. Greenspan. It is wonderful having you back again. I represent a largely senior population and given the recent loss of confidence in the markets today, the stock market and other types of investment, what would you advise Americans, particularly those nearing retirement on the retirement plans, specifically the mix between equities and bonds? And can you comment on possible opportunities that Congress can provide to expand retirement savings opportunities for those nearing retirement?

Mr. GREENSPAN. That is the toughest question I have gotten all day. That really is a job for a specific investment adviser who is knowledgeable about the specific conditions of each person's retirement needs and the like. I think people make generic recommendations in this regard and I think do a disservice to individuals. And I think forecasting markets is very difficult, I would argue at the end of the day, probably with rare exceptions, almost impossible. But what you can do is measure the risks. And the risks essentially are different from somebody who is 30 years old and is saving for retirement or one who is 55. And I think those types of judgments are crucial and important for appropriate investment policies for retirement, and I don't think you can generalize very far down the road.

Mr. GILLMOR. The gentleman——

Mr. FRANK. I just wanted to get a little glass of that. So someone 55 might be retiring in 25 or 30 years and he would want to be prudent.

Mr. GILLMOR. The gentleman from Illinois, Mr. Emanuel, for one question.

Mr. EMANUEL. Thank you. Fifteen months ago the Congress passed one of the largest tax cuts in the history of the country, the net result has been two-and-a-half million lost jobs. Five million more Americans have lost their health insurance, nearly a trillion dollars worth of corporate assets have been foreclosed on, and 2 million Americans who formerly were in the middle class have entered the rolls of poverty in this country.

USA Today in their paper today noted that in the help wanted ads, we have the lowest amount of help wanted ads this March since 1964—available jobs out there. I know I only get one question and I want to clarify a point that I think you answered in responding to the ranking member, Barney Frank, about the role of deficits to the cost of capital. If we have an increasing amount of deficits and they become perceived by the market as structural, not temporary, that would have a direct impact on the cost of capital both to businesses for their investment and ability to borrow in advance, improvement in productivity as well as to family incomes as relates to higher interest rates on mortgages, cars and student loans. The cost of capital due to ever growing deficits would have a direct impact on companies and on the ability of families to meet their needs to provide for their middle class dream?

Mr. GREENSPAN. That is correct, Congressman. I should say that you drew a connection between the 2001 tax cut and a whole series of issues which occurred subsequently in the economy. I think you would be more proper in saying that they were all associated with that time frame, but cause and effect is not evident to me.

Mr. EMANUEL. You do see the debt relationship of the deficit as a cause and effect as it relates to a greater rise in interest rates and that we have a perception that we would have a permanent deficit that would have a direct impact on the cost of capital as it relates to businesses and families as it provides for their children and for their own livelihood?

Mr. GREENSPAN. That's correct.

Mr. GILLMOR. Mr. Chairman, I want to thank you for appearing before us. Your testimony as always is informative, insightful, and if we do this enough, I might understand most of what you said. Thank you.

We will proceed to the second panel. If the panelists can take their place at the table we will get underway. Mr. Peterson is not here yet, but we will proceed. And Mr. Aaron was first. And we would like our panelists to summarize their remarks in about 5 minutes and then we can go to questions. Mr. Henry Aaron, Senior Fellow of the Brookings Institution.

STATEMENT OF HENRY AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. AARON. Thank you very much, Mr. Chairman. I wanted to make five main points and respond to one that was raised in the course of Mr. Greenspan's testimony. The first point is a simple confirmation of the evidence from the Congressional Budget Office and virtually every other forecaster that we face substantial budget deficits over the next decade even if no tax cut whatsoever is enacted. Tax cuts will necessarily increase those deficits. The recent report of the Congressional Budget Office confirms that fact, notwithstanding the oped that was referred to this morning by Martin Feldstein. The CBO report shows it is as likely that dynamic scoring would result in increased estimates of the revenue loss from the tax cuts as that it would show decreased costs.

The more serious point I think is that the longer term budget situation is even more serious than the intermediate term situation because of reasons that were also covered in Mr. Greenspan's testimony; namely, the imminent retirement of the baby boom generation and the attendant increases in pension and health costs. In that situation, I believe it would be unwise to institute any further tax cuts of any kind, including an acceleration of the tax cuts enacted in 2001 or the passage of additional provisions.

There is a case to be made for some short-term economic stimulus, but it is a mixed case. We have had a massive amount of fiscal stimulus over the last couple of years and a massive amount of monetary stimulus. If there is to be any additional stimulus, in my view it should sunset very quickly. The so-called jobs and growth program of President Bush, in my opinion, is misnamed, because it will create neither jobs nor economic growth over the long term. Indeed, the forecast of the very firm on which the Council of Economic Advisers relies showed precisely that result. Some initial job growth was shown under their projections for about 18 months, but job reductions were shown for the remainder of the decade. The overall effect, therefore, is not increase jobs, despite their assumption that they assumed that there would be no tightening of monetary policy in response to the tax cuts.

Finally, I would like to refer back to the discussion that occurred regarding the relative productivity of public and private investment. I rarely heard a falser distinction in my life. The United States has been built on the productive partnership of public and private investment throughout its history. The interstate highway system built with public moneys is the basis for the modern trucking industry, a large private sector investment. Research, funded publicly through the National Institutes of Health, helps support major private investments through the pharmaceutical industry. To be sure, there are wasteful public investments. Each of you no doubt has your list and I have mine. But there are wasteful private investments as well. Consider, for example, the tens of billions of dollars that have gone into fiber-optic cable that is at best premature and may be entirely wasteful. And there are many other cases as well.

The important thing to recognize is that we should be against wasteful investment, whether it is public or private. We should undertake public investments that help support productive private sector investments, and that includes a good deal of what the Federal Government does. It includes enabling students from the bottom quartile of the socioeconomic ladder to attend college if they have as much ability as those at the upper end of the economic distribution. It includes additional support for biomedical research and in other areas.

I think it is also hard to make the case that somehow economic stimulus is on net increased if we cut taxes for people to encourage private consumption and at the same time decide not to provide support for States and localities, thereby resulting in Medicaid enrollees from being cut from the rolls, schools being closed because there are no funds available for after school programs and elderly centers being closed because there are no funds for them either.

This is a choice of priorities. It is not a choice about economic stimulus.

Thank you.

[The prepared statement of Henry Aaron can be found on page 66 in the appendix.]

Mr. GILLMOR. Thank you Mr. Aaron. Mr. David Malpass, Chief Global Economist, Bear Stearns.

STATEMENT OF DAVID MALPASS, CHIEF GLOBAL ECONOMIST, BEAR STEARNS

Mr. MALPASS. Thank you, Mr. Chairman, and members of the committee. I am pleased to have the invitation to talk about these issues. I would like to make several points.

First, I think the economic outlook is actually quite good. We have had a major improvement in macroeconomic policy since 2000. Specifically interest rates have fallen, real interest rates have gone negative just in the last few months, and that is going to encourage inventory and investment. The value of the dollar has changed substantially and moved to a pro-growth level after having been at a deflationary level. Inventories are low now.

Very important in the economic outlook is the issue of the tax cut and the incentives within the economy. It is true that there are problems facing the economy. That is true all the time. But what I think we see right now is a major improvement in the macro environment since 2000 that will lead to a solid economic recovery in coming months.

My statement goes through labor market conditions, describes that even though we have lost a lot of jobs in the last year the number of people employed in the U.S. economy is at $130.4 million. That is over a million and-a-half more than in 1999. And remember 1999 was a boom time. The unemployment rate was down at 3.8 percent. With more people employed now than at that time, that will help contribute to the economic recovery.

My statement goes through some key variables in the outlook. In general the outlook is good. Some of the variables are oil prices, business investment and then the tax cut. The reason the tax cut is important is because of the capital structure of the United States. We right now have a system that biases heavily the capital structure toward debt instead of toward equity, and that reduces the efficiency. It causes the economy, the private sector to make wrong choices based on tax policy. In my view, the President's proposal would add strongly to both the near and longer term growth outlook. It would provide important benefits in terms of jobs, economic growth, capital mobility, national savings and corporate governance.

I think the President's proposal is much superior to some of the alternatives that have been mentioned, either doing nothing or doing cash rebates or doing consumption oriented tax cuts or doing targeted investment incentives such as equipment expensing. What we need to make the economy grow is an improvement in the quality of investment, as much as in the quantity, and that would be achieved through the change in the dividend taxation.

I will mention two side benefits from changing the tax structure. One is the United States is running a big current account deficit now. That shows an investment rate that is above the savings rate. One of the reasons for that is the heavy taxes on savings, and one of those is the taxation of dividends. So we would get a side benefit from the tax cut in added savings.

Also, there are positive implications for the direction of future tax reforms if this particular tax reform is able to move forward.

My statement goes through two other issues which I want to mention. First, the scoring issue. Oftentimes we think of this $350 billion number or $550 billion number as something that might be accurate. Remember scoring is distinctly inaccurate. It has no bearing on what is actually going to happen out of a tax cut. It also has no bearing on the benefits that are enjoyed by the economy from a particular change in the tax. In particular, as they think about scoring a tax cut, they are focused on how much revenues the government will lose.

Their mission isn't even to try to decide what will happen to the Nation as a whole. It is a limited mission; how much will the government lose. In this particular case, one of the benefits to the economy as a whole is the wealth gain for the Nation when there is a tax cut.

My statement shows that we have a recent example of the impact of lower asset taxes on the value of assets and the related economic impact.

In 1997, Congress lowered the capital gains tax on real estate. We saw a major increase in the value of real estate and also in the jobs involved in constructing real estate. I think what we would see similar reactions to a dividend tax cut, a massive increase in national wealth and a surge in economic activity at a relatively small cost to the Federal Government.

The current dividend tax distorts the capital structure. It creates an expensive wedge or a toll gate between retained earnings and the shareholder, plus it encourages debt and unproductive acquisitions. Its elimination would, in my view, improve the allocation of capital, adding substantially to near-term and long-term U.S. Economic aspects.

A final part of my testimony is related to the budget deficits. I will leave you with just one point in this area. Recall that the projection of budget deficits is an extremely inexact science. No one really has any idea what the budget deficit is going to be over the next 10 years. CBO is projecting that the tax receipts to the Federal Government over the next 10 years will be $27.4 trillion. So a gigantic amount of revenue is coming in. You should put a confidence integral on that. That is plus or minus 5 percent. They really have no exact way of knowing how much the receipts are, but let us say that they are close to within 5 percent. That means that you have a one-and-a-half trillion dollar uncertainty about what the receipts are going to be.

Congress is arguing about $200 billion of inaccurate scoring as a way of making tax policies. Instead, Congress should be thinking about what the right tax system is, what the right spending system is and spending less time looking at the budget estimates and the scoring estimates, which everyone is largely in agreement can't be done at all accurately.

Thank you, Mr. Chairman.

[The prepared statement of David Malpass can be found on page 83 in the appendix.]

The CHAIRMAN. Mr. Peterson, welcome back and it is good to see you. I think we were on the same panel up in the Big Apple. Good to see you and welcome.

STATEMENT OF PETER G. PETERSON, PRESIDENT, THE CONCORD COALITION

Mr. PETERSON. Mr. Chairman, in March of 2001, a bipartisan group of us from the Concord Coalition; namely, Warren Rudman, Bob Kerrey, Sam Nunn, Paul Volker and myself, stated our views of what ought to be done about a fiscal stimulus, and we said it should be temporary, it should be targeted to taxpayers and businesses most likely to spend it and you should do nothing to aggravate the long-term fiscal outlook. As we look at the current plan, I am sure our group would agree that what we see and the arguments we hear are not terribly persuasive, particularly against those criteria.

First, a word about worsening fiscal outlook and why it matters. Two years ago, Mr. Chairman, the CBO told us that the 10-year budget balance would be a mountainous $5.6 trillion. We at the Concord Coalition believe there is a more realistic estimate. The 10-year outlook is probably closer to a $4 trillion deficit. That $10 trillion swing is probably the largest in the history of the country except at times of war.

Also, Mr. Chairman, we have to remember that deficits today can be justified by surpluses tomorrow, but right now the long-term deficit outlook is even worse than the 10-year outlook. Let us keep in mind that we face an unfunded obligation on Social Security, Medicare and Federal pensions of $25 trillion, according to the U.S. Department of Treasury. As a share of payroll, the cost of Social Security and Medicare hospital insurance programs alone would need to rise from today's 14 percent to somewhere between 24 and 34 percent of pay. I think most of us would find that unthinkable and unsustainable.

You know, Mr. Chairman, we have gotten used to thinking about entitlements as a long term problem but in fact it is beginning to overlap with our near term. The fact is that in only 5 years the first boomers begin retiring and the entire generation will be on full benefits in 8 years.

Now why do deficits matter, particularly the long-term deficits? The problem with long-term deficits is they soak up national savings and crowd out productive investment. You all know that America's saving pool is already very shallow and getting shallower. Regardless of this endless debate of the effect of deficits on interest rates, increased budget deficits reduce future income. What really matters is the amount of national savings that is consumed by deficits and whether it is offset by private savings. Others argue that we didn't need to worry about this because foreign savers will pick up the slack.

In the first place, Mr. Chairman, our foreign friends in Europe face even more daunting entitlement problems than we do because of the rapidly declining birth rates. In any case, whatever we borrow from abroad we have to pay back or else fork over a permanent debt service to foreigners. Any way future American living standards will be affected.

The current policy, it seems to me, Mr. Chairman, constitutes an explicit decision by today's adults to collectively shift the current cost of government from ourselves to our children and grandchildren. With that background, let us review the basic arguments that I have heard with regard to this tax plan.

The first is that the American people want and deserve a tax cut and a democratic government should respond to their wish. The administration has described a vision of America in which government takes and spends less of our money and leaves more of it in the pockets of those of us who earned it. It is a vision that resonates with many citizens. But I want to be very clear that neither I nor the Concord Coalition is opposed to smaller governments or lower taxes. We simply require that at the end of the day the revenues are sufficient to cover the outlays. Washington policymakers must not pretend that we can have it all, guns, butter, and tax cuts.

In short, I would insist that the bottom line logic of public finance, that the long-term tax burden is determined by long-term spending burden and that unless you reduce the long-term spending burden you don't really cut taxes, you simply shift the burden of taxes from the present to the future. There is no public finance textbook that I know about that teaches you that you can ease the long-term tax burden simply by cutting the tax. Instead of pretending of accomplishing the impossible we should be educating the public that when you face a future of endless huge deficits, you have to cut spending long term before you cut taxes long term.

Argument number two, okay, let us forget the long-term tax burden. The tax package still makes sense as a near term financial stimulus to bring the economy to full capacity. Today's economy remains fragile largely because business and consumer confidence remains fragile. Under these circumstances a stimulus could have a beneficial impact. The problem with the stimulus justifications that I have heard is it doesn't apply to the plan under consideration. For fiscal stimulus to be effective, it has to be put into the consumers' pockets as quickly as possible. Yet just 5 percent of the administration's economic growth projections, those that explicitly advertise a stimulus, would end up in the consumers' pockets this year and over the 10-year period just 17 percent over the first 3 years.

Argument three, even if it doesn't deliver much near term stimulus the tax plan does make the Tax Code more efficient, which translates into less economic waste and a higher standard of living.

Many supporters of the administration's tax plan argue that its provisions to eliminate the double taxation and corporate earnings would make our tax system more efficient. I am sympathetic to this argument. Personally as a matter of tax design I wouldn't do it the same way. A better plan would be to relieve earnings at the corporate level. But my biggest problem with this provision, however, is not its complex design and implementation challenges. My biggest problem is that it is deficit financed. Reducing the taxation on corporate earnings may marginally improve savings behavior, but not nearly enough to compensate for the loss in Federal revenue, which adds directly to Federal debt and in the long term subtracts dollar for dollar from national savings. Far better it seems to me would have been to make any proposal revenue neutral; for example, by genuine tax reform that eliminates many of the obviously inefficient corporate tax subsidies.

Argument number four, the critics just don't get it. What this tax package is really about is improving supply side incentives to work, save and invest. We should all be acknowledged that the supply side reductions in a context of punitive tax rates, and indeed they once were, have sometimes been very successful. And if supply side advocates were less theological in their interpretation of the data, we should be able to acknowledge that in other instances the tax rate reductions have had indifferent or ambiguous results. In fact, there is plenty of evidence when marginal tax rates are not high the efficiency gains from cutting them may be modest. The marginal tax rate, as you probably know, on Federal income and payroll taxes is now 30 percent. It is among the lowest in the developed world. And the impact on economic activity can be ambiguous. In other words, while some people may react to more after tax income by working more, others may react by working less. But even if the supply side response to the administration's tax cuts is both positive and sizeable, the gains would be canceled out, perhaps overwhelmed by the sizeable inefficiencies of the deficit that the administration plans to run in order to pay for it.

According to some of the dynamic models by CBO and several I have reviewed as chairman of the Federal Reserve Bank in New York, the tax plan could actually result in significant GDP losses over the long-term.

Tax plan argument number five, let us be honest. The ultimate purpose of the tax cut plan has nothing to do with economics. It is about politics or political philosophy. The purpose is to starve the government of revenues so that in the long run the Congress will have no choice but to cut back spending and with that diminish the size of government. This is a seductive apologia, but I have three objections to it.

First, I think it is unfair because no end, however legitimate, can justify such means. Nothing excuses holding the next generation hostage, including our own children, on the dubious bet that the other party will have the goodwill to relent.

Second, it could also be cynical because it assumes that our democratic process is broken and no longer makes sense to advocate a policy for the common good, but we have to rely on a certain amount of subterfuge.

Third, I think it could be considered hypocritical. One could take the ostensible goal of tax cuts as smaller government more seriously if we saw the party pushing the tax cut were also trying with great energy to cut spending both short term and over the longer term, for example, with genuine reform of what OMB itself calls are unsustainable entitlement programs. But we see nothing of the sort. Indeed it is hard to find the small government argument persuasive when the budget does nothing to reform entitlements, allows debt service cost to rise along with that and urges greater spending on defense and indispensable homeland security when these functions comprise over four-fifths of all Federal outlays.

Mr. Chairman, our Nation faces at least two history bending challenges, global terrorism and global aging. Meeting the first may require marshalling new resources that are far above the extra spending already legislated. We know that meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet uncovered by deficits as far as the eye can see. To do so would ignore every principle of public finance, generational equity and long-term economic stewardship.

Thank you.

[The prepared statement of Peter G. Peterson can be found on page 95 in the appendix.]

The CHAIRMAN. Thank you, Mr. Peterson. And our final witness, Dr. Kevin Hassett.

STATEMENT OF DR. KEVIN A. HASSETT, DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. HASSETT. Thank you, Mr. Chairman and Mr. Ranking Member. It is a great honor to be here. I guess from looking around it seems like we don't have a baby boomer on the panel but we are on opposite sides, some of us. And I think looking at the baby boom problem as sort of the long run fiscal problem that our Nation faces is very important and provides an interesting perspective on the current fiscal policy debate, and that is the intent of my prepared remarks that you have before you.

Before we can think about the question what solutions should we pursue, we need to identify the problems. And to my mind, there are really two big clear problems that I don't think that you could ignore responsibly going forward. And I think that once these problems are recognized then when we have a package like the budget proposed by the President, for example, then we should take each of the items in the package and compare them to these problems and see if they help make them better. And if they do then perhaps they are good policy ideas.

I think the first problem in the long run, as Chairman Greenspan mentioned, the long run budget outlook is terrible. The short run is bad and the long run is terrible. Indeed, the most recent Congressional Budget Office forecast over the next 75 or so years suggests that Federal deficits as large as 20 percent of GDP will be accomplished absent policy changes. So it is not that if we keep doing these crazy things we are doing and spending new moneys on stuff that we are going to have that big deficit. No. If we keep coasting then we are going to have a deficit that large.

But I think the interesting perspective that I found in the CBO study that came out a year ago, and I understand they are updating this, is that if you try to identify the cause of this 20 percent of GDP deficit, you see that in their forecasts at least and I share Mr. Malpass' criticism of such forecasts—I don't know how accurate they are going to be—but in their forecasts the chart in my testimony which is just reproducing their chart—that the problem is wholly attributable to a surge in outlays. Indeed, relative to GDP the CBO is forecasting that revenues will be about constant but outlays go from a little bit below 20 percent of GDP to about 40 percent of GDP. Now in my testimony, I try to put that in perspective. If the U.S. Were to actually get to the point where we had a Federal Government of about 40 percent of GDP, then that probably means that State and local spending would be about 20 percent of GDP, if it kept up as it normally has, which means about 60 percent of GDP absent policy changes would be spent on government things. Now I don't think that we are going to get there. But again if we did I think it would just be devastating for the economy.

In my testimony I provided a chart that gave you an idea of what kind of growth, economic growth experienced countries with large governments or governments close to that large have had and it is pretty darn terrible. So what is going to happen is at some point we are going to recognize that we can't afford the entitlements that we promised. And I think we are going to have to come together with good faith from both sides of the aisle and work out some kind of solution to it. But I think that recognizing that we kind of face this discrete choice going forward, are we going to become like a socialist European country where we have got a very large fraction of GDP devoted to government or not is a key background debate. And when we look at the President's proposal, then, for example, the prescription drug benefit is something that makes this problem worse and doesn't make it better. I am not an expert on Medicare, and it could be that we need a reform that provides drugs as well, but the expenditure on that certainly doesn't help.

The second problem, I think, and again economic issues can be complex, the second problem is that the U.S. Corporate tax code is out of step with the corporate tax code of the rest of the world. The economics profession has demonstrated I think almost unanimously over the last couple of decades that high capital taxes, as Chairman Greenspan mentioned, can significantly harm economic welfare, even the economic welfare of workers who don't invest in the stock market. And so the idea is that when there is a large capital inflow then that creates jobs and makes wages increase.

I think one of the most interesting facts that demonstrates this effect is the experience of Ireland. Ireland reduced their corporate taxes, their tax on capital, and saw their manufacturing wages for their blue collar workers closed from about half of that of the U.S. To being almost equal to that of the U.S. over a decade. And so because of this, much of the rest of the world has begun cutting their corporate taxes and their dividend taxes as well to the point where the only country with a higher combined tax on this type of income than the U.S. is Japan. And needless to say, I think the Japanese are not having an economic experience we would like to reproduce. And so I think the second problem is very important to keep in mind.

I believe we have reached a point where since we are big and it is not as urgently obvious as it was to European countries but countries have made themselves much more attractive places to operate, it makes sense for our multinationals to locate their operations overseas. And I think ultimately the stress for that and indeed stress that applies to ordinary workers is going to move us to make some kind of change. And I think therefore when you look at the dividend tax proposal—and I will try to finish quickly—then you can see that it does address a very pressing problem.

I think Chairman Greenspan mentioned today that he thought that it would be a slam dunk no brainer if you could find a pay-for for that so that it was revenue neutral. But I would argue that if you were to look at the net effect, the noneconomic effect of the President's plan absent such a pay-for, that it would still move you to make this reform because again if we don't then we are going to fail to address a very pressing problem.

And with that, I will conclude my remarks.

[The prepared statement of Kevin A. Hassett can be found on page 76 in the appendix.]

The CHAIRMAN. Thank you to all of our panelists. Let me begin just to follow up on what you mentioned, Mr. Hassett and Mr. Malpass; that is, this whole idea of a 10-year budget strikes me as totally unrealistic. We are talking about a $200 billion difference in the House and Senate versions over a 10-year period. If you were to give some advice to the budgeteers and how we work or how we try to make some sense out of this whole budget process, what would each of you recommend maybe in a sentence that Congress should do? Should we abolish the budget process or has it been helpful? If we don't abolish the budget process, should we start to try to focus in on a 5-year period? Why don't we begin with, Mr. Aaron, and go down the line?

Mr. AARON. I think the bad mouthing of the budget projections is a classic case of shooting the messenger. We were not of the mind to shoot the messenger two years ago when we looked at those 10-year projections and concluded that there was enough revenue to support a very large tax cut. The current projections dramatically understate the seriousness of the long-term projection, as Mr. Peterson emphasized. The $200 billion number that you cited counts toward the budget all the reserve accumulation now occurring in Social Security, Medicare and Federal employees retirement funds, every penny of which and more besides will be needed to meet current obligations. It doesn't include any allowance for the fix that will be needed for the alternative minimum tax. It doesn't include most of the costs of the war in Iraq. It doesn't include any additional costs that may be necessary for homeland security. We are looking at a very serious 10-year budget projection.

Could we be lucky? Could growth suddenly blossom and might we avoid that problem? Yes, it is conceivable. But as I said in my testimony, just because we cannot see with perfect accuracy what lies over the crest of the hill doesn't mean we should drive on the wrong side of the road, and that is exactly what we are doing.

The CHAIRMAN. You basically don't have a problem with 10-year projections?

Mr. AARON. I have lots of problems with all the projections because we have to make a lot of assumptions. Would we improve matters by adopting a shorter horizon? I don't think we would. I would like to see additional studies and sensitivity analyses. Fortunately, the Congressional Budget Office has started to give us those and I think it has improved the sophistication with which we read their 10-year numbers.

Mr. MALPASS. I think the 10-year budget is actually harmful. It causes you to make decisions that you wouldn't make under normal circumstances. For example, in the 2001 tax cut the conclusion was reached to let it expire in 2010 because that saved money in the 10-year budget window that people were looking at at that time. This created a complicated set of tax policies that wouldn't have been arrived at under any other concept. So I think it should not be done.

What could be put in its place? I think several things. One is a realistic estimate of what the near term spending commitments of the government are. A program that starts small and then grows over time is being heavily underestimated by the 10-year budget window. I am not really a fan of the Medicare expansions that you are considering now. That would be an area where, if you look at the 10-year budget window, it is not really showing you a true look at the cost of what you are really committing to.

That is of course how we got into the Social Security problem. Commitments were made at the beginning that didn't seem all that big. We didn't have a 10-year budget at that time, but looking beyond 10 years, that is when the problem occurs. The 10-year budget window creates the impression that you are making logical decisions when we know from experience that you are being pushed into illogical decisions. I think I would dispense with the 10-year budget. I would try to have a system of entitlement controls that would look at the long-term effects of the commitments that you are getting into.

The CHAIRMAN. Thank you. Mr. Peterson.

Mr. PETERSON. I either have the burden, Mr. Chairman, or the good fortune not to be an economist, so I have great trouble following some of these models, but I would like to make just a few points. First of all, on the cost side I would agree, Mr. Chairman, with Mr. Aaron that it is very likely that we have grossly underestimated. In addition to those that Henry mentioned, let me mention one that I know a little about. I happen to Chair the Council on Foreign Relations and we have a task force working on the Hart-Rudman recommendations with regard to homeland security.

I would be very surprised, Mr. Chairman, if a few years from now you do not find that those needs are so pressing that you are going to appropriate much more money than you have now. For example, our ports are hideously vulnerable at the moment. There are systems available to do something about that, but we have done almost nothing about it. Now the other big item on the cost side is obviously the entitlement burden. Let me make this point about entitlements. They are quite different than other projections. I heard Bill Safire, I think it was, on Meet the Press decry 10-year projections, but I think a distinction should be made between projecting the costs of something like Social Security and projecting other costs.

Why do I say that? The people that are going to retire, Mr. Chairman, have already been born and can be counted. The benefits are in place, and therefore you can make reasonably reliable estimates it seems to me of what those costs are going to be.

Secondly, as you can tell from my testimony, I don't take it seriously as some would like me to take some of the growth estimates that people have been making for 20 some years now that I have been in this budget business. I want to remind you of something you probably know better than I, but in the case of Social Security the benefits are tied to wages and wages in turn are tied very largely to productivity. Therefore, as productivity goes up, the costs go up. And therefore it is a problem that you are going to have a great deal of trouble by saying we are going to grow out of this because the economy is going to get bigger.

I remind you of what happened in Great Britain. Lady Thatcher decided in 1980 that their entitlement programs were unsustainable, and she made one very important reform that you may not agree with but it indicates how important this is. They decided to index the benefits only to inflation and not to wages. And because over a period of time, productivity goes up and wages goes up, it reduced the effect of these on the economy but it did not lower the benefits from where they were when the reform went into effect.

So I think it is extremely important that no one think it is going to be easy to grow out of the entitlement program.

The CHAIRMAN. Thank you. Mr. Hassett.

Mr. HASSETT. I am reminded that you said one sentence. I think that the budget process itself is very important. I think that the $200 billion difference between the House and the Senate right now is a small difference relative to standard errors or anything else that we are talking about. But within that spending, you have to ask yourself is the tax reduction, if you have got one in there, something that is designed to get a big bang for the buck or not. And I would argue that certainly there is a lot of disagreement amongst economists about how much taxes affect things. But there is less disagreement about how, say, the user cost of capital, the thing that the dividend tax reduces affects things than just about any other area. And so it is somewhat ironic to me that the dividend tax proposal seems to be the thing that is going to be thrown out the window in the Senate, or at least that is the rumor, given that is the part of the proposal that has the strongest economic merits.

In terms of forecasts, I think I agree wholeheartedly with Mr. Aaron and Mr. Peterson that any artificial short run cap on how far out you go or if you stop at 5 years or 10 years introduces games that I think that some in this room are probably quite masterful at playing where you can move revenues forward and expenditures out and make it look like you are doing better than you are in the 10-year window. I would guess that anything that is done with prescription drugs would be the thing that would have the biggest effect in the long run on the problems we are discussing here and be the most subject to such games because you only look at a 10-year window. The fact is we have got these entitlements growing to be 20 percent of GDP over the CBO's forecast horizon, and that is before we had these things. And if we stop at a 10-year window, you might miss that.

The CHAIRMAN. The gentlelady from New York, Ms. McCarthy.

Ms. MCCARTHY. Thank you, Mr. Chairman, and thank you all for your testimony. We have been here since 10 o'clock this morning so it is difficult because each person seems to have a different opinion. My job is to try and figure out what is best for the country, and I am not an economist. I am someone who comes from Mineola trying to pay my bills and my mortgage and make sure that when I retire, I am going to have something that I can sustain myself on and not count on my family or anybody else to help me.

You brought up interesting points in my opinion. You are basically forecasting, in my opinion, a pretty rosy future for the market. And if that is the case, then why are we even talking about tax cuts because you are saying we are going to have a good future. I happen to think this country will come back. And if I was to take the money, I would personally look at all our States and I would take that money out of the Transportation Trust Fund, it is already there, nobody has to pay for it, we already paid for it, and do what many Presidents have done in the past, public works projects, working on inner cities, rebuilding our bridges and our transportation system and our roadways. The money is there and that is what it is supposed to be for.

Since I have been here we have been trying to fight to bring down the debt. But I also know when we are looking down at Social Security, we are looking at Medicare. We are going to have a drug plan. I don't know which one will be accepted, but it is going to come down only because the politicians have promised it and the people are demanding it. And to be very honest with you, most of our senior citizens, they actually need it. So the government is going to have to come up with some plan that we can actually afford to keep prescription drug prices down low. And I think that to me is probably the most challenging thing that we are going to face.

So with all of you, and you all have totally different opinions— I agree with Mr. Peterson, this idea about debt is scaring the dickens out of me, because we will be fighting this war in Iraq for a while, not quite the war but certainly the conflict that is going to be there. We are going to have to adjust the AMT and that is coming down the road rapidly. Politically this place is going to have to do it and they will.

And then what Mr. Peterson has said, no one is paying attention to our ports. If you want homeland security, this to me is the scariest thing going on there. And you talk to anyone that works down on the docks. We have 121 ports of entry in this country and we are not even going through a dot of the stuff that is coming in. So we have a long way to go.

So the only thing I can say to all of you is I wish we could all work together and really come up with the solutions that we are going to be facing. But I guess my question to all of you, if you had a choice why can't we have a meeting of the minds, of yes, possibly a small tax cut but also a public works program that is coming out of the Transportation Trust Fund that would help stimulate short term, give our States a 2-year break not having to match it and have people out there working which would stimulate each and every part of our cities, which to me in my own simple little way would be a win-win situation. And I would ask for a comment on that.

Mr. MALPASS. Thank you, Ms. McCarthy. Well, we have a good future, yes, but one of my assumptions is there will be a tax cut.

I think that is pretty clear. As you think about whether you want to do a tax cut, put it in terms of jobs and of the stock market, the national wealth. Right now, Congress is putting it only in terms of this $350 billion number, which is an inherently very inaccurate number. It is not a good way to judge. I think a better way would be to think about whether you want the unemployment rate 5 years from now to be 5.8 percent or do you want it to be 5.2 percent and do you want the stock market to be up 20 percent this year or up only 5 percent this year. You can put it into concrete terms. I think that is a better way to think about it than the way that is dominating the press right now in terms of this $350 billion number.

I will leave you with a final thought. I think you should look at each of the policy issues before you decide on its merits. So as you think about the Tax Code, is it going to be improved by reducing the double taxation of dividends? And the answer overwhelmingly is yes. What we do now is wrong on the Tax Code. We tax corporations when they earn the money and then we tax them again or tax their shareholders when they disburse the money. That causes corporations not to disburse. And so it stops up the capital of the country and so it is a bad system. So you have a choice to improve it, have a lower unemployment rate and a higher stock market. And it is at a cost that is within the rounding errors of their ability to really estimate costs.

Ms. MCCARTHY. From what I understand from business executives because productivity is up I mean the chances of rehiring a lot of people that have been laid off, the executives are saying they are not going to be doing that mainly because they are producing more. I don't know how many jobs we are actually going to bring back in that case.

Mr. MALPASS. Retained earnings in this country are immobile because there is a huge tax placed on them. So if a corporation has cash, it doesn't really give the cash to the shareholders and then let some other company get it. The corporation hoards the cash. The rich keep their pile of money because otherwise it is subjected to a huge tax rate in order to move it around. If you lower that tax, you are going to get a lot more mobility of capital in the country. That means more machines and that is going to create jobs. Two years and three years out you will have a lot more people working in this country if you reduce the double taxation of dividends.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas, Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman. I would like to try to draw attention to a connection between economic policy and monetary policy. We haven't talked too much about monetary policy but I think that is pretty important. Obviously spending is too high and I consider high levels of spending and deficits to be dangerous to the long-term future of this country. For that reason I vote for the least amount of spending of anybody in the Congress.

Mr. PAUL. But I also always vote to cut taxes under the assumption that it is the people's money, and it is never a cost to government because all I am doing is returning the money to the people. So, therefore, it doesn't leave a lot of options of what an individual like myself can do, because the momentum, and the appetite, for spending is so great.

The welfare-warfare state is in place and the odds of that changing, I think, are slim to none, because we do believe in welfare here at home. And both political parties endorse it, and both parties now endorse military adventurism overseas, there is absolutely no limitation on spending.

So the exploding deficits shouldn't surprise anyone, but I think sometimes, though, we deceive ourselves.

I hope the markets turn around, and we do real well, but we ought not to forget about what's happened in Japan. And we ought not to deceive ourselves about the GDP, because if we spend a billion dollar on missiles, we add that into the GDP because it's government spending. But when you blow up a missile, it is not like putting a billion dollars into a hospital or into schools or into housing when you actually raise the standard of living.

So that can be very deceiving, but my point is that sometimes we rely on monetary policy. We rely on the Fed to lower interest rates, that means print more money in order to stimulate the economy, to generate new revenues to help us out in Washington.

Generally that worked in 1990s, to a degree, because of capital gains taxes. And the stock market and revenues came in, and it seemed to help, but I do not see how we can depend on the Fed to bail us out as a Congress. Matter of fact, the system of money we have, I think, encourages us to be irresponsible because we know that unlike a State government, if we spend endlessly, and we vote for guns and butter, and we run up a $500 billion deficit, we always know the Fed is there to buy these Treasury bills and keep interest rates down.

So the question is, do any of you agree that the system of monetary policy, the monetary policy we have and the idea that we can monetize debt is actually an encouragement? Some people would like to argue it helps us out, but doesn't it actually encourage us to be irresponsible and to spend and allow the Fed to pick up the pieces and to buy this debt, because States can't do that? Do any of you care to comment on that?

Mr. AARON. I would go back to the statement that it is the people's money, and, therefore, tax cuts are desirable.

When one cuts taxes in a regime of deficits, it's the people's debt that is being increased. It is, as Mr. Peterson said, the obligations that our children will have to bear.

Would it be better if the debt that the Federal Government wishes to float was liquid and could not be sold on capital markets? No. I don't think it would be. I think it would detract from the efficiency with which the U.S. Capital market operates, which I think all of us here on the panel would agree is really one of the great glories of modern capitalism and one of the great strengths of this Nation.

The U.S. Capital market is remarkably efficient in moving net savings into productive investments. My view is that the important goal in setting tax policy, the most important goal, is to make sure that the Federal Government, by running deficits, does not subtract from national saving and thereby lower the amount of investment that we can afford to manage ourselves. As Mr. Peterson said, “We can borrow abroad, but then we pay the profits from those investments abroad.” We cannot invest a dollar if we don’t first save it.

Mr. PAUL. So you don’t think monetary policy is actually an incentive for us to be irresponsible?

Mr. AARON. No, I don’t. I think you manage it pretty well here in Congress without the assistance of Mr. Greenspan.

The CHAIRMAN. The gentleman’s time has expired.

The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I actually have a question, but I want to make a couple of comments before I get to the question.

And so I hope you all will indulge me, since the first comment I want to make is to thank the Chairman for convening this second panel today. The Members tend to show up and the press tends to show up and savor every single word that Chairman Greenspan gives, and he really didn’t say much today to be honest with you, but it’s this kind of follow-up interchange between people who really don’t seem to have a political ax to grind and who really understand the intricacies of all of these things, that I think are a lot more enlightening to us, to me. I won’t speak for the whole committee, but they are certainly more enlightening to me than anything that Mr. Greenspan said, at least today. Although, I think historically, he has said some things that have been important.

Second I want to thank the members of this panel for not bringing a political ax. I think that’s very important if we are going to try to work through this.

Third, I want to give a special thanks to Mr. Peterson. He doesn’t know this, but if I go back to 1992 when I came out of the private practice of law and really wasn’t paying attention to any of these kinds of discussions, just trying to make a living, and all of a sudden decided I was going to run for Congress because they created a district that I thought I could represent without being a politician, to be honest with you, every single person at that time was calling me a liberal. And the liberal position at that time was that it was okay to have some deficits, and the conservative position at that time was that deficits were the worst thing that could ever happen to the country because, you know, they increased the cost of money and, you know.

So I kind of adopted the liberal position because I was supposed to be a liberal. And the truth of the matter is, it was the Concord Coalition, more than any single entity, that started an evolution on my part. And when I hear people say, “Well, you have changed your position over the years,” you are absolutely right. I have. They are absolutely correct that I have changed my position, and it was the Concord Coalition that had more to do with that than any other single institution that I can think of.

Back 1995 or 1996, somewhere in there, we did this big modeling project where you were going around into congressional districts, inviting people into a room and asking them to balance the budget or create their spending priorities, and I started to understand that every decision that we make has some consequences to it. There are short-term consequences; there are long-term consequences. What I think I have heard Secretary Greenspan, and to some extent this panel, say today is, sometimes the short-term impacts of something, the stimulative impacts, don't necessarily correspond with the long-term impacts. They can be—they can actually be different, and I think this discussion has helped me, even Chairman Greenspan's discussion, helped me this morning to understand that.

I think the thing that is the constant from my perspective is that, while we can run some deficits sometimes and they are not inherently bad periodically, that we cannot constantly do it and, I don't think, regardless of the inaccuracy of the projections for the next 10 years, there is a person at this table that thinks we are not in a hell of a terrible situation for the next 10 years, 15 years when it comes to deficit spending, and there doesn't seem to be any effective way out of it.

I seemed to have used all of my time without asking the questions.

The CHAIRMAN. I will yield to the gentleman. Two minutes for questions.

Mr. WATT. Since I spent 2 minutes for praising the question.

The CHAIRMAN. If the record will reflect it accurately, the distinguished ranking minority member, it was his idea to have this panel. So we have to give credit where credit is due.

Mr. WATT. I am glad to have this bipartisan recognition of a good idea. That's a good sign here, in and of itself.

I want to focus on the stimulative part of this, I guess. Let us assume that some stimulus is needed in the economy and I am not looking at the long-term benefits of a restructuring the tax thing, just at the stimulative effect.

Somebody named economy analysis, that said that just the stimulus part of this, if you extend Emergency Federal Unemployment Benefits, you get one $1.73 for every dollar that you spend. If you accelerate the 10 percent bracket, the lowest bracket, you get $1.34 for every dollar that you spend. If you get more aid to State governments, you get $1.24 for every dollar that you spend. All the way down to the dividend taxation reduction, where you get a$.09 stimulative effect, not long-term effect, but stimulative effect, $.09 for every dollar that you give back on this dividend tax thing.

Just looking at the stimulative part of this, shouldn't we be—and I had this discussion with some corporate executives from GE who were sitting at my table at a dinner the other night—if we need a stimulus, shouldn't we be looking at extending opportunity employment benefits and accelerating the 10 percent, the lowest bracket increase, so we can get more money into the economy. Both of those things I think do it. Just don't worry about the long-term consequences.

I am not arguing with Mr. Malpass or Dr. Hassett about whether restructuring the tax on corporate earnings and dividends might be beneficial long-term, but I am looking at whether it would be beneficial to do something stimulative and whether those two things might not be the highest priority.

Mr. MALPASS. I will give the short answer, and then maybe others have a longer one.

I don't agree with those estimates that you cited. The $.09 benefit from the dividend tax cut is simply a gross underexpectation on the economy. That's a really negative statement on the way the economy works.

Mr. WATT. But that's short-term, now, I am not talking about long-term.

Mr. MALPASS. Markets and people are forward looking. If I tell you that your tax rate 3 years from now is going to be much lower than it is today, you are going to get more education, work harder now, get a better job. You are going to start today. You are not going to wait for 3 years. You are going to know that if you are in a better position 3 years from now, you are going to do more. And that's the same for these S corporations. If businesses in America know that the capital structure is going to be more liquid, they are going to start working harder and more efficiently today.

Mr. WATT. That's exactly the opposite of what the GE executives told me. They told me they would take the money and put it in a savings account, and when the economy turned around, it would have some benefit because they would invest it. And I acknowledged that, but short-term stimulation, the next 6 months to a year, is what I'm talking about.

I absolutely disagree with what you just said.

Mr. AARON. If you want to stimulate in the short run, you must do it through consumption. Investment plans take a while. They are not made overnight. For that reason, I think Mr. Greenspan was entirely right, it does not contribute to long-term growth by building up the capacity of the Nation to stimulate consumption in the short run. But he is talking about stimulating growth through expanding the supply side of the economy.

Short-term stimulation is about spurring demand, and for that purpose, you want to get the money out into purchases fast. The quick way to do that is to cut taxes for people who have high propensities to spend out of current income. And that would involve ideally, in my view, a repetition of the per capita rebate. Not all of it gets spent, much of it does not because it is temporary. A suspension of part of the payroll tax with compensation to the trust funds from the general fund would also stimulate immediate consumption.

Dividend cuts may indeed have long-term effects on investment and may indeed have long-term effects on consumption by those who receive the dividend relief. But if you want to get a big bang for the buck, quick, put it in the hands of middle- and lower-income households who need to spend essentially all their income in order to get by.

The CHAIRMAN. You may respond briefly, then we will move on.

Mr. HASSETT. It is—I disagree with Mr. Aaron on that, Mr. Watt, as have most previous Congresses during recessions. We have very often had investment tax credits during recessions. They have very often stimulated investment, and the investment tax credit equivalent of the President's proposal is about a 5 percent investment, not as big as 10 percent ITCs that we have seen in the past, but it's not tremendously different from the types of things that President Kennedy was one of the first ones——

Mr. AARON. The key to an investment tax credit is that it has to be temporary. This provision is not a temporary tax credit. It is a permanent one. The idea of a temporary tax credit is, you put investment goods on sale, go out and buy them right now, and you get the discount. If you say that the price is going to be cut indefinitely, then the stimulus to go out and buy now is dramatically reduced.

I would agree with Mr. Hassett if he is talking about a temporary investment tax credit, but not a permanent one.

The CHAIRMAN. Gentleman from Washington, Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chairman.

I want to thank all the members of the panel, but again particularly Mr. Peterson. And just to dovetail, what Mr. Watt talked about, about his sort of epiphany or renaissance in regard to the budget deficits, I want to thank you for a different reason. I came to Congress, at least the first time, the same year Mr. Watt did, 1993, but I had a different view. The deficit was one of the reasons I first ran because on Sunday morning when I would open up the newspaper and be having a nice omelet, it would be spoiled by looking at what these idiots in the U.S. Congress were doing, creating this enormous debt burden for my kids. And I have got three sons, and so I kind of had that epiphany maybe a little earlier than Mr. Watt, but I think with the——

Mr. WATT. You are always smarter than me.

Mr. INSLEE. It has been in large part because of Concord Coalition works that you have been instrumental in, and I want to thank you for getting Americans to understand the depth of this problem and the source of the problem which is the U.S. Congress and the Executive Branch.

I just want to give you an impression that I have and just ask for your comment. My impression is almost on an issue perhaps of morality as much as economic theory, in that I believe there is a moral component of when we create this debt burden for our children. Regardless of economic theory, it's something we ought not to do and I look at this, I heard one of the speakers, I think it was maybe John Tanner, during the floor debate about this, he actually likened this tax cut as actually the largest tax increase in American society because, ultimately, it will increase interest rates on the Federal debt. And you and I know, tax payers pay a debt tax, right now almost 14 percent of all the income taxes they pay go to pay the interest on the Federal debt. And in one way or another, I appreciate your testimony because what you talked about is that this basically is just shifting the burden to pay for this to a later period of time. Obviously, at some time, the paper will have to be paid, and this is shifting it down a generation, perhaps, and I look at this, I look at this tax cut as an abject failure of my generation. They talk about the greatest generation, World War II, well, my generation is the baby boom generation, and when we retire, this tax cut is an explicit promise to our kids that they are going to have an enormous tax increase. They are going to finance my generation's retirement, and I think there is a moral component to this, and that's why I feel strongly about it.

So, I guess, I ask you to comment on some of the sentiments.

Mr. PETERSON. If I may, a lecture on morality doesn't come very convincingly from somebody on Wall Street, but let me take a crack at it.

There was a German philosopher named Bonhoffer who said, “The ultimate test of a moral society is the kind of world that it leaves to its children,” and I think what we are doing to our kids is fundamentally immoral.

I would like to respond to a comment that Congresswoman McCarthy made about why we cannot get together and solve this problem, because I don’t know many people that want to consciously hurt their own children.

I think we need a common understanding of what the problem is. And if I could make one suggestion, Mr. Chairman, I would love to have you have a hearing on the single issue of the trust fund, because I think that has done more to confuse the American people and to diminish the importance of this problem than almost anything that has happened.

My father went to his grave saying, “I don’t know why you keep writing books about all these long-term liabilities and stuff. I have got an account, and that money has been set aside, and that’s going to be there when I retire.” I collected oxymorons because I was once called a powerful Secretary of Commerce, and anybody who has ever been here knows there has never been one in the history of the government. In a sense, the trust fund is kind of an oxymoron because it says fund. It’s not funded; it’s unfunded. It says trust, and I think it’s extremely important, Mr. Chairman, that the American people have a common understanding of this problem because as long as they really believe there is a trust fund out there that has been funded and that’s set aside for them, they aren’t going to take this problem seriously. And it is the one thing I think we all agree on, that it is a real problem.

Mr. INSLEE. If I ask Mr. Hassett, we know the arguments for a removal of the dividend tax, the potential of distorting impact, but in your view, given certain facts that I think we all agree on, namely, that people are getting older and medical care costs are going up, the baby boomers are starting to retire, the AMT tax will be fixed in some sentiment, defense costs will go up, Homeland Security increase will go up. All of these are bipartisan consensus items I have stated.

Given that fact and given the fact that deficits will increase as a result, would it not be preferable if you believe you want to remove that distorting impact of the dividend tax, to find some other means so that we don’t end up with these giant deficits? For instance, closing the Bahamian-Bermuda Triangle tax dodge that some of our less patriotic corporations have chosen to take, for instance.

Mr. HASSETT. Thank you for the question. I think that the dividend tax cut is likely an important enough policy that we should try to think what we can agree on to do in order to get it passed. I think that we also have to recognize, however, that, as in my testimony, the charts to my testimony, to the extent that we are doing this irresponsible or you said immoral thing to our children because we are setting them up to have this terrible bill that they are going to have to pay, well, the reason that we are doing it, first order, big reason is that the spending is soaring so out of control.

Mr. Peterson mentioned that Margaret Thatcher indexed retirement benefits to inflation but not to growth. If we did something like that, it would go a long ways towards fixing the problem, and whether we do something like that or not, I don't think is going to be seriously impacted by $200 billion of tax policy this year.

The CHAIRMAN. The gentleman's time has expired. Gentleman from Massachusetts to close.

Mr. FRANK. Mr. Chairman, I want to apologize to our witnesses. Not for my personal shortcomings, but for the shortcomings of our political culture. This is a very useful discussion. I am enormously grateful to these four very busy, very thoughtful people for having a rational and civil discussion about some of the most important issues in society. I am sorry it's not sensational enough to attract the attention it ought to. I am comforted by the fact that C-SPAN is here and that people are interested in it and that the number is 10s and of more thousands, and I think it has been useful time.

I was struck by Mr. Hassett referring back to the Kennedy Administration, because that's when I was taking Economics 125 and Dr. Aaron was grading me. So I was going to say that's an irrelevant, so far time gone, but I can't do that. I was going to suggest to Mr. Peterson that maybe he wasn't governmentally powerful. I think Herbert Hoover used the Secretaryship of Commerce to at least some political advantage. He may have been the only powerful Secretary of Commerce.

Question, first I am struck and I appreciate your honesty. It's been talked about, Mr. Hassett and Mr. Malpass, too, in some extent that each side suggests witnesses. Dr. Hassett, you were particularly explicit in denigrating the marriage-penalty relief and the child-tax credit. Would you expand on that?

Mr. HASSETT. Sure, Mr. Frank. Thank you. I guess you are trying to get me in trouble but——

Mr. FRANK. No, I am reading what you wrote. I am not bugging you.

Mr. HASSETT. I will continue to dig. I think that tax policy needs to be based on sound economic principles, that we need to have broad bases.

Mr. FRANK. We can stipulate to that. Why does that then lead you to be critical of marriage-penalty relief and a child-tax credit?

Mr. HASSETT. That's a more complicated answer. I will be glad to get back to you with that, but there is a reason why. The concern of the marriage penalty is quite cyclical over time, and we get really upset about it for a while. Then we fix it, and the way we fix it, we get upset about that, and then we put it back.

Mr. FRANK. You presumably aren't cyclical about it. Why do you think it's not very important?

Mr. HASSETT. I think that the——

Mr. FRANK. From the economic standpoint.

Mr. HASSETT. On the economics of it, on the marriage penalty, you have to decide whether you want every family who has an income of $100,000 to pay a tax, regardless of where the $100,000 comes from. Is it one person making $80 and one person making $20? Or is it two people making $50? Or do you want to tax everybody who makes $50,000 the same, whether they are married or not? You have to pick, and if you get upset about the way the tax code treats one set of people, then you will change the code.

Mr. FRANK. Give me a factual statement now. You say it does little to strengthen the economy. Why do you say that?

Mr. HASSETT. I think that using the tax code to attempt to shape families is—you are not going to have any use out of that. It is not going to be effective. So if you want to have more children, I don't think a child credit is going to make people have more children. In terms of lowering taxes, we try to stimulate activity——

Mr. FRANK. Neither one of these, in your judgment, would be likely to increase efficiency or productivity or do those things ?

Mr. HASSETT. Correct.

Mr. FRANK. Let me say, I did want to comment, and I respect the integrity of the gentleman from Texas with whom I am often aligned on various matters of personal liberty, but I disagree very much, as Dr. Aaron did, with his formulation that it is the people's money.

This notion that it is the people's money versus some entity called the government's money, I think, greatly misstates things. Of course it is the people's money, but thoughtful people understand that they have two sets of needs roughly. There are needs that we can all best deal with individually, by money that is individually available to us, but there are also needs that, all the people I know believe, that can only be dealt with collectively, cleaning the air, public safety to some extent, public transportation.

So this dichotomy between the people's needs and the government's needs is a mistaken one. There is a dichotomy between those needs which we can best fulfill individually and those which we can best fulfill working together. There are some questions about the inherent efficiency or inefficiency of when we work together. I tend to share Dr. Aaron's view on that but I think that's where we ought to formulate it.

That leads me to this question. We get into debates. Well, first, one preliminary factual question, seriously, for both Dr. Hassett and Mr. Malpass. You are critical of the 10-year window, but to be honest, I wasn't sure whether you want a shorter or a longer time horizon or both of the above. Should we substitute for the 10-year window an indefinite, as far as the eye can see, or should it be 2 or 3 years? I think, frankly, in your criticisms of the 10-year window, sometimes it was too long and sometimes it was too short. Could you expand on that?

Mr. HASSETT. I think it's too short in the sense that you need to look at the total effect of every policy. So I agree that Mr. Malpass and I were saying different things but we were——

Mr. FRANK. Okay. Mr. Malpass, you seem to be saying sort of both. By the way, let me just stipulate to one thing. Passing a tax cut to say 2010 was extremely stupid. I understand. I didn't vote for it. None of us did, and so I am glad you told them that, but should we lengthen or shorten the window?

Mr. MALPASS. I think we should have both. First, an indefinite window, meaning in its fully-mature state. If you develop an entitlement program and you figure out what it is going to cost down the line, that is a relevant number. By having a 10-year window, it is encouraging you to minimize the cost in the first part of that window. You don't get charged for the long-term, and that's an artificiality that is distorting your——

Mr. FRANK. So both of you say it should go on.

Let me put it this way. When we do a budget, should we then do it as binding for 1 year, and then the projection is infinite? We have this 1-year, 5-year. How would you change your procedures in what terms?

Mr. MALPASS. As I mentioned, I think spending restraints on the size of programs might be useful. The budgeting process that you use now doesn't help make good decisions.

Mr. FRANK. I understand. What would you do instead?

Mr. MALPASS. I think you could look at last year's budget deficit, not a projection of budget deficit, and then have your rules be based on whether you are meeting your goals.

One kind of goal is the debt to GDP ratio. We are right now at 35 percent. So you could put in some kind of concept that when you are above that, then it takes more votes, a super majority to pass new entitlements.

Mr. FRANK. I appreciate that. Is that relevant, because that's one of the questions, the ratio of debt to GDP? The argument has been, well, that's really not all that relevant and if it's relevant why? Does it have effect on interest rates or you don't think it crowds out savings? Why should I care what the ratio to debt to GDP is based on your analysis?

Mr. MALPASS. I think a debt to GDP analysis is a relevant way to look at a government's fiscal situation.

Mr. FRANK. What harm does a high one do, is my question to you?

Mr. MALPASS. Right now, the U.S. is at 35 percent of GDP. In Europe, many of the countries are at 60 or 80.

Mr. FRANK. What harm does it do if we get too high?

Mr. MALPASS. As you get too high, you are going to have trouble funding that size of a deficit. So it's like a credit limit. If you think of a person with a given income and then they say, "Well, I am borrowing $50,000," and the bank says, "Okay, that amount you can handle," and then the person says, "Well, I want to borrow $100,000," and they have a health problem, that's going to create a problem.

Mr. FRANK. Meaning people would charge me more for it?

Mr. MALPASS. I don't think the interest rate——

Mr. FRANK. But how is it going to be a problem? I want to borrow more. It sounds like you are now acknowledging that there is some negative to the higher deficits, and I wasn't sure of what they are.

Mr. MALPASS. I really think that the U.S. debt to GDP ratio is low enough that more borrowing won't affect interest rates.

Mr. FRANK. That is not what I am asking, Mr. Malpass. We have been very civil here. I am asking you, in your theoretical terms, what—and we also know it's not either/or, these things are all cumulative. You have ranges. At exactly what point I am not asking now. What is the damage that comes if the ratio gets too high? How does that damage manifest itself?

Mr. MALPASS. I think if you get to a high debt to GDP ratio beyond your creditworthiness, the investment in your country dries up. People don't want to put money in because they see a debt crisis coming. The good news is that the U.S. Isn't anywhere close to that, and I think a better model for thinking about extra debt now is more in terms of quantity discounts. There are a lot of corporations where, if they borrow more money, they get a lower rate.

Mr. FRANK. More debt would be a good thing for us right now?

Mr. MALPASS. No.

Mr. FRANK. That's what you are telling me. I understand that, but I am trying to follow the policy implications.

Mr. MALPASS. I disagree with the argument that a budget deficit——

Mr. FRANK. I understand that, Mr. Malpass, but isn't the implication of what you say, your quantity discount, that more debt could be a good thing?

Mr. MALPASS. I think a tax cut would be very good for the economy now.

Mr. FRANK. I know, but I didn't ask you that. Leaving aside of how we incurred the more debt, what was that reference to quantity discount? It sounded like there could be some value to having some more debt, or is that just a throw in that I shouldn't pay attention to?

Mr. MALPASS. No, no. Very practically, for corporations and for foreign countries, they think about placing debt on the yield curve in order to lower their borrowing rate. It's a very practical concept. You know that there is the concept of a prime rate in the U.S. Who gets prime rate? Is it somebody that doesn't borrow very much money. No. It's always somebody that borrows a lot of money. They get a lower rate because they——

Mr. FRANK. You think that has relevance to the U.S. Government?

Mr. MALPASS. At our current debt to GDP ratio, yes.

Mr. FRANK. Let me take Mr. Aaron's last comment.

Mr. AARON. Just two specific points.

The CHAIRMAN. You can tell what kind of grade you gave.

Mr. FRANK. A minus, so I owe him.

Mr. AARON. A high ratio of debt to GDP means a high ratio of interest to total budget expenditures, and that is a threat to the capacity of the government to meet its obligations in the future. That's point one.

Point two, the more debt that exists, in all likelihood, the larger the holdings abroad of U.S. Debt and hence the greater vulnerability of the U.S. Dollar to shifts in sentiment on the part of foreign debt holders.

The CHAIRMAN. The gentleman's time has expired. All time has expired. We are most in your debt to coin a phrase.

Mr. FRANK. And that's a good thing.

The CHAIRMAN. We appreciate your patience and your participation. It was most enjoyable and the committee now stands adjourned.

[Whereupon, at 1:35 p.m., the hearing was adjourned.]

A P P E N D I X

April 30, 2003

Opening Statement

Michael G. Oxley, Chairman

Committee on Financial Services

Federal Reserve Chairman Alan Greenspan

Before the Committee
April 30, 2003

Good morning, Mr. Chairman.

First of all, I'd like to thank you for your generosity in agreeing to come back to the committee and continue the round of questions from members who weren't able to speak with you in February.

Secondly, let me offer you my congratulations on the President's comments last week that he would reappoint you to another term as chairman when your term expires next summer. I'm sure I speak for the entire Committee when I say we appreciate the strong and steady hand you have exerted in the control of monetary policy.

A great deal has happened in the ten short weeks since you testified before this committee. On February 12, when you were last here, a war in Iraq seemed certain, but its length and outcome were less so. Today, we know that the war was quick, the dictator was ousted and a free Iraqi people are on their way to a new and more democratic government.

Back in February, the economy's fundamentals looked good, but uncertainties about the war and energy prices made it difficult to predict n economic turnaround. Now, with those issues out of the way the consensus is for a gradual, but steady recovery.

Of course, Mr. Chairman, as you know, there are plenty of things that still can throw the recovery off track, namely the continued weakness of the global economy, and as-yet-unknown effects of the SARS epidemic.

That is why I believe it is so important to enact the President's jobs-and-growth package. It's important to note that the President isn't seeking a short-term stimulus. Instead, Mr. Chairman, the President is seeking long-term restructurings of the tax code of the sort that you have tended to favor over time, and that you embraced in your February appearance. I'm particularly interested in the dividend tax cut and its benefits for investors, for the capital markets, and for corporate governance.

As to the other parts of the President's jobs-and-growth package, you have always, Mr. Chairman, said that you believed that tax predictability is important, and that, in general, the lower taxes are and less government spends, the better. I couldn't agree more.

Mr. Chairman, I think most in this room would agree that there is no better time to cut taxes than during an economic slowdown. It's a little harder to reach into the wallet, but now is when it really counts.

In closing, I think the early indicators are moving in the right direction, and that the economy may finally be ready to rally. Since the war, we've had indications that consumer confidence is up sharply, that consumer spending is up and that the market seems to be recovering.

Again, Mr. Chairman, I thank you for your consideration in returning to the committee, and I yield to the Ranking Member, Mr. Frank.

Statement of the Honorable Rahm Emanuel
United States House of Representatives
Committee on Financial Services
April 30, 2003

Hearing on the Conduct of Monetary Policy, Budget Deficits & the Economy

I would like to thank Chairman Oxley for holding this important hearing on monetary policy, budget deficits and the economy. I also appreciate that our distinguished witnesses, including Chairman Greenspan, have taken the time to share their views with us on these subjects.

While national unemployment figures have remained steady over the last 3 months, they are misleading. As a number of observers have commented, those numbers do not reflect the large numbers of "discouraged" Americans who have stopped looking for work and are no longer counted among the jobless. Meanwhile, it was revealed recently that Chicago lost 57,400 jobs last year, more than any other major metropolitan area. Our unemployment rate has jumped to 6.6 %, significantly above the 5.8 % national average. These are not just numbers. They represent people and families with debts and health care needs. They are hurting deeply. They need, want, and expect our national leaders to feel and express a sense of urgency about this economy. For those without jobs or resources, a "stimulus" plan centered on stock dividend tax cuts and a realignment of the tax code in favor of the wealthy means very little.

The Administration has offered differing justifications for its tax plan as economic and geopolitical circumstances have changed. The tax package has been sold as a "growth" and "jobs" plan that will immediately boost the sagging economy. Similar reasoning was offered for Mr. Bush's 2001 tax plan, the largest tax cut in a generation. But as President Ronald Reagan once said, "facts are stubborn things," and these are the facts since Congress gave the President his tax cut in 2001,

- Two and one-half million more Americans are without work;
- Five million more Americans are without health care;
- Nearly $1 trillion worth of corporate assets have foreclosed; and
- 2 million more Americans have moved from the middle class into poverty.

Commentators ranging from financial analysts to business leaders to Nobel prize-winning economists conclude that the Administration's plan fails on its most basic claim, because it doesn't deliver the immediate stimulus needed to help boost the economy in the short term. By the White House's own projections, less than 10% of the package's total spending comes in 2003, when it is needed most. Even by its own estimates, the Bush plan will create only 190,000 jobs this year, just 11 percent of the jobs lost since President Bush took office.

Moreover, the President's plan will only exacerbate the spiraling deficits that have resulted from the 2001 tax cut. Although the White House has attempted to shift the focus away from the deficit impact of tax cuts, the President's own Council of Economic Advisers recently agreed with the Federal Reserve that deficits raise long-term interest rates. In fact, the Council estimates that a persistent $100 billion annual increase in the budget deficit would increase long-term interest rates by about one-third of a percentage point. These numbers would be devastating to working families, who would face rising costs for mortgages, cars, and credit cards. Yesterday, we discovered that the government will need to borrow $79 billion this quarter, a reversal of more than $100 billion from previous projections. In light of this information, the President's plan should be abandoned in favor of a real stimulus plan, one that delivers meaningful tax relief to working Americans.

I hope Mr. Greenspan will expand on his earlier comments about the negligible impact of the President's proposed stimulus. I strongly encourage Chairman Greenspan to advocate an economic plan that stimulates job creation now – not years into the future – and that focuses resources on those who need help the most right now – not those who are doing fine without it.

We will always remember Chairman Greenspan's prescient warnings about irrational exuberance in the stock market. I encourage him to speak out forcefully now against irrational exuberance for huge tax cuts for the wealthy as the best means of providing immediate job opportunities for the millions of Americans without them.

Statement of Congressman Harold Ford
Committee on Financial Services
April 30, 2003

Chairman Greenspan,

In your letter of April 21 to Chairman Baker, you reiterated "the importance of Congressional oversight and study of the role of government-sponsored enterprises in our economy...it is important for them to be subject to the Congressional oversight process."

I agree with you that Congress must have a strong oversight role. As you know, this Committee held 6 hearings on GSE in the 107th Congress. Our predecessor Committee held as many in the 106th Congress. Few topics have received that level of continued attention by this Committee.

Much of the attention of those hearings were on the voluntary initiatives undertaken by Fannie Mae and Freddie Mac. As you know, the GSEs have worked with the Treasury to enhance transparency and provide additional disclosures.

Over the past 2-3 years, Fannie and Freddie have taken 8 concrete steps in this direction. The GSEs have agreed to:

1. Periodically issuing subordinated debt, a market-based mechanism for increasing the oversight of the companies.

2. Standards for liquidity management and contingency planning

3. The Interim Risk-Based Stress Test, which requires the GSEs to prove that they can withstand 10 straight years of economic conditions akin to the Great Depression. No other financial institutions are held to the same standard.

4. new interest rate risk disclosures

5. new credit risk disclosures

6. Public disclosure of an annual rating

7. Voluntary registration of the companies' stock with the SEC

8. And finally, expanded disclosures of mortgage-backed securities.

Mr. Chairman, is it not true that the GSEs have taken substantial steps above and beyond what they are required to do to enhance transparency? And haven't they done everything asked of them by Treasury and the Fed?

April 30, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Full Committee Hearing to Discuss Monetary and Economic Policy

Thank you, Mr. Chairman, for holding this important hearing and providing Members with this additional opportunity to discuss monetary and economic policy. I would also like to thank Chairman Greenspan for making himself available to the committee this morning, along with our other distinguished witnesses.

I was glad to learn that Chairman Greenspan has accepted another term as Federal Reserve chairman and congratulate him on his exemplary record in managing our monetary policy and often unmanageable economy.

Today I am very interested to hear our witnesses' comments on the current state of our domestic economy and any opinions they are willing to share on the President's Jobs and Growth package. I understand fiscal policy falls under our congressional purview but would respect any information or advice that could be shared by our witnesses given their esteemed backgrounds in the study of economics.

Current possible shocks to both our domestic and the global economy are also of great interest to me. When we heard from Chairman Greenspan previously the threat of war was affecting investor confidence, will our continued efforts in the Middle East or the SARS epidemic have similar results?

Again, I would like to thank Chairman Oxley for calling this hearing and look forward to a very informative session.

TESTIMONY OF
Henry J. Aaron[1]

TO THE
COMMITTEE ON FINANCIAL SERVICES
THE HOUSE OF REPRESENTATIVES
30 APRIL 2003

Mr. Chairman:

Thank you for inviting me to testify on current monetary and fiscal policy. In my remarks I shall make five major points:

- *Budget deficits for the next decade are likely even if the president's tax cut plan is not adopted. They are likely to be huge if it is adopted.* The actual situation is worse than official projections indicate because they are based on demonstrably unreasonable assumptions.

- *The longer term budget situation is more dire still*, principally because of projected increases in the cost of Medicare and Medicaid and to a smaller degree because of growth in Social Security outlays.

- In the face of such projections, *acceleration of tax cuts enacted in 2001 and the passage of still other tax cuts would be rash and unwise*. All currently-scheduled, but not-yet-implemented, tax cuts should be put on hold, and consideration of all additional tax cuts should be shelved until the medium-term and long-term budget problems have been resolved.

- Current possible economic weakness *may* justify *short-term economic fiscal stimulus*, although the need for it remains dubious. But any such stimulus *should "sunset" quickly*, certainly before the end of calendar year 2004 so that it minimally aggravates the already serious long-term budget problem.

- *The so-called "Jobs and Growth" program will promote neither job creation nor economic growth over the long-term*. Both the administration's own economic analyses and that of the Congressional Budget Office support this statement.

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[1] Bruce and Virginia MacLaury Senior Fellow, The Brookings Institution. The views expressed here are my own and do not necessarily reflect those of the staff, officers or trustees of the Brookings Institution.

THE TEN-YEAR OUTLOOK

As budget prospects have deteriorated, some officials and analysts have taken to bad-mouthing the ten-year projections that the Congressional Budget Office routinely makes. The projections, they say, are unreliable. Even if the projections are reasonable, the deficits, they say, are not very large. And even if deficits are sizeable, they say that they are relatively unimportant because other things matter more. The first reason for dismissing budget projections is right but irrelevant. The second is wrong because the official projections are unduly rosy. The third is correct, but also irrelevant.

The charge of unreliability is doubtlessly correct. The Congressional Budget Office, which produces the most widely cited projections, devoted a whole chapter in their report on *The Budget and Economic Outlook* this year to the problem of uncertainty. CBO also annually publishes something called the "fan chart" which shows the range of future possible budget balances based on their current best guess modified by the historical record of how far off their best guesses have been. Ten years out they say that the actual budget balance could fall outside a range stretching from $500 billion higher to $500 billion lower than their projection with a likelihood of about one chance in twenty. Before CBO prepared the fan chart, many of us were fond of using a chart originated by former CBO director Robert Reischauer which showed that projected deficits just five years out changed by as much as $400 billion over periods as short as three years.

But *the unreliability of projections, while a fact of life, does not excuse us from making them or heeding them. Laws change. Economic surprises occur. Analytic techniques improve. But just because I am uncertain about what lies over the crest of the hill does not make it prudent for me to drive on the wrong side of the road. And that is just what fiscal policy is doing right now. Current official projections indicate that the budget (excluding reserves being accumulated to pay for future pension and health benefits) will be in deficit by $1.8 trillion over the period 2004 to 2008 and by and by $2.5 trillion over the period 2004-2013*.

These projected deficits are unrealistically low.

- They exclude the first supplemental for the Iraqi war (and, of course, any additional ones).
- They exclude the revenue loss that will be necessary to keep millions of people from sinking into the morass of the alternative minimum income tax.
- They exclude the revenue loss to prevent the 2001 tax cuts and other repeatedly renewed provisions from expiring.
- And they exclude the cost of added expenditures that may result if Congress increases domestic discretionary at all in real terms.

A policy of balancing the budget exclusive of additions to pension health reserves would, in my view, be prudent. It may be so far beyond the reach of current policy that some members of Congress would rather not even talk about it. But that is the sort of planning all of us would expect from prudent businesses. In my view, we should demand no less for our nation.

Failure to pursue such a policy has very large costs. Compared to a policy of balancing the budget exclusive of additions to pension and health reserves, actual policy is likely to deprive the nation of approximately $5 trillion in domestically owned capital by 2013. *The steady short fall in the accumulation of domestically owned capital will result in a cumulative loss of national output of roughly $1.5 trillion over the decade from 2004-2013 and of $300 billion in 2013 alone.*

Can you or I be sure of these projections? Of course not! Would such uncertainty give you license to pursue deficit increasing policies? Does the question require an answer?

THINGS GET WORSE

Things get worse after the current budget window because retiring baby-boomers and increasing *per capita* medical costs are projected to push up federal spending on Social Security, Medicare, and Medicaid. The first baby-boomers become eligible for Social Security in 2008 and for Medicare in 2011. Between now and 2008, the share of GDP devoted to these two programs and Medicaid is not projected to change and it is projected to rise by just one percentage point by 2013. Costs rise steeply thereafter. *The Congressional Budget Office anticipates that the share of GDP devoted to these three programs alone will rise by 7.9 percentage points between 2000 and 2040.*

Costs rise for two reasons. Everyone knows the first—*the baby-boomers will be retiring*. The second factor, nearly as important as the first, is that *age-adjusted health care costs are projected to rise sharply*.

The cost of Social Security, measured as a share of GDP, is projected to rise by 2 percent of GDP over the four decades from 2000 to 2040. That increase is the same as the actual increase in Social Security costs that occurred between 1970 and 1983. Nobody paid much attention to that increase. The economy took it easily in stride. If nothing other than the projected increase in pension costs were happening, I believe that the economy would also take in stride the future increase in Social Security costs, which is spread over forty years not just thirteen.

One reason the cost increase is so modest is that in 1983 Congress enacted benefit cuts of about 15 percent that are being phased in gradually and will partly offset the added pension costs for the boomers. These benefit cuts are mislabeled and misunderstood as an "increase in the retirement age." In fact, the Social Security entitlement age was, is, and—under current law—will remain age 62. The effect of increasing the "full benefits age" is simply to cut benefits relative to prior law, whenever people elect to retire after age 62.

But much more is projected to happen. *Three quarters of the increases in costs for benefits for the elderly and disabled are projected to occur in the health programs, Medicare and Medicaid.* The driving force behind the projected increase in the cost of these programs is not simply a jump in the number of beneficiaries, nor is it a projected increase in the average age of beneficiaries. If the number of beneficiaries were all that is involved and health costs rose no more than earnings do, then Medicare and Medicaid costs would increase roughly half as much as the projections indicate. Nor are costs rising because the average age and, hence, the average health care cost of Medicare and Medicaid beneficiaries is projected to increase between now and 2040. It isn't. Because of the rapid addition to beneficiary ranks of newly eligible and therefore relatively young boomers, the age distribution of Medicare and Medicaid beneficiaries will not change much until after 2040.

Medicare and Medicaid costs are projected to rise fast also because the menu of health care services is expected to lengthen and the age-adjusted cost of those services is projected to increase. Were it not for this projected increase in costs, projected Medicare and Medicaid costs would rise roughly half as fast as projected.

Regardless of the source, the bottom line is that the major threats to the budget lie outside the ten year budget window on which most attention is now focused. To formulate current budget policy without regard for what occurs just beyond it is foolish.

NO NEW TAX CUTS!

The foregoing fiscal picture—current, medium term, and long term—is uniformly bleak. However bleak, these projections make no allowance for fiscal damage from future recessions. They make no allowance for future wars or other foreign policy threats that may necessitate increased defense or overseas spending. In brief, under current policy the U.S. government is not paying for the services Congress has voted. How future Congresses may deal with this gross fiscal imbalance remains unclear. But one thing is clear—any further tax cuts now—any at all—will exacerbate those problems.

President Bush and his supporters have argued that tax cuts he has proposed will not have these bad effects. Unfortunately, they have presented no credible evidence to support this claim. The laws of arithmetic decree that the direct effect of tax cuts is to lower revenue. Only if the tax cuts stimulate income growth so much that taxes on that added income exceed the initial reduction could a tax cut lower the deficit. No responsible forecaster thinks that is likely. Here is why.

Even without additional tax cuts, most forecasters expect that the combination of stimulative monetary and fiscal policies over the last two years will return the economy to full employment soon. The speedy victory in the war in Iraq makes that forecast more likely. The threat of SARS makes it less likely. But when the economy does return to full employment, a tax cut can increase revenue only by raising growth. The direct effect of tax cuts that permanently lower revenue in an economy with fully employed resources is just the reverse—to cut revenues, increase the deficit, and lower national saving. *Well-designed tax cuts also stimulate labor supply and private saving, which positively affect growth. But even with well-designed tax cuts, the balance of reduced public saving, increased private saving, and increased labor supply is as likely to lower growth as to increase it and is most unlikely to raise revenue.*

President Bush's proposed tax cuts were not well designed to promote growth. All of the initial benefits from the dividend exclusion would apply to profits generated by capital already in existence, which, by definition, is immune to any positive tax incentives. A tax cut well-designed to stimulate investment would apply entirely or principally to new investment. The tax exclusions for personal saving would do more to facilitate asset transfers from existing taxable accounts—which lowers growth by cutting revenues, increases the deficit, and lowers national saving—than to encourage additional saving—which adds to income growth. And the increased child credit, which has appealing distributional features, would lower labor supply, not increase it. *Labeling such a plan a Jobs and Growth plan owes more to rhetorical creativity than to descriptive accuracy*.

This is the clear verdict on President Bush's proposed tax cuts from the honest trial of dynamic scoring reported recently by the Congressional Budget Office.[2] CBO ran several models that allow for feedbacks of tax changes on growth. Some models predicted the plan would lower growth, others that it would increase growth. All predicted that it would increase the deficit. This CBO report flatly refutes any claim that tax cuts will raise revenue by spurring growth and shows that effects on growth are as likely to be negative as positive.

The economic model that the Administration cited in support of its economic program also casts doubt on the long-term value of that program.[3] This model forecasts higher employment and income this year and next if the monetary authority allows the money supply to grow as fast with the tax cut as they would without it. This assumption is almost certainly unrealistic as most observers think the FED is likely to use economic recovery as an opportunity to boost interest rates so that it will have room to cut them in the future if economic weakness reappears. But even if the assumption regarding monetary policy turns out to be correct, the same model indicates that the administration's program will reduce economic growth after 2004 for the rest of this decade and boost unemployment from 2006 through 2014.

I realize that neither a Congressional majority nor the administration is disposed now to reconsider the 2001 tax cuts. This unwillingness is unfortunate. When the 2001 tax cut was enacted, the United States was basking in what turned out to be the Indian summer of the longest economic expansion in U.S. economic history. Al Quaeda had not yet violated the nation's domestic tranquility. Budget projections were as rosy as they have ever been. If events since then have not been sufficient to cause a reconsideration of the size or duration of that tax cut, one struggles to imagine what cataclysm would be great enough to do so.

At a minimum, however, the deplorable state of the federal budget and the likelihood that the situation will grow more dire should cause Congress to reject any additional permanent tax cut at this time. The word "any" includes not only a tax cut of the magnitude proposed by President Bush in January, but also the so-called compromise cuts of only $550 billion or $350 billion over ten years, particularly if the plans are back-loaded so that the revenue loss grows.

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2 Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004,* March 2003, pp. 16-32.

3 Macroeconomic Advisers, LLC, *A Preliminary Analysis of the President's Jobs and Growth Proposals*, January 10, 2003

For release on delivery
10:00 a.m. EDT
April 30, 2003

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

April 30, 2003

Mr. Chairman and members of the committee, I am pleased to have this opportunity to update you on developments in the U.S. economy since mid-February, when I presented the Federal Reserve's semiannual monetary policy report.

At that time, I noted that the economic expansion over the preceding year had been modest. Spending by households had contributed importantly to the gains in economic activity. The nation's strong underlying productivity performance was providing ongoing support for household income. That rise in income, combined with low interest rates, reduced taxes, and the availability of substantial home equity, had spurred solid gains in consumer spending and a robust advance in residential construction.

In contrast, although the contraction in capital spending appeared to have slowed, we had yet to see any convincing signs that a sustained pickup in business spending was emerging. Moreover, heightened geopolitical tensions were adding to the already considerable uncertainties that had clouded the business outlook over the preceding three years. The general climate of caution in the business sector was manifest in a number of ways, including restrained hiring, a reluctance to invest in new capacity, and aggressive actions to maintain low levels of inventories.

In late February and early March, the risks and uncertainties surrounding the economic outlook intensified as the range of possibilities for the timing, duration, and economic consequences of the pending war in Iraq appeared to widen. In financial markets, a greater sense of caution among investors seemed to bolster the demand for Treasury and other fixed-income securities at the expense of equities; the price of crude oil moved up, as did the prices of gasoline and home heating oil; and consumer confidence sagged further. After picking up in January, payroll employment and manufacturing production turned down again in February and March.

When the onset of the war became imminent, financial markets rallied, and the price of crude oil dropped back. Market participants seemed buoyed simply by the elimination of uncertainty about the timing of the start, and hence the end of hostilities, although a still-significant amount of unease inevitably remained about the way the war might progress and how severely it might disrupt oil production and economic activity.

In such an environment, we had little ability to distinguish temporary changes from more persistent shifts in underlying economic trends. For that reason, the Federal Open Market Committee, at its March 18 meeting, refrained from making a determination about the balance of risks with respect to its long-run goals of price stability and sustainable economic growth. At the same time, we stepped up our surveillance of economic developments.

As part of that surveillance, we receive virtually continuous information from commodity and financial markets. The price of crude oil is now well below its peak of early March, as the potential for serious supply disruptions in world oil markets has diminished. Broad equity indexes remain well above their lows of mid-March and have been boosted most recently by incoming information on first-quarter earnings that market participants appear to view as generally positive.

In contrast, six weeks after the beginning of the war, we have only limited readings on broader economic conditions, and that information has been mixed. Households appear to have become somewhat less apprehensive about the economic outlook in recent weeks, though reports from businesses have not exhibited a similar improvement in tone. Consistent with this, the persistent high level of new claims for unemployment insurance suggests that firms may still be finding it possible to meet their customers' tepid increases in demand with a leaner workforce.

Going forward, some further unwinding of the economic tensions that have been associated with the situation in Iraq seems likely. As that occurs, the fundamental trends shaping the economic outlook should emerge more clearly. As I indicated when I met with you earlier this year, I continue to believe the economy is positioned to expand at a noticeably better pace than it has during the past year, though the timing and the extent of that improvement remains uncertain. Fundamentally, the long-run growth potential of the economy remains solid. And the enhanced flexibility inherent in that trend imparts resilience against shocks of the kinds that we have experienced in the past few years.

Unfortunately, the future path of the economy is likely to come into sharper focus only gradually. In the interim, we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

As you may know, the consensus of economic forecasters is that a material rebound in economic activity will develop in the second half of this year, and certainly a number of elements should be working in that direction. The recent improvements in financial markets that I noted earlier, if maintained, would seem to suggest a turnaround in capital spending. In this regard, the ongoing decline in risk spreads in corporate bond markets so far this year is an encouraging development. To be sure, spreads remain high by historical standards, but the constraint imposed by last fall's huge run-up in risk premiums now appears to have been put largely behind us.

In addition, businesses should see some relief from the pressure on profit margins that had developed in recent months as energy prices rose sharply, and improvement on this front could be a positive development for capital spending. A modestly encouraging sign is provided by the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Households, too, are likely to welcome lower energy bills and a continuation of favorable conditions in mortgage and credit markets.

As you know, core prices by many measures have increased very slowly over the last six months. With price inflation already at a low level, substantial further disinflation would be an unwelcome development, especially to the extent it put pressure on profit margins and impeded the revival of business spending.

The balance of influences on inflation and economic activity will be among the subjects of discussion by the Federal Open Market Committee when it meets in six days.

Testimony Submitted
To
The United States House of Representatives
Committee on Financial Services

April 25th, 2003

Kevin A. Hassett*
AEI

*Dr. Kevin A. Hassett is Director of Economic Policy Studies at the American Enterprise Institute.

Introduction

There is no question that our political process has produced a fiscal policy machine that spews out promises to voters that—while providing short-term benefits to politicians of both parties—expose our nation and our economy to significant long-run risks. As we gather this week to consider new fiscal policies, it is my belief that much valuable perspective can be gained from a careful enumeration of our most difficult problems.

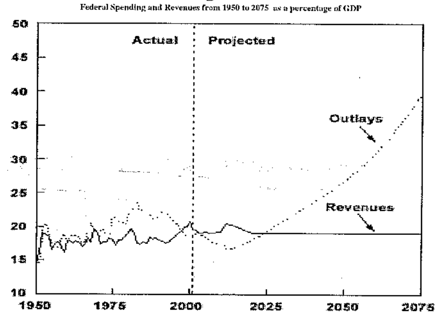
A look into the distant future can help provide insights into the strength and weaknesses of different proposals today. I will focus on the two issues that I believe are the most important. I will then discuss the extent to which current proposals adequately respond to these challenges.

The Coming Train Wreck and Its Causes

It is common knowledge that the long run fiscal position of our nation is very poor. Under current policies, for example, federal deficits as large as 20 percent of GDP have been forecast by the Congressional Budget Office (CBO) over the next 75 years. Such observations provide powerful ammunition to those who would oppose tax reductions at the present time. If we are headed for enormous deficits in the future, how can we possibly cut taxes today?

Figure 2

Federal Spending and Revenues from 1950 to 2075 as a percentage of GDP



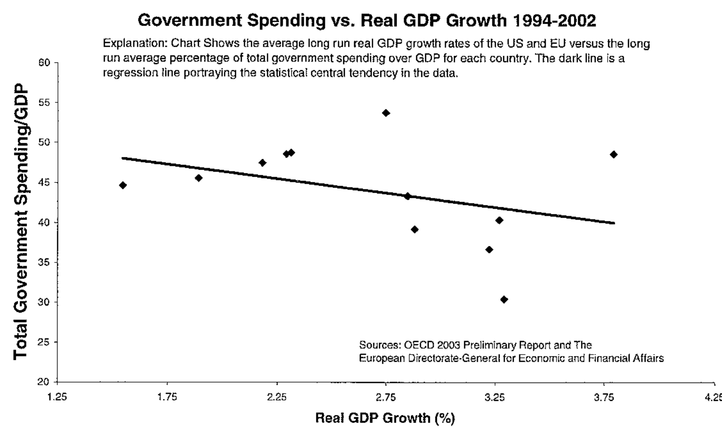
A look at the underlying details, however, suggests a possible answer. The problem is not caused by taxes, but rather by spending. Figure 1, which has been constructed from CBO data, provides a graph of projected federal spending and revenues from 1950 through 2075. These data include all of the tax reductions of the past few years, but do not include any proposed changes to law this year. The chart tells an interesting story. The "train wreck" is attributable to a projected explosion of government spending. Total federal government spending increases over these decades from about 20 percent of GDP to about 40 percent of GDP. Revenues, on the other hand, hold steady at 19 percent of GDP. Since GDP grows over this period, revenues do as well. Revenues are not lower than they are today in 2075, but much higher. Spending, however, is higher still. If one assumes that state and local government spending will likely follow a similar path, then one can conservatively conclude that government spending is currently on a course that will lead it to consume almost 60 percent of GDP by 2075, about double the current percentage of GDP devoted to government spending. This does not happen because of new policies. Government will consume 60 percent of GDP if we do nothing. It will consume significantly more than that if prescription drug coverage is passed this year.

If the long-run imbalance is attributable to spending outracing revenue, then Congress has two choices. It can control spending growth, or it can raise taxes. Neither choice is politically popular. Controlling spending means that promised benefits for senior citizens will be reduced. Increasing revenues only continues government on a path to consume more than half of GDP.

Enough policymakers have argued that long-run deficits make tax reductions today "irresponsible" that it is worth exploring the implications of a government that large. For implicit in the anti-tax-reduction view must be the belief that "responsible" tax policy will raise tax rates until the long-run budget is balanced. Under current policy, the combined government of the U.S. is on target to be about 30 percent larger than the current federal government of France, which already consumes nearly 50 percent of its nation's GDP.

This large devotion of resources to government would undoubtedly have negative economic consequences. Economists have generally found that countries with large governments grow slower than countries with small governments. This relationship is clearly evident in the data.

Figure 2



For example, Figure 2 indicates for a sample of OECD countries that countries with smaller governments have significantly outperformed countries with large governments. The most likely explanation for this pattern is that governments tend to be much less efficient than private individuals.

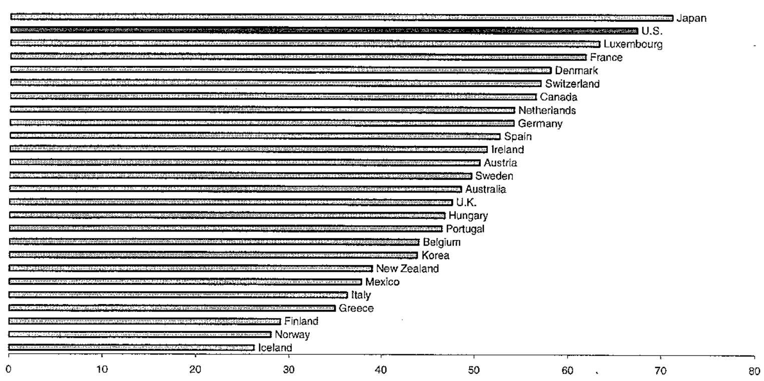
Since very few among us want our country to become France, it is useful to consider how this problem will work itself out. It is my opinion that we will either have a large entitlement reform or a long sequence of small tax increases. Even small tax reductions today, then, make the high tax path less likely. This is because they increase the politically-difficult tax increases required to close the gap between revenues and spending in the future. My own guess is that we will ultimately recognize that it is foolish to bankrupt ourselves by paying ourselves ever-richer retirement benefits. Real GDP is forecast by the CBO to be almost 7 times higher than it is today in 2075. Since social spending is motivated by a worthy concern to provide a safety net, one might conjecture that the case for high across-the-board social spending weakens as income rises. Finally, it may well be difficult if not impossible to solve these problems with tax increases. A recent study of OECD countries, for example, found that fiscal adjustments that rely upon spending cuts have tended to successfully restore fiscal discipline. Those that rely on tax increases failed to.[1]

The U.S. Corporate Tax Code Must Be Reformed

The second pressing problem is the terrible state of our corporate tax code. While U.S. corporate tax policy has seen little change over the past decade, the rest of the world has been active reducing tax rates. As a result, the U.S. has acquired an extremely unfavorable position relative to the rest of the world.

Why is the rest of the world reducing taxes on capital income? The best explanation is that the view accepted by most economists that high capital income taxes can be harmful to economies has received a fairly broad acceptance among our trading partners. Since the U.S. has lagged behind, we now find ourselves in the uncomfortable position of being second only to Japan in the degree to which we tax corporate income. As can be seen in Figure 3, which plots the combined corporate and dividend tax across countries, the evidence is striking.

Figure 3
Combined Corporate and Personal Dividend Tax Rates (2003 Under Current Legislation)



Sources: Effective Corporate Rates are from the KPMG Corporate Tax Rate Survey (Jan 2002) and Personal Rates are from the OECD. 2001 Data Used: Australia, France, Greece, Japan, Korea, Luxembourg, Sweden, Switzerland, UK, 2003 data for Can Canada, Belgian Data from Price Waterhouse Coopers and Italian data from Deloitte.

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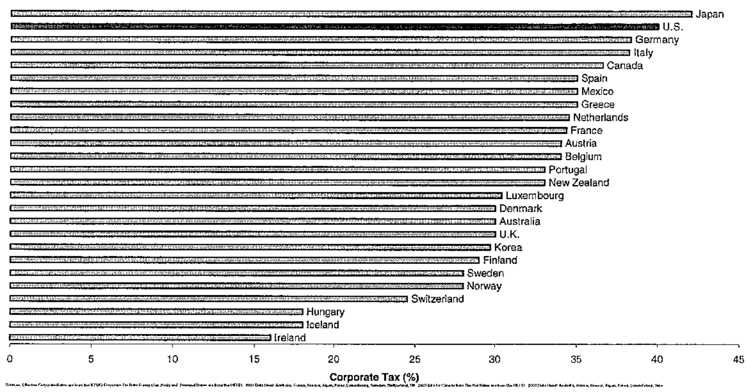
[1] Alesina, Aleberto, and Perotti, Roberto, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects." NBER Working Paper No. 5730, August 1996.

As Figure 4 demonstrates, the result is not solely attributable to the double tax on dividends. The U.S. corporate tax rate is second from the top as well.[2]

Figure 4
Effective Combined Top Central and Local Corporate Tax Rate (2003)



These figures should provide food-for-thought for those who would contend that the reduction in double taxation disproportionately benefits the wealthy. If that were true, why do Scandinavian countries with historically strong social welfare objectives tax corporate capital at a lower rate than ours? The answer is simple. High tax rates encourage firms to locate elsewhere. When this occurs, shareholders may come out ahead, but workers will not. The best policy for a country is to make itself as attractive as possible to capital. If it does succeed in keeping its own capital at home and luring foreign capital in large quantities, everyone will benefit. Workers will have higher wages, government will receive higher tax revenues, and investors will reap higher returns. The U.S. and Japan are among the few countries not to have recognized this.

One should not take these tax disadvantages lightly. Under current law, for example, a U.S. firm intent on paying dividends has to have more than double the after-corporate tax profit of a Norwegian firm in order to offer a taxable shareholder the same after-tax cash flow.

It is my belief that international tax competition is going to put ever-increasing pressure on the U.S. to sharply reduce taxes on capital income. This pressure will make it very difficult to solve the long-run fiscal crisis by increasing tax revenues.

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[2] A number of countries have recently stepped away from imputation systems, but after significantly lowering their corporate tax rates. This highlights the fact that it is not the "double tax" that presents the problem, but the combined tax rate on corporate income.

Current Tax Proposals and the Long-Run Debate

Nothing on the current agenda fundamentally addresses the long-run budget imbalance. However, even the largest of the proposals currently in play—a tax reduction of $550 billion over then next ten years---is miniscule in size relative the economy and the long run problem. The annual cost, statically scored, of any likely proposal will be around one half a percent of GDP. [3]

The President's plan to reduce dividend tax rates has a strong appeal given the second problem. Income that has been taxed once will not be taxed again. It will not be taxed at the shareholder level if the corporation uses its income to pay a dividend. Capital gains that are attributable to the retention of after-tax corporate income will also not be taxed. While there are many challenges ahead, this is a major step in the right direction, significantly reducing the gap between the U.S. and its competitors.

What would the effect of dividend tax reduction be? The largest and most direct effect will likely be a stimulus to capital spending. This will increase economic growth and give society more resources to devote to its long run problems.

The literature relating tax factors to firm capital spending was reviewed recently by Hassett and Hubbard (2002).[4] We found that economists have often identified strong effects of tax policy on investment behavior. The literature on *dividend* tax policy and investment has had a rather contentious history. Theoretically speaking, it is possible to derive cases where dividend taxes have a large effect on investment, but other cases exist that are equally plausible that suggest that dividend taxes have a smaller effect. An early and pathbreaking study by Poterba and Summers (1985) concluded, "our results suggest that dividend taxes reduce corporate investment and exacerbate distortions in the intersectoral and intertemporal allocation of capital".[5] A more recent study that I coauthored with Alan Auerbach of the University of California at Berkeley found evidence that supported somewhat smaller economic effects of dividend tax reductions.[6]

Accordingly, it is appropriate given the academic literature to be somewhat cautious concerning the likely investment effect of the President's plan, and to account for the eventuality that perhaps as many as half of firms will respond in a small way. Calculations that I have performed confirm the recent testimony of the Chairman of the Council of Economic Advisors that the reduction in the net cost of a new equipment investment associated with the President's proposal is in the range of 4 to 7 percent.[7] If one is willing to assume that state and local taxes will also be eliminated in response to the federal action, the effects can climb higher. To put these reductions in perspective,

[3] The word "cost" in this context is rather loaded. The reduction of a tax is not traditionally described as a cost in the economics literature. The revenue lost by the government remains with the original taxpayer and does not simply disappear.

[4] Kevin A. Hassett and R. Glenn Hubbard (2002), "Tax Policy and Investment," in A. Auerbach and M. Feldstein eds., *Handbook of Public Economics*, volume 3, pp. 1293-1338.

[5] Poterba, J.M., and L.H. Summers, "The Econonomic Effects of Dividend Taxation", (1985) in E. Altman and M. Subrahmanyam, eds., *Recent Advances in Corporate Finance*, pp. 227-284.

[6] Auerbach, A.J., and K.A. Hassett (2003), "On the Marginal Source of Investment Funds," *Journal of Public Economics*, 87, pp. 205-232.

[7] Testimony of R. Glenn Hubbard before the Senate Budget Committee, February 3rd, 2003. Other calculations suggest that the impact on incentives to invest in nonresidential structures is much greater than that, but the empirical link between the marginal incentive to invest and structures investment is much weaker.

the low end of Dr. Hubbard's range is approximately the same reduction in the cost of new investments achieved by last year's stimulus bill that included temporary partial expensing. The high end of the range provides about double the stimulative effect of the 2002 temporary partial expensing provision.[8]

If capital spending does respond proportionately to the increased incentive to invest, then simple arithmetic suggests that the true revenue cost of the dividend tax proposal may be very close to zero, and will certainly diminish over time. [9] Thus, it is simply incorrect to state that dividend tax reductions are too costly given our budget circumstances.

I would argue that each fiscal policy measure that Congress adopts be measured against these pressing problems. Does the tax or spending change provide a strong foundation for economic growth? Does it worsen our already difficult problems? By this measure, the dividend tax reduction deserves high grades.

To be sure, other policies currently in play have significantly less economic merit than dividend tax reductions. Politically popular changes such as marriage penalty relief and the child credit will do little to strengthen the economy. The proposed introduction of a drug benefit for our senior citizens could have an exploding cost over the next few decades, significantly exacerbating our long run challenges.

It is exactly these policies that we should not adopt until the long-run entitlement problems are resolved. As the members of this august Committee discuss policy changes, they must keep these facts in mind. Indeed, to the extent that revenue shortfalls are a concern for some when considering dividend tax proposals, a solution is readily at hand. In order to adopt the policies that improve the efficiency of the tax code, budget hawks should be willing to pay for reforms by passing up tax measures that are more sound bite than sound policy. The gravity of our long run problems makes any alternative unacceptable.

[8] The incentive effects of the Job Creation and Worker Assistance Act of (2002) were discussed in, Cohen, D.S., Hansen, D.P. and K.A. Hassett (2002), "The Effects of Temporary Partial Expensing on Investment Incentives in the U.S.," *National Tax Journal* Volume LV, *No. 3, pp 457-466.*

[9] I should note that alternative proposals that simplify the President's proposal by disconnecting the dividend tax reduction from the corporate tax status of the firm have similar economic effects when the personal dividend tax is reduced by between 50 and 70 percent.

Statement of
David R. Malpass before the
House Committee on Financial Services
April 30, 2003

Chairman Oxley, Mr. Frank, members of the Committee, thank you for the invitation to testify on United States monetary and economic policy. I've organized my testimony into three parts: the economic outlook, key variables including the tax cut, and some comments on the budget deficit.

Despite slow growth in the first quarter, I think the economic outlook is good. The U.S. economy grew 2.9% in 2002 and is likely to grow well above that in 2003. Job growth should begin later in the year. We are likely to see a new record in U.S. employment in 2004, topping the 132.5 million in March 2001. Orders for durable goods grew 2% in March from February despite the weather and Iraq-related uncertainties. Consumer confidence has taken a sharp upturn.

The pace of the recovery from the 2001 recession has been modest by historical standards yet well above the prevailing pessimism. I think oil prices, business investment, and the tax cut are the primary variables in the outlook, though SARS is important for now. In my view, these variables are more important than the bearish focus on the trade deficit, the budget deficit, past deflation, excess capacity, consumer debt and housing prices.

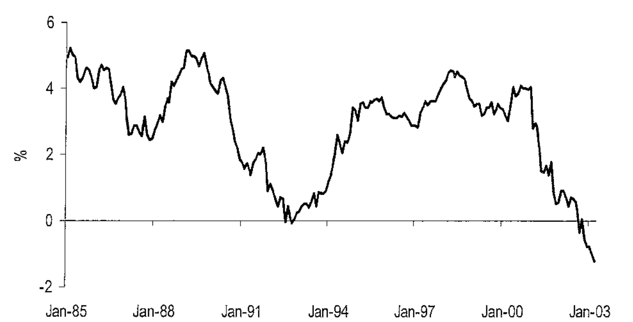
Much of the pessimism on the economy is backward looking, reaching a grim outlook by comparing current conditions to the strong-dollar-induced bubble of the late 1990s. True, we shouldn't expect a return to the bubbly 1990s in terms of the 3.8% unemployment rate, the high-flying dollar, or regular double-digit equity returns. Those conditions felt good at the time, but left the economy on the brink of a deflationary recession. The macro-economic causes of the global recession are clear: the ever-strengthening dollar and the resulting deflation; very high real interest rates; high OPEC-controlled oil prices; and a record tax burden which drained a net $236 billion (2.4% of GDP) from the private sector in 2000 in the form of the fiscal surplus. *None of these contractionary forces is present now.*

Arrayed against these problems are the improved macro-economic polices, the small-business character of the U.S. economy, a strong, flexible labor force, and fast productivity growth. The balance, in my view, is favorable for the U.S. outlook. I will be even more confident if a growth-oriented tax cut passes Congress.

Good Platform For Growth

The platform for future economic growth is in much better shape than in 2000. Interest rates are very low. Real interest rates (the Fed funds rate minus the inflation rate for personal consumption expenditures) finally went deeply negative in late 2002, encouraging investment and inventory rebuilding.

Real Fed Funds Rate (Fed Funds Minus PCE Deflator)



Source: Haver; Bear, Stearns & Co. Inc.

The value of the dollar is back at a pro-growth level after its deflationary strengthening from 1997-2001. Inventories are low. Tax rates are lower than they were in 2000, with the prospect of more rate cuts. Corporate profits and the stock market are rising. Oil prices have fallen and the OPEC cartel seems to be losing its ability to keep oil prices artificially high.

- Yes, the economy lost 108,000 jobs in March. Still, the current level of U.S. employment is over a million and a half higher than the 1999 average. This is discussed in detail in the next section.

- I expect the next interest rate move by the Federal Reserve to be up, not down, probably in the second half of 2003. Still, the economy will enjoy lasting benefits from the current period of low interest and mortgage rates, helping make up for the damage from the high real interest rates during the bubble.

- Consumer debt has reached record levels at $8.7 trillion. Still, personal income hit a new record in March at $9.16 trillion, arguing for consumer resilience. Consumer assets are holding at $48 trillion and part of the debt buildup reflects record home and auto ownership and related debt.

- The U.S. current account deficit, at 4.8% of GDP, is in record territory. Still, U.S. economic growth is well above our trading partners, and investment into the U.S. dwarfs investment into other countries.

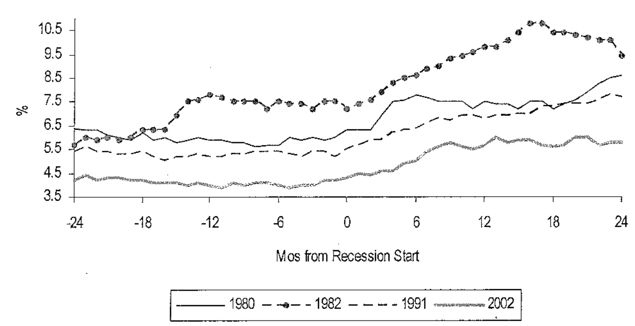
- The U.S. fiscal deficit will probably top $300 billion in fiscal year 2003. Still, at 2.7% of GDP, this is well below the 1983 peak of 6% of GDP. The debt/GDP ratio is 35.5% , well below the 49.5% recorded in 1993. Given low interest rates, the cost of servicing the U.S. government's debt is also steady relative to the budget and GDP.

- Clearly, SARS will hurt non-Japan Asia's second quarter growth and must already be having a small impact on the U.S. through our broad trade and investment relationships. Still, our current estimates show that SARS will have about one-tenth the impact of the 1997-1998 Asia devaluation crisis, roughly a $30 billion subtraction from Asia's GDP versus a $345 billion subtraction in 1998. SARS may cause some temporary disruptions in supply lines from Asia to the U.S. However, I note that the U.S. economy adjusted fast to the California energy crisis, minimizing the damage from the disruptions.

Labor-Market Conditions

Employment is a critical part of economic success. Jobless claims have grown in recent weeks, reaching 455,000 in the week ending April 19. Rather than a "jobless recovery", though, I think the economy is reacting more as if there was a bubble in employment in the late 1990s, followed by a reversal. The March 5.8% unemployment rate, which I expect to go somewhat higher in April, was relatively low by historical standards.

Unemployment Rate: Current Vs. Previous Cycles



Source: Haver; Bear, Stearns & Co. Inc.

- At 130.4 million workers in March, U.S. employment is still 1.5 million above the 1999 average achieved during the boom. With productivity growth fast, driven in part by the investment boom of the 1990s, I don't think employment will grow strongly from current levels until later in the expansion.

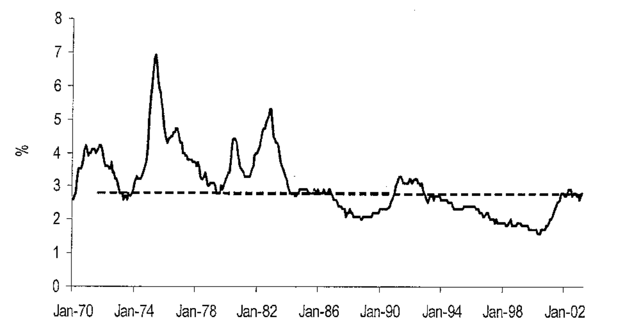
- While initial jobless claims have risen in recent weeks, they should be compared to the bigger employment base. For example, in the 1993-1996 economic expansion, jobless claims were generally 350,000 per week. However, the level of employment at that time averaged 115 million. With employment now over 130 million, the equivalent jobless claims would be 400,000 in an expansion. The graph shows that jobless claims are relatively low compared to pre-irrational-exuberance times.

Initial Jobless Claims as % of Employment

Source: Haver; Bear, Stearns & Co. Inc.

- The number of workers receiving continuing unemployment compensation as a percentage of total employment is also low relative to past business cycles. The current rate (slightly less than 3%), even though well above the 1999 low, is consistent with strong expansions in past business cycles.

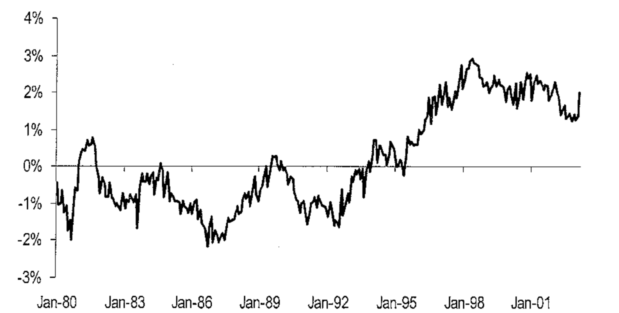
Continuing Unemployment Claims as % of Employment



Source: Haver; Bear, Stearns & Co. Inc.

- Real wage growth held up well through the 2001 recession. This and the 5.8% unemployment rate help explain the steady growth in consumption in recent years.

Real Wage Growth (using Core PCE Deflator)



Source: Haver; Bear, Stearns & Co. Inc.

Key Variables

Due to the dollar's decline, I expect a constructive, multi-year reflation process. This will be a challenging environment for business profits but a decided improvement over deflation. In most other parts of the world, economies are substantially weaker than ours, with unemployment higher, government spending and unfunded pension liabilities bigger, health care systems less effective, and currencies even more volatile. Even so, world nominal dollar GDP looks like it will grow well over 7% in 2003, twice as fast as in 2002 and a sea-change from the 1.4% decline in 2001's deflationary recession. Clear U.S. leadership will play a critical role in helping improve growth policies elsewhere, including promoting tax reform, currency stability, and restraint on the size of government.

I would like to emphasize three key variables in the U.S. growth outlook – oil prices, business investment and the tax cut.

Oil prices. With the regime change in Iraq, oil prices have fallen sharply to $25 per barrel from $37. I expect further declines as Iraqi oil begins to ship and U.S. inventories build. This will be a significant stimulus to the economy, including the consumer effect and, more important in my view, the positive effect on the business outlook.

Business investment. Low interest rates, low inventories, the prospect of a tax cut, and less Iraq-related uncertainties should improve "animal spirits", the willingness to take business risk. I expect investment in business equipment to grow 7.7% in 2003 (fourth quarter over fourth quarter), up from 3.3% growth in 2002. This is modest growth by the standards of previous recoveries, reflecting caution after the investment boom of the late 1990s.

I disagree with the bearish concerns over the 74.8% capacity utilization rate. 1) Capacity utilization data covers only about one-third of the economy. 2) Idle capacity is heavily concentrated in telecommunications and semi-conductors. 3) Business investment usually recovers while the government's measure of capacity utilization is still declining. 4) Much of the capacity was short-lived and installed prior to or during the late-1990s boom, meaning a boom in obsolescence in many sectors. 5) I think the government data on capacity utilization can't effectively measure write-offs, obsolescence, or innovation and can't keep up with the economy's rapid structural changes. This makes capacity utilization a lagging and unreliable indicator of future investment.

Tax Cut Would Improve The Capital And Incentive Structure

My testimony has lauded various structural aspects of the U.S. economy. It stands out around the world in terms of productivity and flexibility, auguring well for long-term growth.

However, one area where the U.S. is sorely deficient is the tax code. We suffer from very high marginal income tax rates, a heavy payroll tax on both the employer and employee, and huge tax incentives encouraging all types of debt – high-yield corporate debt, state and local debt, mortgage debt, etc.

A growth-oriented tax cut is a critical part of the U.S. and global recovery and one of the key variables in the outlook. Economic health depends on the efficiency of the capital and incentive structures. The President's proposal to complete the 2001 tax cuts and eliminate the double taxation of dividends (which heavily biases the corporate sector toward debt) would, in my view, add strongly to both the near- and longer-term growth outlook. It would provide important benefits in terms of jobs, economic growth, capital mobility, and corporate governance.

When you tax something less, you get more of it, in this case more capital, labor, and wealth. Under the Administration's proposal, that would mean more productivity, jobs and economic growth. In terms of near-term and long-term growth, I think the President's proposal is much superior to cash rebates or other consumption-oriented tax cuts. It is preferable to targeted investment incentives such as equipment expensing -- we need to improve the quality of investment as much as the quantity. Though intangible, one big benefit from enacting the Administration's tax cut proposals would be the positive implication for the direction of future tax reforms.

Mis-scoring the Tax Cut

The President's full proposal, including income tax cuts and other provisions, was scored as a $726 billion "cost" over 10 years. This is only 0.5% of the Congressional Budget Office's $146 trillion GDP expectation for those years, but even so I think the $726 billion estimate overstates the cost and ignores the benefits. I don't claim to know exact numbers for a proper estimate. Economics isn't a science. But I know that simply looking at the static cost to the government (the current approach) is incomplete and highly misleading.

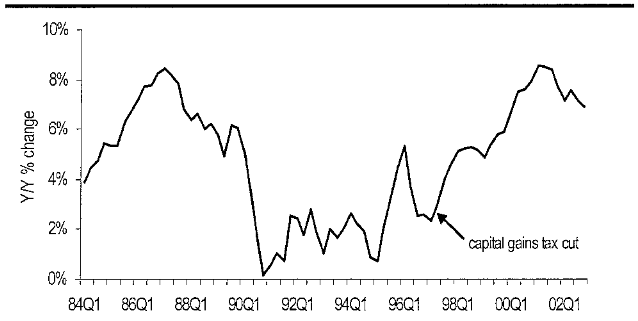
- First, most of the "cost" to the government is a straight benefit to taxpayers. From the standpoint of national well-being, the first-order effect is a wash, not a $726 billion loss.

- Second, the cost estimate drastically understates the impact of tax changes on economic growth. If the tax cut raises the growth rate by just 0.25% -- I think it would due to increased entrepreneurism, a lower tax on work, more capital, and a better allocation of capital – the 10-year revenue gain to the government might be $500 billion. (This estimate is based on CBO's Budget and Economic Outlook for FY2004-2013, p. 132, calculation of a $208 billion loss in 10-year receipts from a 0.1% decrease in the growth rate.)

- Third and most important, the cost estimate is a purely income statement concept, ignoring changes in national wealth. I think the elimination of double taxation of dividends would quickly add $1.5 - $2 trillion to equity market capitalization (works out to 13% - 18% of the $11 trillion equity market capitalization) with large collateral benefits for business confidence and employment. The scoring estimates ignore this benefit completely, yet the gains to the economy and employment would be real. Taxing dividends reduces the value of corporations and encourages debt. Reversing that would cause higher stock prices, more capital gains, more capital gains taxes, a lower cost of equity capital, and a more efficient allocation of capital. None of these benefits is reflected in the "scoring" process, which puts the scoring "loss" of a dividend rate cut at roughly $30 billion per year (still only a fraction of the gains in national wealth from lowering the asset tax).

We have a recent example of the impact of lower asset taxes on the value of assets and the related economic impact. In 1997, the government cut the capital gain tax rate on houses, losing a small amount of revenues but creating a tremendous gain in the national wealth. (By my rough estimate, the U.S. housing stock has increased roughly $4 trillion since the 1997 tax cut, though not all of that is attributable to the tax cut.) Jobs in residential construction surged.

U.S. House Prices



Source: DLX Haver; Bear, Stearns & Co. Inc.

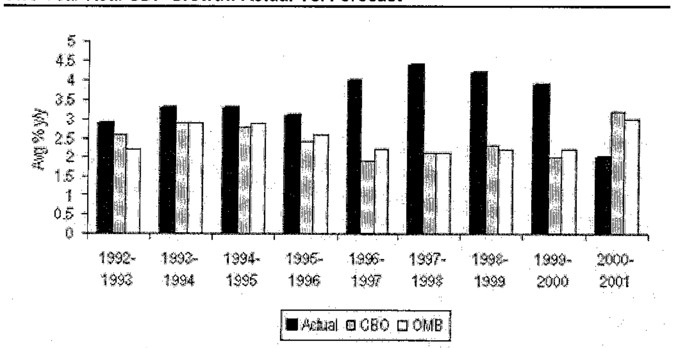
I would expect the same type of reaction to a dividend tax cut – a massive increase in national wealth and a surge in economic activity -- at a relatively small cost to the federal government. The current dividend tax distorts the capital structure. It creates an expensive wedge or toll gate between retained earnings and the shareholder, plus it encourages debt and unproductive acquisitions over equity capital and dividends. Its elimination would improve the allocation of capital, adding substantially to near-term and long-term U.S. economic prospects.

Budget Deficits Hard To Forecast

I would like to offer some comments on the budget deficit and its economic impact. We should accept at the outset of a budget discussion that no one knows, even roughly, what the budget deficit will be over the next ten years.

- Forecasting budget deficits isn't accurate. For example, in the 1990s U.S. GDP growth was consistently above OMB and CBO forecasts (as well as private sector forecasts). Conversely, the recession produced growth well below forecasts.

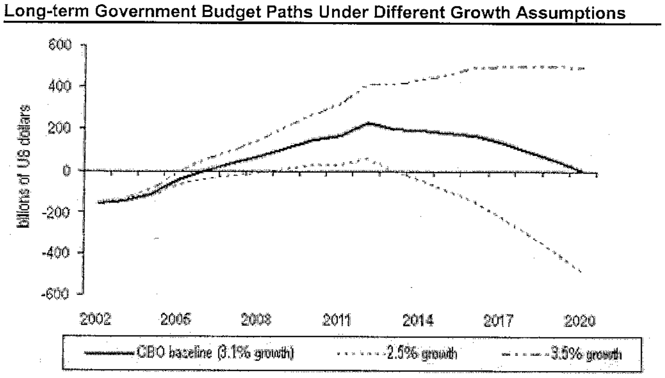
Two Year Real GDP Growth: Actual Vs. Forecast



Source: Bloomberg; Bear, Stearns & Co. Inc.

- Budget deficits are very sensitive to the future growth rate.

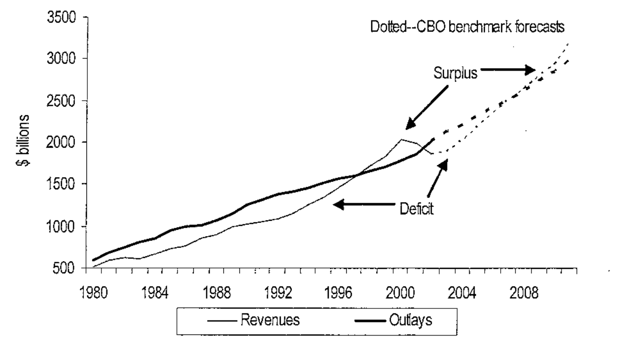
Long-term Government Budget Paths Under Different Growth Assumptions



Source: Congressional Budget Office and Bear, Stearns & Co. Inc.

- The result is wide, relatively unpredictable swings in the budget deficit based on fluctuations in economic growth rates, government spending binges, and the effectiveness of tax policy.

Government Revenues and Outlays



Source: Congressional Budget Office; Bear, Stearns & Co. Inc.

It looks to me as if CBO has used very conservative estimates for GDP growth in its current estimates of the 10-year budget deficit. Both near-term and longer-term growth are likely to be higher than CBO estimates. If so, the 10-year budget deficit might be substantially lower than now expected.

CBO estimates that the growth rate will slow over the next ten years, sinking to 2.6%. It assumes that U.S. output remains below its potential throughout the entire 1-year budget window. By the end of the budget, it assumes potential U.S. growth is only 2.8%.

I think these assumptions are decidedly too pessimistic. One simple double check: The labor force may grow about 1% per year (trend) and labor productivity may grow 2.25% per year (below recent trends). This would yield roughly a 3.25% long-term growth rate, higher if innovation takes place.

A small increase in the estimate of potential growth may not appear to be significant, but it really is—especially to the budget deficit outlook. According to CBO estimates, a 0.25% increase in real GDP growth over 10 years will reduce the budget deficit by more than $600 billion.

Based on its cautious growth forecast, CBO estimated that the President's January budget would generate a total deficit of $1.8 trillion over the next ten years. If my estimates of potential growth are closer to the mark, either due to the positive effects of the President's tax cut or faster productivity growth, the cumulative deficit would be more than one-third lower.

Over the ten-year budget, CBO estimates the revenue baseline at $27.9 trillion. This is likely to be off by $1-2 trillion. As I understand it, the gap between the Senate and House is $200 billion, 0.7% of tax receipts.

I emphasize the fallibility of budget deficit assumptions (and the scoring of tax cuts). In my view, tax policy should not be made on the basis of these estimates, but should instead reflect our economic values -- common sense, fairness, a preference for low rates and a broad base.

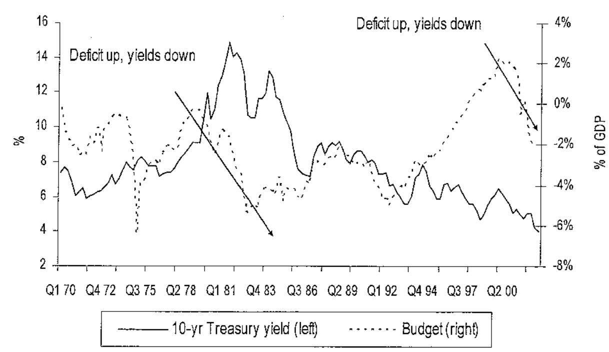
No "Crowding Out"

I want to take strong exception to another part of the budget debate, the idea that a tax cut would somehow "crowd out" private sector activity through higher interest rates or reduced national savings, worsening the economy. This concept has been studied extensively. I think the evidence definitively rejects that hypothesis, but it's clearly one of the many issues on which economics simply hasn't been able to reach a consensus.

Comparing bond yields and interest rates among developed countries turns up no discernable relationship between a country's debt burden and its interest rate. Japan has a huge budget deficit (nearly 8% of GDP) and a similarly huge national debt (more than 140% of GDP). Yet it's overnight interest rate is 0% and its ten-year bond yield is 0.7% (versus 4% for the U.S.)

Likewise, the historical data on the U.S. doesn't simply show a relationship between the level of government borrowing and interest rates. Deficits were large in the 1980s and government debt grew sharply, yet interest rates and bond yields fell and job growth was rapid. Deficit projections have worsened over the last three years, yet interest rates and bond yields have fallen sharply.

Treasury Note Yields and The Budget Deficit



Source: Datastream; Bear, Stearns & Co. Inc.

I expect interest rates and bond yields to rise in coming months based on faster growth and higher long-term inflation expectations. Some will blame that on the budget deficit, which will also be growing. I don't think there will be much connection between the two developments.

Some argue that, apart from interest rates, a tax cut will reduce national savings and take funds away from the private sector. Again, this is a static analysis that views the national "savings pool" as fixed and unresponsive to a more vibrant economy. Lower tax rates leave more capital available for savers, create faster growth, and actually increase capital and savings. For those worried about the government's impact on private sector investment, the focus should be on government spending, not the fiscal deficit.

In sum, we are running a cyclical deficit during a period of war at the early part of an economic recovery with the national debt/GDP ratio at only 35%. Whatever the theoretical view about fiscal deficits, interest rates, and the national debt, I think there are higher budget priorities than the 2003 deficit. The tax code is a huge drag on the economy. Social security and medicare need reforming. New health care proposals would impose big new drains from the private sector to the public sector. I think these should be given more attention, and the budget debate should move away from inherently inaccurate guesses about future spending and tax receipts.

Testimony by

Peter G. Peterson*

House Financial Services Committee

April 30, 2003

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Peter G. Peterson

Executive Summary

Mr. Chairman and members of the Committee, thank you for inviting me to comment on the administration's tax plan. While I am not here representing The Concord Coalition, many of that organization's leading members—including Bob Kerrey, Warren B. Rudman, Robert E. Rubin, Sam Nunn, Chuck Bowsher, Lloyd Cutler and Paul A. Volcker—have joined me in recent and similar public messages on fiscal policy.

On the question of tax cuts, we perhaps best expressed our views at a Concord Coalition press conference on March 8, 2001. We said at that time that, if a fiscal stimulus is enacted, its main purpose should be demand-side stimulus. As such, it should (1) be temporary; (2) be targeted to taxpayers and/or businesses most likely to spend it; and (3) do nothing to aggravate our already unsustainable long-term fiscal outlook. Looking at the administration's current tax plan, I'm sure our group would all still agree with this formulation—and would express even more urgency than before over the fiscal long-term implications. Indeed, a group of us did so in the recent attached op-ed piece in the New York Times.

In my complete testimony I review the grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations. I then turn to the arguments the administration has made in favor of its tax plan and why I don't find many of them particularly persuasive. Allow me to summarize the highlights.

The Worsening Fiscal Outlook

Mr. Chairman, two years ago, the ten-year budget balance was projected by the CBO to be a mountainous surplus of $5.6 trillion. A large tax cut and unexpected spending growth, combined with the bursting of the stock market bubble and the 2001 recession, slashed that surplus to a mere $0.9 trillion by March of 2003. The CBO says enactment of the administration's 2004 budget proposals would pull the projected ten-year balance down to a *deficit* of $1.8 trillion. I believe a more realistic estimate is a deficit of $4.0 trillion. In just two years, America has thus witnessed a $10 trillion projected deficit swing—undoubtedly the biggest swing in fiscal expectations in U.S. history other than during years of total war.

There are times, to be sure, when deficits today can be justified by surpluses tomorrow. But right now the long-term deficit outlook is even worse than the 10-year outlook. Let's keep in mind that we face an unfunded liability for Social Security, Medicare and federal pensions of $25 trillion. As a share of payroll, the cost of Social Security and, Medicare's Hospital Insurance program alone will rise from 14 percent today to between 24 and 34 percent by 2040. If senior entitlements are simply left on autopilot, both the CBO and GAO conclude that deficits will eventually rise to economy-shattering levels. We've grown used to thinking about entitlements as a "long term" problem, but in fact it's beginning to overlap with our near-term projections. The first Boomer will be eligible for early retirement on Social Security (at age 62) in 2008; this generation will be retiring on full benefits by 2011.

Why Deficits Matter

A future of mounting deficits is a cause for grave concern. Mounting deficits can slow and even halt the steady growth in material living standards that has always nourished the American Dream. When such deficits are incurred in order to fund a rising transfer from young to old, they also constitute an injustice against future generations.

Economically, the problem with deficits is that they soak up national savings and crowd out productive investment. Since America's savings pool is shallow, the impact of large deficits is especially harmful. From 10.9 percent of GDP in the 1960s, America's net national savings rate slid to 4.8 percent in the 1990s—and to two consecutive postwar lows of 3.3 percent of GDP in 2001 and 1.7 percent in 2002.

With real interest rates now so low, some defenders of deficit spending say there's little reason to fear that today's growing deficits are about to crowd out productive investment. I believe, however, that today's low rates are a cyclical phenomenon and is not likely to last. Moreover, as economists William Gale and Peter Orszag have recently pointed out, the strength of the relationship between interest rates and deficits is "at least partially a red herring." Regardless of the effect of deficits on interest rates, increased budget deficits reduce future income. What really matters is the amount of national savings consumed by deficits and whether it is offset by private savings.

Others argue that, even if deficits undermine America's national savings rate, they need not undermine investment and living standards because foreign savers are taking up the slack. Lets remember that our foreign friends in Europe and Japan have even more daunting future entitlement deficits than we do. The problem with capital imports, however, is that they can't last forever. In any case, whatever America borrows it will have to pay back—or else fork over a permanent debt service charge to foreigners. Either way, future American living standards will suffer.

Are we meeting our generational obligations? One has to worry when we embrace a policy of endlessly rising deficits. This policy, after all, constitutes an explicit decision by today's adults to collectively shift the current cost of government from themselves to their children and grandchildren.

What's Wrong with the Arguments for the Tax Plan

Keeping in mind the clear and present danger deficits pose to our future, let me now turn to the advisability of the administration's current tax plan. It seems to me that the case boils down to five basic arguments.

Tax Plan Argument One. The American people want and deserve a tax cut. A democratic government should respond to their wish.

The administration has described a vision of America in which government takes and spends less of our money and leaves more of it the pockets of those who earned it. Overall, it is a vision of a dynamic and entrepreneurial society in which government is smaller and less intrusive. It is a vision that resonates with many citizens.

I want to be very clear on this point. Neither I nor The Concord Coalition is opposed to smaller government or lower taxes. We simply require that, at the end of the day, revenues are sufficient to cover outlays. Washington policymakers must not pretend that we can have it all — guns and butter AND tax cuts.

In short, I insist on the bottom line logic of public finance—that the long-term tax burden is determined by the long-term spending burden, and that unless you reduce the long-term spending burden you do not really cut taxes, but only shift the burden of taxes from the present to the future. As the CBO points out, "at some point in the future under the President's proposals, either taxes would have to be higher than they otherwise would have been, or spending would have to be lower."

There is no public finance textbook that teaches that you can ease the long-term tax burden simply by cutting the tax. Instead of pretending it can accomplish the impossible, the administration should be educating the public that, when you face a future of endless deficits, you have to cut spending long term before you cut taxes long term.

Tax Plan Argument Two: OK, let's forget the long-term tax burden. The tax package still makes sense as near-term fiscal stimulus to bring the economy back to full capacity.

I believe there is some merit in this argument. Today's economy remains fragile, largely because business and consumer confidence remain fragile. Under these circumstances, stimulus could have a beneficial impact. As Federal Reserve Board Chairman Alan Greenspan puts it, it would help the economy get through a "soft patch."

The problem with the stimulus justification is not that it's wrong. The problem is that it doesn't apply to the plan under consideration. For fiscal stimulus to be effective, it has to put money into consumers' pockets as quickly as possible. Yet just 5 percent of President's "economic growth" provisions, those explicitly advertised as stimulus, would end up in consumers' pockets this fiscal year. Over the entire ten-year projection period, just 17 percent of the full $1.5 trillion tax-cut package would end up in taxpayers' pockets over the *first* three years. Fifty-four percent would be distributed in the *last* three years.

Tax Plan Argument Three: Even if it doesn't deliver much near-term stimulus, the tax plan does make the tax code more efficient—which translates into less economic waste and a higher standard of living all around.

Many supporters of the administration's tax plan argue that its provision to eliminate the double taxation of corporate earnings would make our tax system more efficient by reducing the tax penalty on the return to saving generally and on the return to corporate equity (versus corporate debt) in particular. As a sort of representative of "Wall Street," I have to confess I'm sympathetic to this argument.

Personally, as a matter of tax design, I wouldn't do it the same way. A better plan would be to introduce relief on earnings at the corporate level. My biggest problem with this provision, however, is not its complex design and implementation challenges. My biggest problem is that it is deficit-financed. Reducing the taxation on corporate earnings may marginally improve savings behavior—but not nearly enough to compensate for the loss in federal revenue, which adds directly to the federal debt and, in the long run, subtracts dollar-for-dollar from national savings. Far better to have made any proposal revenue neutral, for example by genuine tax reform that eliminates many of the ineffective corporate tax subsidies.

Tax Plan Argument Four: The critics just don't get it. What this tax package is really about is improving "supply side" incentives to work, save, and invest.

We should all be able to acknowledge that "supply-side" reductions in punitive tax rates — as indeed they once were — have sometimes been very successful. And, if supply-side advocates were less theological in their interpretation of the data, we should also be able to acknowledge that in other instances tax-rate reductions have had indifferent results.

In fact, there's plenty of evidence that, when marginal tax rates are not high the efficiency gains from cutting them may be modest. (The average marginal tax rate on federal income and payroll taxes is now 30.0 percent, among the lowest in the developed world.) And the impact on economic activity may be ambiguous—in other words, while some people may react to more after-tax income by working more, others may react by working less. Even if the supply-side response to the administration's marginal rate cut is both positive and sizeable, moreover, the gains would be cancelled out—perhaps even overwhelmed—by the sizeable inefficiencies of the deficits the administration plans to run in order to pay for it.

That's the conclusion reached by CBO's examination of the new tax plan. According to some of the dynamic models reviewed by CBO and indeed several others that I as Chairman of the Federal Reserve Bank of New York have had the opportunity to observe, the tax plan would actually result in significant GDP losses relative to baseline and further revenue losses relative to the official "static" projection of the plan. Such losses, needless to say, would constitute a sad outcome for a tax reform purchased at the cost of $1.5 trillion in extra public indebtedness.

Tax Plan Argument Five: Let's be honest. The ultimate purpose of the Administration's tax cut plan has nothing to do with economics. It's about politics or political philosophy. The purpose is to starve the government of revenue so that, in the long run, Congress will have no choice but to cut back spending and, with that, diminish the size of government.

This is a seductive apologia. But I have three objections to it: It is unfair, it is cynical, and it is hypocritical.

It is unfair because no end, however legitimate, can justify such means. Nothing excuses holding the next generation hostage—any more than your own children—on the dubious bet that another party will have the good will to relent.

It is cynical because it assumes that our democratic process is broken and that we can no longer directly advocate a policy for the common good, but must instead rely on subterfuge to achieve our purpose.

And it is hypocritical. One could take the ostensible goal of the tax cutters—smaller government—more seriously if we saw that the party pushing the tax cut were also trying with great energy to cut spending, both short-term and over the longer term with genuine reform of what OMB itself calls our unsustainable entitlement programs. But we see nothing of the sort. Indeed, it's hard to find the small-government argument persuasive when the budget does nothing to reform entitlements, allows debt-service costs to rise along with the debt, and urges greater spending on defense—and when these three functions comprise over four-fifths of all federal outlays.

America at a Crossroads

Mr. Chairman, our nation faces at least two history-bending challenges: global terrorism and global aging. Meeting the first may require marshalling new resources far above the extra spending already legislated. We know that meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. To do so would be to ignore every principle of public finance, generational equity, and long-term economic stewardship.

Peter G. Peterson

Full Testimony

Mr. Chairman and members of the Committee, thank you for inviting me to comment on the administration's tax plan. While I am not here representing The Concord Coalition, many of that organization's leading members—including Bob Kerrey, Robert E. Rubin, Warren B. Rudman, Sam Nunn, Charles Bowsher, Lloyd Cutler and Paul A. Volcker—have joined me in recent public messages on fiscal policy. I am attaching to my written testimony a copy of a full-page statement in the *New York Times* (February 2, 2003) and an op-ed essay in the same newspaper (April 9, 2003).

On the question of tax cuts, we perhaps best expressed our views at a Concord Coalition press conference on March 8, 2001. We said at that time that, if a stimulus is enacted, its main purpose should be demand-side stimulus. As such, it should (1) be temporary; (2) be targeted to taxpayers and businesses most likely to spend it; and (3) do nothing to aggravate our already unsustainable long-term fiscal outlook. Looking at the administration's current tax plan, I'm sure our group would all still agree with this formulation—and would express even more urgency than before over the fiscal implications.

I will begin by reviewing the grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations. I will then turn to the arguments the administration has made in favor of its tax plan and why I don't find many of them particularly persuasive.

The Worsening Fiscal Outlook

Mr. Chairman, two years ago, the ten-year budget balance was projected by the CBO to be a mountainous surplus of $5.6 trillion. Many hoped that this surplus could pay off a substantial portion of the publicly held debt, or even better, fund a reform of Social Security that would shore up its finances without raising anyone's taxes or cutting anyone's benefits. Either way, it would be translated into a vast boon to future generations. But that opportunity quickly passed. A large tax cut and unexpected spending growth, combined with the bursting of the stock market bubble and the 2001 recession, slashed that surplus to a mere $0.9 trillion by March of 2003.

Unfazed by this turnaround, the administration is proposing a budget that includes a second large tax cut and various new spending items, such as a Medicare prescription drug benefit, that the CBO says would pull the projected ten-year balance down to a *deficit* of $1.8 trillion. And this may be an underestimate. It doesn't count the cost of war and reconstruction in Iraq and, in my view, indispensable homeland security. It almost certainly understates the costs of improving homeland security. It ignores the inevitable reform of the alternative minimum tax, which will apply to some 39 million returns within 10 years (assuming that the 2001 tax cuts do not expire in 2010), up from 2 million today. And it assumes large and unspecified reductions in discretionary spending that most legislators *of both parties* know will never come to pass. A more prudent projection—one that assumes AMT relief will be extended and that discretionary spending will grow at the rate of the economy—would push the ten-year deficit projection to \$4.0 trillion.

What does this all add up to? In just two years, America has witnessed a \$10 trillion projected deficit swing—undoubtedly the biggest swing in fiscal expectations in U.S. history other than during years of total war.

With total war, of course, large deficit swings may be good policy. The nation may expect the emergency to be over soon and thus be able to pay back the new debt during a subsequent era of peace and prosperity. Yet few experts believe that the major drivers of today's deficit projections are similarly short-term. The Vice President has warned that the "War on Terror" may last "a couple of generations." And the biggest single driver of the projections, the growing cost of senior entitlements like Social Security and Medicare, is certain to become much worse just beyond the ten-year horizon when the huge Baby Boom generation starts retiring in earnest. We've grown used to thinking about entitlements as a "long term" problem, but in fact it's beginning to overlap with our near-term projections. The first Boomer will be eligible for early retirement on Social Security (at age 62) in 2008; this generation will be retiring on full benefits by 2011.

In theory, it is true, we are "prefunding" some small portion of these extra entitlement costs through the build-up of the Social Security and Medicare trust funds. But the deficit numbers cited above *include* these trust-fund surpluses. If we set these surpluses aside and put them truly off-budget, the deficit numbers would be \$2.7 trillion larger. And even accepting this accounting, the prefunding would only pay for a small fraction of the estimated \$25 trillion in unfunded Social Security, Medicare and federal pensions benefits payable to today's adults.

As a general matter, longer time horizon does not justify near-term deficits. If anything, the longer-term demographics are an argument for sizeable near-term surpluses. Over the entire decade of 2003 to 2013, the CBO projects that Social Security, Medicare, and Medicaid will grow by less than 1 percent of GDP. But from 2013 on, they will be growing by 1 percent of GDP every three and one-half years. All told, the total cost of these programs is due to more than double as a share of GDP between 2000 and 2040, from 7.6 percent to 15.5 percent of GDP. The cost of Social Security and Medicare's Hospital Insurance program alone will rise from 13.8 percent of worker payroll today to between 24.2 and 34.3 percent of payroll by 2040. If senior entitlements are simply left on autopilot, the official long-term projections of both the CBO and GAO conclude that deficits will eventually rise to economy-shattering levels.

This is not a partisan issue. Even the OMB, the agency responsible for orchestrating the administration's fiscal strategy, concurs that senior entitlements will grow explosively in the decades ahead. According to the President's *Budget of the U.S. Government for Fiscal Year 2004*, the cost of Social Security, Medicare, and Medicaid together, which amounted to 30 percent of noninterest federal spending in 1980, has reached 45 percent today and will be shooting past 65 percent by 2040. "These long-run budget projections," says the OMB, "show clearly that the budget is on an unsustainable path.... As the Baby Boomers reach retirement age in large numbers, the deficit is projected to rise steadily as a share of GDP. Under most scenarios, well before the end of the projection period for this chapter rising deficits would drive debt to several times the size of GDP."

Some supporters of the administration's fiscal strategy dismiss these long-term projections as little more than guesswork. We hardly know what the economy will do next year, they say. How can we possibly make projections forty years out? The unanimity among official agencies on the magnitude and severity of entitlement cost growth, however, should give these supporters pause.

The long-term projections are in fact much more reliable than most other predictions economists and demographers make. The aging of America is about as close as social science ever comes to a certain forecast. Absent a Hollywood catastrophe—a colliding comet or an alien invasion—it will surely happen. The reason is simple. Over the next 65 years, the number of elderly is easily projectable since they have already been born and are thus countable. Because the typical mortality assumptions are quite conservative, most of the surprises on the longevity side would make the cost outlook even worse. As for the future number of younger people, even a dramatic turnaround in birthrates would have little impact for the next 30 years.

Although some of the economic variables are harder to forecast, these do not influence the long-term cost projections as much as many would suppose. Higher productivity growth, for example, pushes up revenues, and this helps. But it also pushes up benefit awards (which are linked to wages), so that the net result is largely a wash. This is why—contrary to glib reassurances from the "new economy" advocates—we cannot grow out way out of this challenge.

Why Deficits Matter

A future of mounting deficits is a cause for grave concern. Mounting deficits can slow and even halt the steady growth in material living standards that has always nourished the American Dream. When such deficits are incurred in order to fund a rising transfer from young to old, they also constitute an injustice against future generations.

Economically, the problem with deficits is that they soak up national savings and crowd out productive investment. They do so by raising interest rates, probably by 25 to 50 basis points for each one percent increase in the long-term federal deficit as a share of GDP. The former figure appears in a just-released study by the Federal Reserve Board; the latter figure was cited in a recent report by the Center for Economic Development. Many other studies have confirmed a response of at least this magnitude.

Since America's savings pool is shallow, the impact of large deficits is especially harmful. The U.S. net national savings rate is already low both relative to other developed nations and to our own history. From 10.9 percent of GDP in the 1960s, it slid to 4.8 percent in the 1990s—and to two consecutive postwar lows of 3.3 percent of GDP in 2001 and 1.7 percent in 2002. Current fiscal policies are due to push net national savings still lower. It may drop below zero within the next few years. The last time this happened was during the depths of the Great Depression.

This brings us to history's bottom line, as insisted on by one economic luminary after another, from Adam Smith to Karl Marx to Alfred Marshall to John Maynard Keynes: No country can enjoy sustained living standard growth without investing, and no country can sustain high investment for long without saving.

These thinkers all understood that capital formation may not be a sufficient condition for rising living standards, but it is certainly a necessary condition. Moreover, it is the one condition that a society can directly influence. We cannot legislate technological breakthroughs—nor even a higher private savings rate. But we can legislate a budget surplus, and surpluses add to national savings just as surely as deficits subtract from it. It may not matter much to private savers whether they end up purchasing a tractor or a T-bill. But it matters a great deal to the economy.

With real interest rates now so low, some defenders of deficit spending say there's little reason to fear that today's growing deficits are about to crowd out productive investment. I believe, however, that today's low rates are a cyclical phenomenon and unlikely to last. As the economy revives and investment rekindles, real interest rates will surely rise—and the vast majority of economists agree that they will rise faster and farther with large deficits than without.

Moreover, as economists William Gale and Peter Orszag have recently pointed out, the strength of the relationship between interest rates and deficits is "at least partially a red herring." They explain: "The more fundamental point is that long-term budget deficits reduce national saving and impose substantial long-run costs on the economy, regardless of whether interest rates are affected. As long as an increase in the budget deficit is not fully offset by an increase in private saving—and such a full offset is a theoretical possibility that almost all economists reject in practice—the expanded budget deficit will manifest itself in some combination of reduced domestic investment and an expanded current account deficit. Either way, and regardless of the effect of deficits on interest rates, increased budget deficits reduce future income. That reduction in future income is the true cost of a failure of long-term fiscal discipline."

Others argue that, even if deficits undermine America's national savings rate, they need not undermine investment and living standards because foreign savers are taking up the slack. And in fact since the late 1990s surging capital imports have helped to prop up U.S. investment. The problem with capital imports, however, is that they can't surge forever. Today, with the U.S. current account deficit hitting 5 percent of GDP, the highest rate in at least a century, an urgent question for many economists is how suddenly, or even catastrophically, this surge will stop. In any case, the potential for financial crisis aside, whatever America borrows it will have to pay back—or else fork over a permanent debt service charge. Either way, future living standards will suffer.

There's a related concern. For decades, deficit apologists excused federal debt by pointing out that "we only owe it to ourselves." This was never true in the figurative sense in which the apologists meant it—namely, that borrowing from ourselves has no economic cost. It does. But today, this is not even literally true. Already, 35 percent of the U.S. public debt is owned by foreigners, a percentage that has doubled over the past ten years. If the trend continues, the United States may find itself increasingly hostage to global financial markets—and perhaps even to the whims of foreign governments.

It's important to keep in mind the global context of American fiscal policy. In recent decades, America could count on large capital imports from other rapidly growing industrial economies like Germany and Japan that were generating large savings surpluses. Over the next two or three decades, all of these nations will be aging more rapidly than America. Many will be in steep demographic decline, experiencing zero GDP growth, and struggling to finance a tidal wave of pension and health-care outlays. In my book *Gray Dawn*, I calculate that the combined pension deficit of the G-7 countries would, by the 2030s, grow large enough to consume the net economic savings of the developed world. In short, our habit of borrowing from abroad will be cut short by the overseas age wave. To maintain even a minimal level of domestic investment, America will have to save more on its own.

When we reflect on the fiscal, financial, and geopolitical challenges our children must confront over the next century, we have reason to pause and ask ourselves: Are we meeting our generational obligations? Are we providing them with the economic resources they need to overcome these challenges? Are we investing as much in them as our own parents invested in us? Or are we not in our public policies taking from them more than we are giving? All of the evidence suggests that our kids are getting a bad deal, whether we look at declining rates of return on Social Security contributions or the disquieting findings of a whole new branch of policy analysis, generational accounting. However we quantify the current deal between old and young, one has to worry that we are greatly worsening the terms of the transaction by embracing a policy of endlessly rising deficits. This policy, after all, constitutes an explicit decision by today's adults to collectively shift the current cost of government from themselves to their children.

What's Wrong with the Arguments for the Tax Plan

Keeping in mind the clear and present danger deficits pose to our future, let me now turn to the advisability of the President's current tax plan. It seems to me that the case boils down to five basic arguments.

Tax Plan Argument One. The American people want and deserve a tax cut. A democratic government should respond to their wish.

The administration has described a vision of America in which government takes and spends less of our money and leaves more of it the pockets of those who earned it.

Overall, it is a vision of a dynamic and entrepreneurial society in which government is smaller and less intrusive. It is a vision that resonates with many citizens.

How much it resonates, to be sure, remains a matter of some debate. Relative to other countries, after all, the United States doesn't seem especially overtaxed. And right now, in the wake of 9/11, many surveys indicate that voters are a lot more concerned about whether government has the resources to meet urgent public needs than whether it taxes too much. According to two Gallup polls taken in 2003, the share of Americans who say that the federal income tax is "too high" is lower than in any year since 1962. Nonetheless, I think it's fair to give the President the benefit of the doubt on this point. Americans remain wary of a large and burdensome government. And if they aren't especially concerned about high taxes at this moment, they soon will be given the projected upward trend in public spending. Where spending goes, taxes must sooner or later follow.

I want to be very clear on this point. Neither I nor The Concord Coalition is opposed to smaller government or lower taxes. We simply require that, at the end of the day, revenues are sufficient to cover outlays. If we can manage this without raising taxes, that would be great. And if we can manage it while cutting taxes, that would be even better.

In this, not surprisingly, I part company with those Democrats who are ideologically wed to big government and hate to vote down a dime's worth of outlays. But I also part company with many Republicans who, despite their rhetoric, aren't doing much to cut spending either. Indeed, we seem to have embraced a policy of guns and butter AND tax cuts.

I insist on the bottom line logic of public finance—that the long-term tax burden is determined by the long-term spending burden, and that unless you reduce the long-term spending burden you do not really cut taxes, but only shift the burden of taxes from the present to the future. The administration's budget, however, does not propose anywhere near the level of spending restraint that would be needed to justify its long-term tax cut proposals. As the CBO points out in its *Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, "at some point in the future under the President's proposals, either taxes would have to be higher than they otherwise would have been, or spending would have to be lower."

Public finance textbooks teach us many things—how to finance temporary deficits, how to save temporary surpluses, how to structure a tax system that is stable, efficient, and equitable. But there is no textbook that teaches that you can ease the long-term tax burden simply by cutting the tax. Instead of pretending it can accomplish the impossible, the administration should be educating the public that, when you face a future of endless deficits, you have to cut spending long term before you cut taxes long term.

Tax Plan Argument Two: OK, let's forget the long-term tax burden. The tax package still makes sense as near-term fiscal stimulus. Given the current weakness in employment, investment, and the stock market, we badly need stimulus to bring the economy back to full capacity. A tax cut is the quickest and most effective way to accomplish this.

Thirty years ago, President Nixon famously declared that "We are all Keynesians now." Since the disastrous stagflation of the 1970s, faith in Keynesianism may have waned, but even today few doubt that when the economy suffers multiple shocks, the best way to avert a severe contraction is to apply an immediate dose of fiscal stimulus. Most economists still believe it. I still believe it. And apparently President Bush still believes it. In describing his tax plan, the President often uses classic Keynesian rhetoric. "That money can cover a lot of bills," he explains. "That money can help families with purchases they have been delaying. That money will be in circulation, which will be good for our economy."

Again, I believe there is some merit in this argument. Today's economy remains fragile, largely because business and consumer confidence remain fragile. Under these circumstances, stimulus could have a beneficial impact. As Federal Reserve Board Chairman Alan Greenspan puts it, it would help the economy get through a "soft patch."

The problem with the stimulus justification is not that it's wrong or that the President doesn't articulate it well. The problem is that it doesn't apply to the plan under consideration. For fiscal stimulus to be effective, it has to put money into consumers' pockets as quickly as possible. Yet just 5 percent of President's "economic growth" provisions, those explicitly advertised as stimulus, would end up in consumers' pockets this fiscal year. Over the entire ten-year projection period, just 17 percent of the full $1.5 trillion tax-cut package would end up in taxpayers' pockets over the *first* three years. Fifty-four percent would be distributed in the *last* three years.

Indeed, the whole design of the plan is long-term and structural, not near-term and countercyclical. That's why nearly all of its changes are permanent, and that's why many of them do nothing except turn temporary provisions enacted in 2001 into permanent changes. Reportedly, the administration is willing to delay the phasing-in of its new tax cuts so long as the ultimate reductions remain unchanged beyond 2010, when they would otherwise expire. What we need is short-term stimulus and long-term restraint. In the administration's plan, it seems to me we get neither.

Tax Plan Argument Three: Even if it doesn't deliver much near-term stimulus, the tax plan does make the tax code more efficient—which translates into less economic waste and a higher standard of living all around.

An efficient tax system can be defined as a system which raises revenue with minimal distortions in economic behavior and thus with minimal "dead weight" loss of wealth and income. Finance theorists have come up with many complex equations to quantify tax efficiency, but it's fair to say that most of us know it when we see it. The acid test is how much the tax system itself changes people's work, saving, and investment choices in order to raise a given amount of revenue. Much change means inefficiency. Little change means efficiency. But let me repeat the key clause for reasons that will become clear shortly: *in order to raise a given amount of revenue.*

Many supporters of the administration's tax plan argue that its provision to eliminate the double taxation of corporate earnings would make our tax system more efficient by reducing the tax penalty on the return to saving generally and on the return to corporate equity (versus corporate debt) in particular. As a sort of representative of "Wall Street," I have to confess I'm sympathetic to this argument. For decades, many smart economists have been making a very persuasive case that our tax treatment of corporate earnings is conspicuously inefficient and that—a sore point for me—it discourages capital formation. So put me down as a supporter of this type of efficiency reform.

Personally, as a matter of tax design, I wouldn't do it the same way. A better plan would be to introduce relief on earnings at the corporate level. This would be much simpler, because it would avoid complicated "look back" readjustments to the tax basis of everyone's stock. It would also be fairer, because it would extend relief to the two-thirds of all stockowners (especially to millions of younger, moderate-income workers with retirement plans) whose dividends aren't currently taxable at the personal level and who thus won't benefit from the administration's plan.

My biggest problem with this provision, however, is not its design. Such things can be discussed and resolved. My biggest problem is that it is deficit-financed. As such, it does not deserve to be called an efficiency reform—which, by definition, requires that the reform be revenue neutral since deficits themselves are a new source of economic inefficiency. To ignore the deficit-financing of a tax cut is like trying to ignore the extra $50,000 you just paid for a car that promises to give you an extra mile-per-gallon in fuel efficiency. Reducing the taxation on corporate earnings may marginally improve savings behavior—but not nearly enough to compensate for the loss in federal revenue, which adds directly to the federal debt and, in the long run, subtracts dollar-for-dollar from national savings.

Far better to have made any proposal revenue neutral by engaging in genuine tax reform. The administration's policy makers could have paid for this revenue loss by combining it with other efficiency-enhancing provisions that add rather than subtract from revenue. Even within the corporate realm alone, they could have targeted any number of inefficient loopholes and subsidies for elimination—or any number of gaps for base-broadening. They chose not to do so.

Tax Plan Argument Four: The critics just don't get it. What this tax package is really about is improving "supply side" incentives to work, save, and invest.

Since the late 1970s, a core proposition of what has come to be known as the "supply side" case for tax reform is that reductions in high marginal tax rates can sometimes have a dramatic and positive impact on both economic activity and revenue. In a sensible world, we would all be able to discuss supply-side tax cuts as a special and important category of efficiency reform. We would all be able to acknowledge that "supply-side" reductions in punitive tax rates, which we indeed once had in the United States, have sometimes been very successful and also acknowledge that in other instances tax-rate reductions have had indifferent results.

That would be a sensible world. The reality is that the supply-side case has developed into something approaching a theology, ruling out any reasonable discussion of the evidence. Heartened by their success with targeted cuts in marginal rates of 70 percent or higher, supply-side true believers move on to the proposition that vast free-lunch efficiency and revenue gains can be derived by cutting nearly any tax rate whenever and wherever they can take a cross-the-board whack at it.

In fact, there's plenty of empirical evidence that, when marginal tax rates are not high, the efficiency gains from cutting them may be modest and the impact on economic activity may be ambiguous—in other words, while some people may react to more after-tax income by working more, others may react by working less. With the top marginal federal income tax rate currently at 39.6% and the average marginal rate on federal income and payroll taxes at 30.0%, it's not clear that the U.S. economy is in the "high" range. Even if it is, the marginal rate impact of the reform hardly seems sufficient to trigger a sizeable response. According to the CBO, the administration's total two-part tax package, the 2001 enacted plan and the current plan, is expected to cut the average marginal rate by no more than 1.5 percentage points (from 32.0% to 30.5% in 2011). That's less than a 5 percent reduction.

Even if the supply-side response is both positive and sizeable, moreover, the gains would be cancelled out—perhaps even overwhelmed—by the sizeable inefficiencies of the deficits needed to pay for it. That's the conclusion reached by CBO's examination of the new tax plan. The tax-rate induced gains in labor supply, reports the CBO, would be positive but small, and in any case they would be neutralized by the deficit-induced losses in investment and capital. According to some of the dynamic models reviewed by CBO, the tax plan would actually result in significant GDP losses relative to baseline and further revenue losses relative to the official "static" projection of the plan. Such losses, needless to say, would constitute a humiliating outcome for a tax reform purchased at the cost of $1.5 trillion in extra public indebtedness.

Some supporters of the tax plan complain that CBO should have assessed the dynamic supply-side gains independently from the dynamic deficit losses. But this clearly would make no sense. If it did, we may as well propose getting rid of taxes altogether and assessing the wonderful efficiency gains independently of the fact that our government no longer has any revenue. Rather than lodge their complaint with the CBO, these supporters might ask the administration why, here too, it failed to incorporate into its package any efficiency-enhancing provisions that add rather than subtract from revenue. When it doesn't come at the expense of deficits, the logic of reducing marginal tax rates is persuasive. Historically, some of the most successful tax reforms in history featured a combination of marginal rate reduction with expansions in the taxable income base. This was, for example, the template for the Tax Reform Act of 1986.

Tax Plan Argument Five: Let's be honest. The ultimate purpose of the Administration's tax cut plan has nothing to do with economics. It's about politics or political philosophy. The purpose is to starve the government of revenue so that, in the long run, Congress will have no choice but to cut back spending and, with that, diminish the size of government.

Some Republicans argue that tax cuts are the only way to reduce government spending in a world in which powerful interest groups, allied with the opposition party, stand ready to punish any attempt to cut off the flow of government largess. A direct approach, they say, is futile. The only practical option is to pursue the indirect but more popular course of revenue reduction, choking off government's resources at the source. True, deficit financing can keep outlays flowing for a time. But as in the famous story of Solomon, these strategists hope that Democrats will agree to cut spending rather than punish our children by smothering them with debt.

This is a seductive apologia. But I have three objections to it: It is unfair, it is cynical, and it is hypocritical.

It is unfair because no end, however legitimate, can justify such means. Nothing excuses holding the next generation hostage—any more than your own children—on the dubious bet that another party will have the good will to relent. What if instead they employ your strategy in reverse? What if they call your bluff, raise your ante, and allow a floodtide of debt to sweep forth? What next step do these partisans suggest?

It is cynical because it assumes that our democratic process is broken and that we can no longer directly advocate a policy for the common good, but must instead rely on subterfuge to achieve our purpose. It assumes a political system in which the two parties are so polarized that they no longer share any common values or aspirations on which open agreement can be reached. I for one refuse to accept this dismal view.

And it is hypocritical. One could take the ostensible goal of the tax cutters—smaller government—more seriously if we saw that the party pushing the tax cut were also trying with great energy and diligence to reduce government spending in the near-term and especially in the long term with genuine reform of what OMB itself calls our unsustainable entitlement programs. But we see nothing of the sort.

If you doubt me on this point, listen instead to Urban Institute tax expert Eugene Steuerle, respected by both parties for his long track record of dispassionate objectivity. To date, Steuerle writes, the Bush administration has assiduously tried "to avoid budget choices that might take some tax or benefit expenditure away from anyone. Thus it has not pushed to enact any systematic reform that almost inevitably creates losers as well as winners. Every significant enactment so far has involved losing revenues by more spending or more tax cutting—whether this issue has been domestic discretionary spending, defense spending, or tax cuts. So far, few benefits, however unworthy, have been taken away from interest groups—as reflected in the dearth of base broadening tax proposals. Preferences sought by many groups—farmers, steel workers, and railroads, among others—have often been expanded."

In other words, it's hard to find the small-government argument persuasive when, on the spending front, the GOP leaders do nothing to reform entitlements, allow debt-service costs to rise along with the debt, and urge greater spending on defense—and when these three functions comprise over four-fifths of all federal outlays.

America at a Crossroads

Mr. Chairman, the current debate over the President's tax plan needs to be viewed in broader context of our long-term fiscal challenge. In this respect, America stands at a crossroads. We can demand that our leaders undertake the kinds of reforms, including long-term entitlement reforms, that are needed to put the budget on a sustainable trajectory—and face up to the required sacrifice. Or we can continue to pretend that our choices have no consequences—and let our children pay the price in lost opportunities, lower living standards, and a less safe and secure place in the world.

Social Security, as officially projected, will be able to pay only 74 percent of its now-scheduled benefits by the year 2045. Should we face that fact or bury our head in the sand? Neither party has demonstrated much courage here.

I have often criticized the free-lunch games of many GOP reform plans for Social Security—such as personal accounts that will be "funded" by deficit-financed contributions. But at least the GOP pretends to have reform plans. *Democrats have nothing.* Or, as Bob Kerrey puts it quite nicely, most of his fellow Democrats propose the "do-nothing plan," a blank sheet of paper that essentially says it is OK to cut benefits by 26 percent across the board when the money runs out. Assuming that Democrats would feel genuine compassion for the lower-income retirees, widows, and disabled parents who would be most affected by such a cut, I have suggested to them that maybe we ought to introduce an "affluence test" that reduces benefits for fat cats like me. To my amazement, Democrats angrily respond with irrelevant clichés like "programs for the poor are poor programs" or "Social Security is a social contract that cannot be broken."

Apparently, it doesn't matter that the program is already unsustainable. They cling to the mast and are ready to go down with the ship. I have already mentioned how many Republicans regard supply-side tax cuts as a sort of theology. But the Democrats have their own theology--federal entitlements.

Mr. Chairman, our nation faces at least two history-bending challenges: global terrorism and global aging. Meeting the first may require marshalling new resources far above the extra spending already legislated. We know that meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. To do so would be to ignore every principle of public finance, generational equity, and long-term economic stewardship.

In his State of the Union Address, President Bush himself has said, "This country has many challenges...we will not pass along our problems to other Congresses, to other Presidents, and other generations." My colleagues and I firmly believe that's a promise America needs to keep.

ATTACHMENT
New York Times op-ed

Bob Kerrey, Sam Nunn and Warren B. Rudman are former senators. Peter G. Peterson and Robert E. Rubin are former cabinet secretaries. Paul A. Volcker is former chairman of the Federal Reserve. All are members of the Concord Coalition, a group that focuses on federal budget policy.
By Bob Kerrey, Sam Nunn, Peter G. Peterson, Robert E. Rubin, Warren B. Rudman and Paul A. Volcker

With a war in Iraq and looming postwar costs, growing pressures for a prescription drug benefit, increased expenses for domestic security and a ballooning budget deficit, Congress must exercise restraint on both revenues and spending to prevent fiscal policy from spiraling out of control. The consensus in favor of long-term budget balance must be re-established. This issue is now directly before Congress as it debates the federal budget.

The fiscal outlook is much worse than official projections indicate. These projections assume that the tax cuts enacted in 2001 will expire at the end of 2010. They also assume that discretionary spending, the part of the budget that pays for national defense, domestic security, education and transportation, will shrink continuously as a share of the economy. Neither of these assumptions is realistic.

Moreover, the official projections do not include the costs of war and reconstruction in Iraq. And they ignore the inevitable need to reform the alternative minimum tax, which is not indexed for inflation and will apply to some 40 million households within 10 years - up from two million today.

Under more realistic assumptions, the deficit projections are cause for alarm. A recent study by Goldman Sachs includes this forecast: if the president's proposed new tax cuts are enacted, a Medicare prescription drug benefit is approved, the A.M.T. is adjusted and appropriations grow modestly, the deficits over the next 10 years will total $4.2 trillion - even if the Social Security surplus is included. If it is not included, the deficit would be $6.7 trillion. Under these circumstances, the ratio of publicly held debt to gross domestic product climbs within 10 years to nearly 50 percent, from 33 percent just two years ago.

And all of this happens before the fiscal going gets tough. Looming at the end of the decade is a demographic transformation that threatens to swamp the budget and the economy with unfunded benefit promises, like Social Security and Medicare, of roughly $25 trillion in present value. Our children and grandchildren already face unthinkable payroll tax burdens that could go as high as 33 percent to pay for these promised benefits. It is neither fiscally nor morally responsible to give ourselves tax cuts and leave future generations with an even higher tax burden.

And yet tax cuts are the primary focus of this year's budget debate. To speed enactment of tax cuts, Congress is planning to use a special fast-track procedure called "reconciliation" in the budget resolution. While determining the size of the tax cut to be given fast-track protection in the budget is sometimes dismissed as a procedural matter, it is not: whatever its size, a tax cut that receives this protection is almost certain to be enacted in the later tax legislation. Members of Congress should not therefore approach the budget decision with the idea that a tax cut given such status now can be easily scaled back later.

The president has proposed a cut of $726 billion, which the House has already approved. The Senate has reduced the cut to $350 billion.

Given the rapidly deteriorating long-term fiscal outlook, neither proposal is fiscally responsible. It is illogical to begin the journey back toward balanced budgets by enacting a tax cut that will only make the long-term outlook worse. Furthermore, the proposed tax cuts are not useful for short-term fiscal stimulus, since only a small portion would take effect this year. Nor would they spur long-term economic growth. In fact, tax cuts financed by perpetual deficits will eventually slow the economy.

The tax cuts now before Congress do not pay for themselves. No plausible array of matching spending cuts or offsetting revenue increases has been, or will be, proposed to close the gap resulting from a large new tax cut.

We believe that there should be no new tax cuts beyond those that are likely to provide immediate fiscal stimulus, and that avoid growing revenue loss over time. If, however, Congress decides it must approve a tax cut, it should pass the Senate's. While a $350 billion tax cut does not fit our definition of fiscal responsibility, it comes closer than a tax cut of $726 billion. Moreover, Congress should re-establish the pay-as-you-go rule in which tax cuts and entitlement expansions must be offset. The discipline of this rule greatly contributed to the elimination of budget deficits in the 1990's and is clearly needed again.

Congress cannot simply conclude that deficits don't matter. Over the long term, deficits matter a great deal. They lower future economic growth by reducing the level of national savings that can be devoted to productive investments. They raise interest rates higher than they would be otherwise. They raise interest payments on the national debt. They reduce the fiscal flexibility to deal with unexpected developments. If we forget these economic consequences, we risk creating an insupportable tax burden for the next generation.

New Evidence on the Interest Rate Effects of Budget Deficits and Debt

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Board of Governors of the Federal Reserve System

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Abstract

Estimating the effects of government debt and deficits on Treasury yields is complicated by the need to isolate the effects of fiscal policy from other influences. To abstract from the effects of the business cycle, and associated monetary policy actions, on debt, deficits, and interest rates, this paper studies the relationship between long-horizon expected government debt and deficits, measured by CBO and OMB projections, and expected future long-term interest rates. The estimated effects of government debt and deficits on interest rates are statistically and economically significant: a one percentage point increase in the projected deficit-to-GDP ratio is estimated to raise long-term interest rates by roughly 25 basis points. Under plausible assumptions these estimates are shown to be consistent with predictions of the neoclassical growth model.

JEL classification: E6, H6.

Keywords: Government debt, government deficits, interest rate regressions, CBO projections, OMB projections.

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1 Introduction

Much controversy surrounds the quantitative effects of government debt and deficits on long-term real interest rates. Economic theory provides different answers depending on issues such as whether deficits reflect changes in government expenditures or shifts in the timing of taxes, and on the planning horizon of households who hold government debt and pay taxes. One might hope that empirical evidence could be brought to bear on this question, but here the results are just as ambiguous. One major obstacle in obtaining empirical estimates is the need to isolate the effects of fiscal policy from the many other factors affecting interest rates. The most obvious of these factors is the state of the business cycle. If automatic fiscal stabilizers raise deficits during recessions, while at the same time long-term interest rates fall due to monetary easing, deficits and interest rates may be negatively correlated even if the partial effect of deficits on interest rates – controlling for all other influences – is positive.

This paper proposes to address this identification problem by focusing on the relationship between long-horizon forecasts of both interest rates and fiscal variables. Deficits and interest rates expected to prevail several years in the future are presumably little affected by the current state of the business cycle, thus greatly reducing the reverse-causality effects induced by countercyclical monetary policy and automatic fiscal stabilizers. Of course, there are many conceivable factors that jointly determine fiscal variables and interest rates, and it is unlikely that a reduced-form regression would ever completely overcome this endogeneity problem, but focusing on long-horizon forecasts is an important step in the right direction. Moreover, deficits projected several years into the future may be informative about the longer-run fiscal position, and may therefore approximate investors' expectations about the eventual level of government debt relative to GDP. Such measures of expectations thus hold out the prospect of uncovering any causal relationship from fiscal variables to interest rates.

Expectations of future fiscal policy are proxied in this paper by projections published by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) for the federal government's unified budget deficit, the stock of federal government debt held by the public, and other fiscal variables, all expressed as percentages of the respective agency's own projection of GNP or GDP. The forecast horizon is five years in the future, which is the longest horizon for which a reasonably long time series of projections is available. Consistent with the use of 5-year-ahead projections of fiscal variables by the CBO and the

OMB, the analysis focuses on expectations of future nominal interest rates derived from forward rates 5 to 14 years ahead embedded in the term structure of interest rates.

The results reported below show that a percentage point increase in the projected deficit-to-GDP ratio raises the 10-year bond rate expected to prevail five years into the future by 20 to 40 basis points; a typical estimate is about 25 basis points. The estimates are very precise compared to most of the literature mentioned below. Similarly, a percentage point increase in the projected debt-to-GDP ratio raises future interest rates by about 4 to 5 basis points, and these estimates are statistically significant, too. Importantly, these estimates are shown to be robust along many dimensions. Moreover, under plausible assumptions about the persistence of changes in projected deficits, the estimated 25 basis point effect on interest rates of a percentage point increase in the projected deficit-to-GDP ratio is shown to be consistent with the 4-to-5 basis point effect of an increase in the projected debt-to-GDP ratio.

This study is by no means the first to use published projections of future budget deficits. Wachtel and Young (1987) use CBO and OMB projections to analyze *changes* in long-term interest rates on the day of the release of the respective projection.[1] Unlike those shown here, their results therefore depend on correctly identifying the unanticipated component of the release. They find that a $1 billion increase in the projected deficit (at that time roughly 0.025 percent of nominal GDP) raises interest rates by between 0.15 and 0.4 basis points, depending on the maturity of the interest rate series and the source of the projections. Their estimates therefore imply an increase in interest rates on the order of 6 to 16 basis points in response to a percentage point increase in the deficit-to-GDP ratio. However, many of their estimates are statistically insignificant.

Cohen and Garnier (1991) and Elmendorf (1993) present results concerning the effect of deficit projections on the change in interest rates between release dates. Like the present one, these studies are based on the weaker assumption (in comparison to Wachtel and Young's) that the deficit projections are good proxies of private agent's expectations of future fiscal policy at the time of the release. The projections used in these studies, as well as in Wachtel and Young, are relatively short – for the current and next fiscal year in Wachtel and Young and in Cohen and Garnier; for up to eight quarters ahead in Elmendorf. Forecasts at this horizon are presumably still affected by the state of the business cycle. Cohen and

[1]Other studies using similar event analysis are Elmendorf (1996) and Kitchen (1996).

Garnier address this problem by using projections for the cyclically adjusted federal deficit, thus in principle eliminating the business cycle effects. Using OMB projections, they find statistically significant effects of a percentage point increase in the projected deficit-to-GDP ratio on interest rates on the order of 40 to 55 basis points. Using DRI forecasts, Elmendorf finds a statistically significant increase in interest rates at maturities up to five years of about 50 basis points, but the effects on long-term interest rates are smaller and statistically insignificant. Canzoneri, Cumby, and Diba (2002) use 5-year-ahead and 10-year-ahead CBO projections of cumulative budget deficits and study their effects on the *spread* between 5-year or 10-year, and 3-month Treasury yields. Their estimates are of similar magnitude as those reported in Cohen and Garnier and in Elmendorf, but are considerably more precise.

The present study confirms the importance of using measures of long-horizon expectations of deficits and debt for identifying their effects on interest rates.[2] It departs from the previous studies in several respects. Unlike Canzoneri et al., this study uses the level of interest rates expected to prevail 5 years ahead instead of the slope of the term structure. As shown below, omitting the near-term component from the long-term interest rate measures further helps to identify the effects of the fiscal variables. In comparison to previous studies, I also include additional variables suggested by economic theory in the regressions; doing so again helps to identify more precisely the effects of fiscal variables on interest rates. Moreover, I present results concerning the effects of both government deficits and government debt on interest rates. Feldstein (1986) argues that the interest rate effects of deficits depend on how persistent these deficits are assumed to be. The relative magnitudes of the estimated effects of deficits and the estimated effects of debt reported below are consistent with the assumption that increases in projected deficits are persistent, but not permanent. Finally, the fourth section discusses the predictions of the neoclassical growth model – the simplest general equilibrium framework for this purpose – for the relationship between the stock of debt and interest rates. Under plausible assumptions, the empirical results are consistent with the predictions from this model.

[2]This point is convincingly illustrated in Elmendorf (1993). He examines the findings of studies that proxy for expectations of fiscal variables by using forecasts from VARs (see Plosser 1982, 1987, and Evans 1987). Elmendorf shows that these VAR forecasts are poor compared to projections available at the time, and that the conclusions of these studies are overturned once better measures of expectations are used. For a taxonomy of studies in this area according to their measurement of expectations see Gale and Orzsag (2002).

2 Specification and Data

The empirical method used in this paper is to regress expected future interest rates on projections published by the CBO and the OMB for the deficit-to-GDP ratio and the debt-to-GDP ratio five years ahead, as well as other determinants of long-term interest rates suggested by economic theory. As regards the latter, the Ramsey model of optimal growth, combined with a representative household with CES utility, implies that the net real return on capital, i.e. the real interest rate, is determined by

$$r = \sigma g + \theta$$

where g denotes the net growth rate of technology, output, and consumption, σ is the coefficient of relative risk aversion, and θ is the household's rate of time preference. This relationship therefore suggests that both trend growth and risk aversion should play a role in determining yields on risk-free Treasury instruments: an increase in trend growth should raise interest rates, whereas an increase in risk aversion should lower Treasury yields because it raises the demand for safe assets. The regressions reported in the next section are therefore variants of

$$r_t = \beta_0 + \beta_1 f_t + \beta_2 g_t + \beta_3 e_t + \epsilon_t \tag{1}$$

where r_t is the real Treasury yield expected to prevail at some horizon, f_t is a fiscal variable, e.g. the projected deficit-to-GDP ratio, g_t is a measure of potential GDP growth, and e_t is a measure of the equity premium discussed below.

The following discussion of the data used in this study is deliberately kept short; more details can be found in the appendix. From the CBO, five-year-ahead projections for both the unified budget deficit and GDP (GNP until 1991) are available at an annual frequency from 1976 to 1984, and at a semiannual frequency from 1985 until the most recent projection in January 2003. For the early years, the CBO did not publish projections for federal debt held by the public; those projections are therefore computed by adding the CBO's deficit projections for the current and next five fiscal years to the stock of debt held by the public at the end of the previous fiscal year. From the OMB, five-year-ahead projections of deficits, debt held by the public, and GNP or GDP are available at an annual frequency from 1983 on. I also collect projections for the net interest component of outlays, and for total outlays, which I will use later on.[3]

[3]The 5-year-ahead projections of debt held by the public are of course affected by projected near-term

Figures 1 and 2 show the actual deficit-to-GDP ratios and debt-to-GDP ratios, expressed as percent of GDP, together with CBO's and OMB's five-year-ahead projections. The projections are shown for the (fiscal) year for which they were made. Clearly, both agencies made large forecast errors, but this is irrelevant for our purpose. The only relevant question is whether these agencies' projections accurately reflect market expectations at the time the projections were made. While it is impossible to assess that issue directly, arguably these agencies' projections are using most of the information about future deficits and debt available at the time, although in different ways: Whereas the CBO's projections are usually based on fiscal policies that have been enacted at the time the projection is made, the OMB's projections include the administration's policy proposals. If market participants believe that the administration's policies are likely to pass as proposed, their expectations may be closer to the OMB's projections; in other instances, they may be closer to the CBO's. It is worth noting that over the sample for which both agencies' 5-year-ahead projections can be evaluated (fiscal years 1988 to 2002), the biases of the CBO projections (1.2 percent for the deficit/GDP ratio, 5.1 percent for the debt/GDP ratio) are larger in absolute value than those of the OMB projections (-0.7 percent and -1 percent respectively), but the standard deviations of the CBO's forecast errors (2.9 percent and 10.4 percent) are slightly smaller than those of the OMB (3.1 percent and 12 percent). There is no obvious reason why investors should prefer one agency's projections over the other, and below I will present results using both sets of projections.

For the regressions involving CBO projections, the interest rate data are sampled on the last trading day of the month of the CBO release. For the regressions involving OMB projections, I use the value of interest rates as recorded on the last trading day of February, except in those years in which a new administration took office, when I use observations from the last trading day of March. Three different interest rate series are considered below: the yield expected to prevail five years ahead on a 10-year Treasury note, the yield expected to prevail five years ahead on a 5-year Treasury note, and the (conventional) 10-year constant maturity Treasury yield.[4] The first two are measured as simple averages of one-year forward

cyclical deficits; however, the effects of the deficit in any one given year on the stock of debt is generally small.

[4]Although this study focuses on government yields, it should be noted that the results are likely to carry over to corporate yields. Based on regression analysis, I find no evidence that yield spreads between corporate bonds and Treasuries, adjusted for cyclical variation, are systematically related to projected deficit-to-GDP

rates 5 to 9 years and 5 to 14 years ahead, respectively, calculated from the zero-coupon yield curve.[5] Nominal interest rates are converted into real interest rates using a proxy for 10-year consumer price inflation expectations that is based on survey data for most of the sample; details are provided in the appendix. In some regressions the dependent variable is the real interest rate, whereas in others it is the nominal interest rate; in these latter regressions, inflation expectations are allowed to enter with a coefficient different from 1. The series of nominal interest rates and expected inflation, sampled in the months of annual CBO releases, are shown in figure 3.

For trend growth, I use CBO's 5-year-ahead projections of the growth rate of real GNP or GDP as a proxy for agents' views about the trend growth rate of the economy at a given point in time. It is also the growth rate that is consistent with CBO's deficit projections five years ahead. The equity premium, which is used as a proxy for risk aversion, is calculated as the dividend component of national income, expressed as a percent of GDP, minus the real 10-year Treasury yield, plus the trend growth rate. I use the value of the equity premium in the quarter prior to the release of the respective budget projections, assuming that this is the best available forecast of this variable five years ahead. Because the equity premium is a function of the real 10-year Treasury yield, the issue of simultaneity of the dependent variable and this measure of the equity premium is addressed below. Both series are shown in figure 4.

3 Empirical Results

Table 1 presents some baseline results, using the real 5-year-ahead 10-year Treasury yield as the dependent variable. It reports the estimated coefficients on the deficit-to-GDP and debt-to-GDP ratios, both expressed as percentages of GDP, trend growth, and the equity premium; the intercept estimate is omitted from all tables. Also shown are the R^2, the standard error of the regression, the Durbin-Watson statistic, and the number of observa-

ratios.

[5]It has often been noted that forward rates are biased predictors of future interest rates, presumably because they include term and/or risk premia. For the 5-year-ahead 10-year interest rate used here, for example, the bias throughout the 1990s is about 2 percent. Because forward rates are affecting *current* interest rates and hence the current cost of capital relevant for business and residential investment, however, the fact that forward rates may not be unbiased predictors of future interest rates is not a concern.

tions. The t statistics are based on standard errors using the Newey-West correction for heteroskedasticity and serial correlation; the lag truncation, based on automatic selection criteria, is 3 for the CBO data, and 2 for the OMB data.[6]

The first two columns show the results for the largest data set, the CBO projections including the mid-year updates from 1985 on. The coefficient on the deficit-to-GDP ratio is 0.29 and its t statistic is large. The coefficient on the debt-to-GDP ratio is also highly significant, and as argued below, its size appears to be consistent with the estimated coefficient on the deficit-to-GDP ratio. Trend growth and the equity premium enter with statistically significant and economically meaningful coefficients. The Durbin-Watson statistics indicate some degree of serial correlation in the residuals of both regressions. As shown in columns 3 and 4, omitting the mid-year updates eliminates this problem without significantly affecting the other results; in the following I will only use the annual CBO data. Columns 5 and 6 show that similar results are obtained using OMB's projections, except that the coefficients on the fiscal variables are no longer estimated as precisely as for the CBO projections.

To provide some idea of the interest rate effects predicted by these regressions, consider the CBO's annual projections. Between January 2001 and January 2003, the CBO's 5-year-ahead projection of the surplus-to-GDP ratio declined from 3.8 percent to about 0.5 percent. The regression shown in column 3 implies that this swing raised the 5-year-ahead real interest rate by 92 basis points, everything else equal. Similarly, the projected 5-year-ahead debt-to-GDP ratio increased from about 9.5 percent to 28.5 percent; the regression shown in column 4 implies that, all else equal, this swing raised the 5-year-ahead real interest rate by 99 basis points.

Tables 2 and 3 examine the robustness of these results along several dimensions. The dependent variable in these tables continues to be the 5-year-ahead 10-year Treasury yield. Despite the use of long-horizon projections, it is possible that the results may not only reflect the effects of fiscal policy on interest rates, but may also confound those effects with monetary policy. The early 1980s in particular are an episode in which both projected deficits and interest rates rose sharply, with the latter arguably driven at least in part by the Volcker disinflation. The first two columns of table 2 therefore present the same regressions shown in table 1, using annual CBO projections only from 1985 on – that is,

[6] A caveat in interpreting the t statistics is that augmented Dickey-Fuller tests do not reject the hypothesis of a unit root at the 5 percent level for either the dependent variable or for the regressors. In view of the small number of observations, however, these tests have very low power.

after the most intense phase of the disinflation had been completed.[7] As shown in column 1, the coefficient on the deficit-to-GDP ratio is slightly larger, and its t statistic very high. The results shown in column 2 using the debt-to-GDP ratio are nearly identical to those for the full sample.

A different approach to assessing the role of the early 1980s is to use nominal yields as the dependent variable, and to include expected inflation as an additional regressor. As shown in columns 3 to 6, the coefficient on expected inflation is always estimated to be larger than 1. This finding may reflect a demand by investors for increased risk premia on nominal assets to compensate for greater uncertainty about future inflation when the current level of inflation is elevated (see e.g. Okun (1971) and Ball and Cecchetti (1990)). In addition, Feldstein (1976) points out that, because taxes are levied on nominal returns, nominal interest rates have to increase more than one-for-one with expected inflation. Consequently, in these regressions the implied effect of the rising deficits of the early 1980s on real interest rates is attenuated. This is because, relative to the earlier regressions in which nominal yields and expected inflation move one for one by assumption, a larger portion of the high level of nominal interest rates during this period is now attributed to high expected inflation. Consistent with this reasoning, the estimated coefficients on the fiscal variables are slightly smaller than those presented in table 1, but still highly significant. Returning to the example above, the results shown in columns 3 and 4 imply that the revisions to the CBO's projections between January 2001 and January 2003 added about 75 basis points to 5-year-ahead long-term interest rates, all else equal. The improvement in the regression R^2 is almost entirely due to the change in the dependent variable, as shown by the nearly unchanged regression standard errors. Because of the economic arguments mentioned before, however, the following tables report results for regressions with nominal yields as dependent variables.

Two issues related to including trend growth and the equity premium in the regressions are addressed in table 3. The first is how omitting one or both of these variables affects the estimated coefficients on the fiscal variables. To be concise, results are shown only for annual CBO data. The first two columns show results when both variables are omitted from the regression, and the next two columns show results when only the equity premium

[7] Results using OMB projections from 1985 on are little changed from those shown in table 1, as only the first two observations are omitted.

is omitted. Comparing those results to the ones shown in the middle two columns of table 2, we find that the coefficients on both fiscal variables are quite similar whether one or both of the non-fiscal regressors are omitted. However, the coefficients on growth are essentially zero when the equity premium is omitted. For the theoretical reasons discussed in the previous section, I will continue to include both variables in the regressions.[8]

A different concern is that the equity premium contains the real 10-year Treasury yield, and is therefore correlated with the residual. In the last two columns of table 3 I report results from regressions in which I use the lagged equity premium as instrument for the current equity premium. Compared to the results shown in the middle two columns of table 2, the only notable difference is that the t statistics on the equity premium fall to 1.7. The results concerning the fiscal variables, however, are robust.

Table 4 assesses the effects of using either the current 10-year Treasury yield, or the 5-year Treasury yield expected to prevail five years ahead, instead of the 10-year Treasury yield expected to prevail five years ahead. For convenience, the last two columns repeat the results shown in the middle two columns of table 2. The results using the conventional 10-year Treasury yield show clearly that controlling for the cyclical variation embedded in the short end of the yield curve is important for identifying the effects of fiscal variables on interest rates.[9] Once the first five years of the term structure are omitted, the point estimates using the 5-year-ahead 5-year yield are similar to those using the 5-year-ahead 10-year yield, but not as precise.[10]

Finally, table 5 considers the effects of using two other combinations of fiscal variables. The first column in table 5 addresses the concern of reverse causation from the interest rate to projected deficits through higher outlays on debt service. Here the regressor is the ratio of the primary deficit, defined as the projected deficit less projected net interest outlays, to projected GDP. The coefficient on the primary deficit is larger than the coefficient on the deficit shown in table 2, and its t statistic about the same. The second column shows

[8]Qualitatively the same results obtain when using OMB projections, except that the coefficient on the debt-to-GDP ratio in the regression including growth remains significant at the 5% level, with a t statistic of 2.28. It should also be noted that the coefficient on trend growth remains significant in the regressions shown in tables 3 through 5 when the dependent variable is the real 5-year-ahead Treasury yield.

[9]When using the *real* 10-year yield as dependent variable, however, the coefficients on the fiscal variables remain significant and of similar magnitude as those reported in the middle two columns of table 1, although their t statistics are lower than those reported there.

[10]Again, the same conclusions obtain using OMB projections.

the results from including the projections for the primary deficit and total outlays, both expressed as percentage of GDP, in the regressions. The question is whether the effects of deficits on interest rates depend on whether the deficits are caused by spending increases or by changes in the timing of taxes. According to Ricardian equivalence, for example, changes in projected deficits without changes in government purchases should leave expected interest rates unchanged. If so, the coefficient on the projected deficit-to-GDP ratio in a regression including projected government purchases should be zero. By contrast, the coefficient on the deficit-to-GDP ratio shown in the second column is even higher than before, whereas that on projected total outlays is negative, but statistically insignificant. The sum of the coefficients on the two fiscal variables in column 2 is close to the coefficient on the projected deficit-to-GDP ratio in column 1, and its t statistic is 2.67. The counterintuitive sign on total outlays may in part reflect the fact that total outlays include transfer payments as well as government purchases.[11]

Is the result that the estimated coefficients on the deficit-to-GDP ratio are about seven times as large as the ones on the debt-to-GDP ratio economically plausible? If increases in deficits were serially uncorrelated, so that the effect of a projected increase in the deficit on the stock of debt in subsequent years would be simply one for one, the coefficients on the deficit-to-GDP ratio and the debt-to-GDP ratio ought to be the same. But consider the opposite extreme, in which every increase in projected deficits is expected to be permanent. The steady-state effect on the debt-to-GDP ratio of a permanent one percentage point increase in the deficit-to-GDP ratio is $(1+g)/g$ percent, where g is the net growth rate of nominal GDP. Over the sample 1976-2003, this growth rate averaged about 8 percent per year, implying that the coefficient on the deficit-to-GDP ratio ought to be 13.5 times as large as the coefficient on the debt-to-GDP ratio. The fact that the estimated coefficients on the deficit-to-GDP ratio are about seven times as large as those on the debt-to-GDP ratio is consistent with the view that investors perceive increases in projected deficit-to-GDP ratios as highly persistent (as they are in the historical data), but not strictly permanent.

[11]The results shown in table 5 are nearly unaffected when using instead the real five-year-ahead 10-year yield as dependent variable.

4 Are the Results Consistent with Economic Theory?

A skeptical view of the evidence presented in the previous section would hold that the identification problems involved in these kinds of regressions are too severe to be ever completely overcome. One may therefore ask whether the empirical results can be reconciled with priors based on economic theory. One potential answer to this question, based on the neoclassical growth model, is sketched below; the argument is closely akin to the one developed in Elmendorf and Mankiw (1999).[12] Because in the neoclassical growth model the real interest rate is determined by the capital-output ratio, the discussion below focuses on the link between the stock of debt and the capital stock, and assesses the plausibility of the results for the debt-to-GDP ratio reported in the previous section. As Elmendorf and Mankiw (1999) point out, however, whether it is deficits or debt that matter for the determination of interest rates depends ultimately on which model of consumer behavior one assumes. The analysis below therefore illustrates only one particular argument by which the empirical results can be related to economic theory.

Suppose that an increase in government debt reduces the private capital stock by a fraction c; that is, if D denotes the stock of government debt, and K the private capital stock, $\partial K/\partial D = -c$. The parameter c denotes the degree of crowding out, with the remaining fraction $1-c$ being the increase in private savings or capital inflows from abroad in response to the increase in the interest rate. Assuming factors of production earn their marginal product, the share of capital in income, s, is equal to the marginal product of capital times the capital-output ratio $k = K/Y$. Moreover, the marginal product is equal to the sum of the depreciation rate d of the private capital stock and the real interest rate r. Hence we can solve for r as $r = s/k - d$.

The effect of a one percentage point increase in the debt-to-GDP ratio on r can now be computed by calculating the partial derivative $\partial r/\partial D = \partial r/\partial k \cdot \partial k/\partial K \cdot (-c)$. Using a Cobb-Douglas production function $Y = K^s L^{1-s}$, we find that $k = K^{1-s}L^{-(1-s)}$, and therefore $\partial k/\partial K = (1-s)/Y$. Putting the pieces together, an increase $\Delta D = 0.01Y$ raises the interest rate by $(1-s)cs/k^2$ basis points.

The final step in obtaining numerical predictions of the interest rate effects is to choose values for c, s, and k. As an example, consider $s = 0.33$, consistent with a capital share

[12]A similar argument is used in Council of Economic Advisers (2003).

in national income accounts data of about 1/3. For the parameter k, consider the BEA's estimate of private fixed assets at the end of 2001 ($22.2 trillion) divided by output in the nonfarm business sector in 2002 (approximately $8.4 trillion). This yields $k = 2.5$. The most difficult parameter to quantify is the degree of crowding out, c. Elmendorf and Mankiw (1999) survey a number of studies which show that, under assumptions for households' intertemporal elasticity of substitution consistent with household data, the increase in private savings in response to the change in interest rates is close to zero. Moreover, recent studies in the vein of Feldstein and Horioka (1980) suggest that roughly two-thirds of saving in developed countries is retained for domestic investment in the long run, implying that capital inflows from abroad offset about one-third of the increase in debt. Suppose, therefore, that $c = 0.6$. Then a one percentage point increase in the debt-to-GDP ratio raises the real interest rate by 2.1 basis points. This is only half of the effect reported in the regressions using the real interest rate as dependent variable, but only slightly less than the estimates reported in Tables 2 and 3 using the nominal interest rate as the dependent variable.

It should be noted, however, that the estimate of 2.1 basis points is conservative because it takes into consideration the endogenous response of output to the decline in the capital stock, but it omits the second-round effect that the debt-to-GDP ratio is effectively increasing by more than one percentage point. Moreover, as pointed out in the previous section, increases in projected *deficits* tend to be highly persistent, and hence a given increase in the 5-year-ahead projected debt-to-GDP ratio might be expected to be followed by larger increases in the debt-to-GDP ratio beyond five years into the future. If so, a percentage point increase in the debt-to-GDP ratio projected five years ahead should be associated with an increase in interest rates larger than the one implied by a percentage point increase in the *steady state* debt-to-GDP ratio predicted by the model.

5 Conclusions

This study has shown that statistically significant and economically plausible estimates of the effects of government deficits and debt on interest rates can be obtained by focusing on long-horizon forecasts of future deficits or debt, and future interest rates. The projections of deficits and debt published by the CBO and the OMB are arguably among the best publicly available forecasts for these variables. The effects of these projections manifest themselves at the longer end of the yield curve, as economic reasoning would predict. All else equal, the results of this study suggest that interest rates rise by about 25 basis points in response to a percentage point increase in the projected deficit-to-GDP ratio, and by about 4 basis points in response to a percentage point increase in the projected debt-to-GDP ratio.

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A The Data

The OMB data are taken from the annual releases of the administration's budget published in February, or slightly later in years in which a new administration took office. The months of CBO releases used in this study (releases omitted from the annual data set are marked by *) are 1/76, 12/76, 1/78, 1/79, 2/80, 7/81, 2/82, 2/83, 2/84, 2/85, 8/85*, 2/86, 8/86*, 1/87, 8/87*, 2/88, 8/88*, 1/89, 8/89*, 1/90, 7/90*, 1/91, 8/91*, 1/92, 8/92*, 1/93, 9/93*, 1/94, 8/94*, 1/95, 8/95*, 12/95*, 5/96, 1/97, 9/97*, 1/98, 8/98*, 1/99, 7/99*, 1/00, 7/00*, 1/01, 8/01*, 1/02, 8/02*, 1/03. For the early years of the sample (1976-1982), constructing the series of both projected deficits and debt entails a choice because the CBO reported different projections of future deficits depending mainly on alternative assumptions regarding policy responses to the inflation-induced uptrend in tax receipts. To be consistent across the entire sample, I used the estimates based on the assumption of no policy change. The January 1991 projections are not the CBO baseline, but are based on the already legislated discretionary spending caps, which were the CBO's baseline for the remainder of the 1990s. The December 1995 projections are included despite the fact that they were based on a budget resolution already vetoed by the President. By contrast, the August 1996 update is omitted because of incomplete projections, given that the annual projections had only been published in May.

The series of inflation expectations, which is taken from the Federal Reserve Board's FRB/US model, consists of three different pieces. Until 1981:Q1, the series is an estimated step function based on the changepoint model developed in Kozicki and Tinsley (2001). From 1981:Q2 until 1991:Q2, the series is based on the Hoey survey of decision makers, which was conducted by Drexel-Burnham-Lambert, and later by Barclays De Zoete Wedd. Participants in this survey were polled for their expectation of CPI inflation ten years ahead. Finally, since 1991:Q3 the series is based on the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, in which participants are asked for their expectation of CPI inflation over the next ten years. Thus, while the series is not ideal for our purposes, it should provide a good measure of inflation expectations over either of the horizons of the nominal yield series described above. The series is extrapolated to monthly frequency, and is sampled in the months corresponding to the yield data.

Table 1: Results for Real 5-Year-Ahead 10-Year Treasury Yield

	Source of Projections					
	CBO, Semiann.		CBO, Annual		OMB	
Proj. Deficit/GDP	.29	–	.28	–	.40	–
	(10.83)		(12.07)		(4.45)	
Proj. Debt/GDP	–	.053	–	.052	–	.053
		(5.52)		(5.22)		(3.32)
Trend Growth	1.11	1.53	1.02	1.45	1.01	1.51
	(4.10)	(3.70)	(3.39)	(3.10)	(2.69)	(2.77)
Eq. Premium	-.41	-.45	-.41	-.48	-.40	-.36
	(4.83)	(3.69)	(4.32)	(3.88)	(2.29)	(2.05)
R^2	.61	.44	.65	.48	.58	.49
S.E.	.64	.76	.70	.85	.64	.70
DW	1.14	.97	2.06	2.07	2.20	2.16
N	46	46	28	28	21	21

Notes: Newey-West t statistics in parentheses.

Table 2: Results for Shorter Sample and for Nominal Yields

	CBO, 1985-2003		CBO, Nom. Yield		OMB, Nom. Yield	
Exp. Inflation	–	–	1.19	1.32	1.12	1.16
			(5.63)	(5.96)	(10.88)	(10.37)
Proj. Deficit/GDP	.30	–	.23	–	.36	–
	(6.36)		(4.17)		(3.29)	
Proj. Debt/GDP	–	.053	–	.036	–	.046
		(5.05)		(2.46)		(2.68)
Trend Growth	1.11	1.58	.68	.72	.86	1.26
	(3.43)	(3.12)	(1.53)	(1.06)	(2.28)	(2.28)
Eq. Premium	-.37	-.41	-.40	-.45	-.41	-.37
	(3.58)	(2.98)	(4.30)	(3.33)	(2.41)	(2.19)
R^2	.68	.58	.92	.90	.91	.90
S.E.	.56	.64	.69	.79	.64	.70
DW	1.86	2.16	2.05	2.04	2.38	2.33
N	19	19	28	28	21	21

Notes: Newey-West t statistics in parentheses.

Table 3: The Role of Trend Growth and the Equity Premium

	CBO, 1976-2003					
	OLS				IV	
Exp. Inflation	1.23	1.35	1.20	1.37	1.19	1.32
	(9.62)	(9.96)	(4.44)	(5.40)	(5.73)	(6.29)
Proj. Deficit/GDP	.21	–	.23	–	.23	–
	(3.96)		(2.60)		(3.96)	
Proj. Debt/GDP	–	.030	–	.029	–	.036
		(2.68)		(1.54)		(2.20)
Trend Growth	–	–	.10	-.05	.57	.76
			(.18)	(.07)	(1.14)	(.94)
Eq. Premium	–	–	–	–	-.33	-.47
					(1.72)	(1.70)
R^2	.89	.86	.89	.86	.92	.90
S.E.	.80	.90	.81	.92	.71	.80
DW	1.57	1.55	1.59	1.54	1.92	2.02

Notes: Newey-West t statistics in parentheses.

Table 4: The Role of Forward Rates and Maturities

	CBO, 1976-2003					
	10-Year Yield		5-Y-Ah-5-Y Yield		5-Y-Ah-10-Y Yield	
Exp. Inflation	1.62	1.71	1.21	1.31	1.19	1.32
	(7.13)	(7.85)	(5.94)	(6.71)	(5.63)	(5.96)
Proj. Deficit/GDP	.09	–	.19	–	.23	–
	(1.40)		(2.38)		(4.17)	
Proj. Debt/GDP	–	.007	–	.033	–	.036
		(.45)		(2.14)		(2.46)
Trend Growth	.73	.59	.65	.76	.68	.72
	(1.25)	(.80)	(1.40)	(1.23)	(1.53)	(1.06)
Eq. Premium	-.72	-.72	-.50	-.54	-.40	-.45
	(4.93)	(4.13)	(3.66)	(3.31)	(4.30)	(3.33)
R^2	.93	.93	.90	.89	.92	.90
S.E.	.76	.79	.79	.84	.69	.79
DW	1.47	1.53	1.50	1.62	2.05	2.04

Notes: Newey-West t statistics in parentheses.

Table 5: Other Combinations of Fiscal Variables

	CBO, 1976-2003	
	Primary Deficit	Pr. Deficit and Outlays
Exp. Inflation	1.22	1.28
	(6.63)	(6.04)
Proj. Deficit/GDP	.32	.41
	(4.35)	(4.75)
Outlays/GDP	–	-.13
		(.97)
Trend Growth	.58	.48
	(1.46)	(1.09)
Eq. Premium	-.41	-.41
	(4.16)	(3.79)
R^2	.93	.93
S.E.	.68	.68
DW	2.00	2.13

Notes: Newey-West t statistics in parentheses.

Figure 1: Actual and Projected Deficits as Percent of GDP

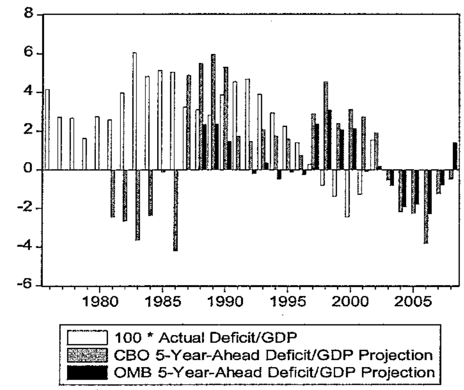


Figure 2: Actual and Projected Debt as Percent of GDP

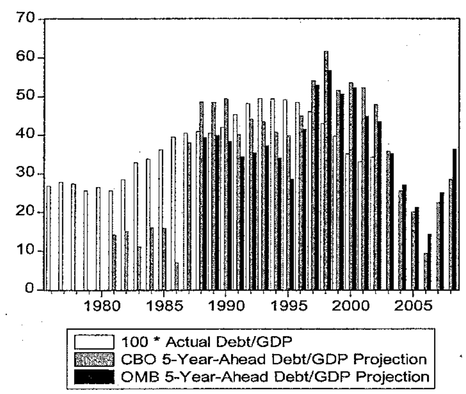


Figure 3: Interest Rates and Inflation Expectations

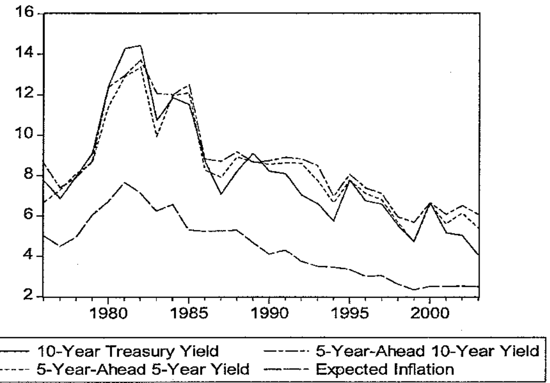
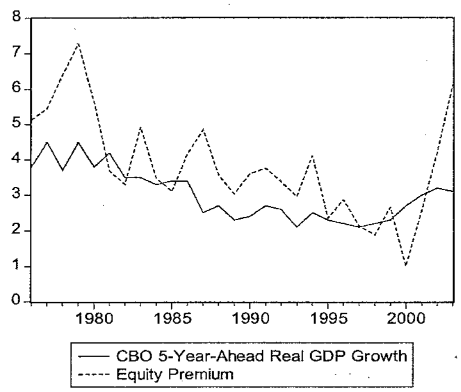


Figure 4: Projected GDP Growth and Equity Premium



Chairman Greenspan subsequently submitted the following in response to written questions received from Congressman Luis Gutierrez in connection with the House Committee on Financial Services hearing of April 30, 2003:

Question:

Mr. Greenspan, during your testimony on April 30, 2003, I inquired about Treasury's recently released final rule regarding Section 326 of the USA PATRIOT Act, which provides guidelines for financial institutions to identify their customers.

The final rule says that "if the customer is a non-U.S. person and does not have a U.S. taxpayer identification number, the bank may obtain an identification number from other form of government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard."

Under the rule, therefore, financial institutions could have the flexibility to accept government-issued IDs, such as the Mexican matrícula card, to allow their nationals to open bank accounts in the United States.

As you know, there are approximately 28 million foreign born people in the U.S. and the matrícula consular represents a common-sense step in enabling them to access our financial system.

Being able to open a bank account ensures that individuals will not have to rely on unregulated check-cashers. It also helps lower the transfer costs for remittances that are sent abroad because it permits the use of regulated financial institutions, such as banks and credit unions, that offer better wire transfer rates.

More importantly, this rule protects immigrants from being increasingly vulnerable to crime and theft. The matrícula consular represents a strong sense of security for those who no longer have to carry their paychecks around with them in cash.

During the hearing, I asked you whether you agreed that the acceptance of the matrícula card is an important and fundamental step in helping better monitor who's accessing our financial markets and, at the same time, whether you believed this card provides an opportunity for financial institutions to tap new customers that could serve as an important channel of economic growth that our country needs to positively stimulate markets. Finally, I asked you whether the Federal Reserve was prepared to take a position on the acceptance of the use of the matrícula consular?

At that time, your response was that you would prefer to "go back and take a look at some of the details of the argument here and perhaps respond to you in writing to give you a more informed view than I could at this particular point."

Now that you have had more time to study this issue, could you please inform me of the Federal Reserve's views on these types of identification cards and whether you will take a position on the acceptance of the use of the matrícula consular, and if so, what would that position be?

Answer:

Any mechanism that improves the process for verifying identity--which banking institutions must undertake when opening account relationships--is important to helping better monitor access to our financial markets. Identification systems that offer reliable verification increase opportunities for financial institutions to standardize processes for opening accounts and expanding their customer base. They enhance opportunities for consumers to participate in mainstream banking, improving their ability to access more competitive or responsive services. Such effects can improve banking market operations and contribute to economic growth by increasing overall competition and efficiency.

While facilitating access to banking services, any government-issued identification cards also can present problems and the possibility of fraud. Consequently, it is important that banking institutions adopt necessary measures to reduce their potential exposure to fraud. The Federal Reserve expects institutions to conduct due diligence--to assess and mitigate the risks of liability--with respect to all of their accounts, including those opened based on the matrícula consular.

The New York Times
SUNDAY, FEBRUARY 2, 2003

THE CONCORD COALITION

Are We Really Cutting Taxes - Or Just Raising Them On Our Kids?

With the recovery still sluggish and the dual prospects of war in Iraq and terrorism at home weighing down on business and consumer confidence, President Bush deserves credit for proposing steps to spur the economy. Yet less than 9 percent of the 10-year $670 billion tax cut he has proposed would have an impact this year – a stimulus amounting to less than 6 tenths of one percent of GDP. Most of the cut is scheduled for later years when the main effect may simply be to enlarge the long-term deficit. A responsible plan would combine an effective dose of short-term fiscal stimulus with plenty of long-term fiscal restraint. We should make any new tax cut effective immediately, target it at households likely to spend rather than save the money, and avoid provisions that cause growing revenue loss over time. We urge leaders to remember that the 10-year budget outlook is rapidly deteriorating. A projected $5.6 trillion surplus has turned into a likely deficit of at least $1.5 trillion – even if the Social Security surplus is included and before any new tax cuts or spending initiatives are enacted. Moreover, the baby boomers' retirement looms just over the horizon. Let's be sure that a lighter tax burden on us today doesn't mean an even heavier burden on our children tomorrow.

Guns and Butter and Tax Cuts: Can We Have it All?

To enact permanent new tax cuts in the face of large new spending pressures – such as the prospect of a war in Iraq and the inevitable post-war costs, massive but indispensable homeland security needs, and a major prescription drug add-on for Medicare – is to proclaim that America can painlessly have it all. Unfortunately, we can't. Sooner or later someone has to pay the bills for guns and butter and tax cuts. Many worry about "class warfare." Almost no one seems concerned about another kind of warfare – "generational warfare." Yet that's what we risk if we continue to live beyond our means and pass the IOUs to our children and grandchildren.

A $25 Trillion Fiscal Millstone: Shouldn't the Government Use Honest Accounting Too?

The truth is, future generations are already burdened by an off-the-books obligation of $25 trillion. This fiscal millstone represents the unfunded benefit obligations of federal entitlement programs such as Social Security and Medicare – that is, the total value of benefit promises accrued to date for which nothing has been saved. It is equivalent to the total amount of money that would have to be set aside in interest-earning accounts, starting today, to pay for all of the unfunded benefits that have thus far been promised to workers and retirees. No amount of fiscal stimulus or "pro-growth" tax cuts will come close to lifting this $25 trillion millstone. If a private corporation ran up unfunded benefit promises of $25 trillion someone would go to jail. In the private sector, federal law requires such benefit obligations to be amortized over 30 years and recorded as an annual charge against revenues. Politicians have justifiably criticized recent corporate accounting scandals, but if the federal government required itself to recognize the true cost of the benefit obligations on its own balance sheet, the annual charge would be $1.7 trillion. Recognizing this charge on next year's budget would produce an honest accrual-based deficit approaching $2 trillion – a sobering perspective for policymakers eager to incur new long-term debt.

When Is a Tax Cut Not a Real Tax Cut?

Many advocates of permanent tax cuts apparently believe that debt is a painless alternative to taxes. In fact, deficits merely shift the tax burden toward the future. But haven't we shifted more than enough burdens onto our children and grandchildren already? According to the Social Security and Medicare trustees, these two programs alone are on track to consume between a quarter and a third of worker payroll. That is an unthinkable tax burden. Adding more would be unconscionable. At a time when the young men and women of the armed forces are being asked to risk the ultimate sacrifice, are the rest of us to "sacrifice" by shifting even more of our tax burden onto their future paychecks?

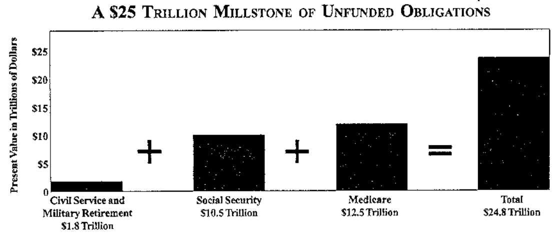
If policymakers desire to reduce or eliminate the "double taxation" of corporate dividends, such structural reforms should be framed as a comprehensive revenue-neutral package to avoid worsening the long-term deficit. Reducing the taxation on dividends may marginally improve personal savings but the loss in federal revenue adds directly to the federal debt and in the long run subtracts dollar-for-dollar from desperately needed national savings.

Fiscal responsibility requires tough choices on both revenues and spending. Spending restraint, in turn, requires measures that restrain the cost of major entitlement programs. While fundamental reform of Social Security and Medicare is needed, entitlement reform has been discussed, debated and deferred on a separate track from taxes. It cannot be. In the long run, proposing tax cuts while proposing substantial spending increases is not a real tax cut at all.

America at a Crossroads

The nation now faces two history-bending challenges: global terrorism and global aging. Meeting the first will require marshalling new resources far above the extra spending already legislated. We know that meeting the second will test the ability of society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. In his State of the Union Address, President Bush said, "This country has many challenges...we will not pass along our problems to other Congresses, to other Presidents, and other generations." The Concord Coalition strongly agrees with the President. But turning this worthy sentiment into reality requires making hard choices such as avoiding tax cuts we can't afford and reforming entitlements to put our budget on a sustainable trajectory – and facing up to the required sacrifice. The alternative is to continue to pretend that our choices have no consequences and saddle our kids and grandkids with taxes that will soon ramp up to unsustainable levels.

A $25 Trillion Millstone of Unfunded Obligations



Source: Office of Management and Budget and U.S. Department of Treasury

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