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SPEND LESS, OWE LESS, GROW THE ECONOMY

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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FIRST SESSION

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SPEND LESS, OWE LESS, GROW THE ECONOMY

TUESDAY, JUNE 21, 2011

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, persuant to call, at 2:00 p.m. in Room 1100, Longworth House Office Building, the Honorable Kevin Brady, Vice Chairman, presiding.

Senators present: Casey and Lee.

Representatives present: Brady, Mulvaney, and Sanchez.

Staff present: Gail Cohen, Colleen Healy, Jesse Hervitz, Jessica Knowles, Will Hansen, Ted Boll, Jayne McCullough, and Robert O'Quinn.

OPENING STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Vice Chairman Brady. Good afternoon. On behalf of Chairman Casey and myself, I want to welcome everyone to this hearing entitled "Spend Less, Owe Less, Grow the Economy." I want to welcome our witnesses as well, and members of the Joint Economic Committee.

Chairman Casey and I have agreed to share the task of organizing hearings for the Joint Economic Committee during the 112th Congress. Pursuant to our agreement, I convened this hearing because the once-vigorous American economy is languishing.

A recent op-ed by Harvard University Professor Martin Feldstein entitled "The Economy is Worse Than You Think," laments that final sales grew at an anemic annual rate 0.6 percent during the first quarter of 2011. The month of May witnessed the unemployment rate rising above 9 percent again, and a collapse of payroll employment gains. Feldstein offers us another wakeup call.

President Obama's economic policies have failed to launch a vigorous expansion. Instead, his policies have increased the cost of doing business, heightened uncertainty, and deterred job-creating investment. Moreover, his policies have burdened our children with enormous Federal debt that continues to grow as a share of the economy.

One of our witnesses, Stanford University Professor John Taylor, published a graph that depicts President Obama's last two spending proposals, his budget in February and his informal framework in April, and compares them with the House budget resolution. From this graph, it is clear that President Obama and congressional Democrats want to make Federal spending a permanently

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larger share of our economy, whereas congressional Republicans want merely to return Federal spending to its pre-recession share of our economy.

Returning Federal spending to a pre-recession share of the economy is normal and prudent. Nevertheless, President Obama and some in Washington have embraced the radical, historically unprecedented expansion of the size and scope of the Federal Government.

Let me be clear. Excessive Federal spending is our disease. Large Federal budget deficits and accumulating Federal debt are symptoms of this disease. If you cure our spending disease, the symptoms will vanish. If you treat the symptoms, you may temporarily alleviate some of the pain, but over time our economy will continue to weaken, our international competitiveness will erode, and our children will become the first generation in American history that is poorer than the previous generation.

In response to these grave fiscal challenges, the House of Representatives passed a responsible budget resolution that would bring Federal spending in line with revenue over time. Unfortunately, the Senate has failed to even consider, let alone pass, a budget resolution.

Congressional Republicans want to cure our spending disease in part by reforming entitlement programs to make them sustainably solvent for future generations. In contrast, President Obama and others have reverted to the discredited notion that entitlement programs can largely continue as they are without reforms if we only tax the rich enough.

Congressional Republicans are demanding that any debt ceiling legislation must contain substantial spending reductions and new fiscal guardrails to ensure these reductions actually take place. In response, President Obama and Democrats in Congress have launched all-out political attacks asserting cuts in Federal spending would push the economy back into recession and destroy social programs. These false attacks must cease if Americans are to come together to reduce Federal spending and grow our economy.

On March 15 of this year, I released a JEC staff commentary entitled "Spend Less, Owe Less, Grow the Economy." This study examined other developed countries, our international competitors, that had large, persistent government budget deficits and a high level of government debt.

The study found:

Countries that adopted fiscal consolidation plans to reduce their government budget deficits and stabilize the level of government debt that were based predominantly or entirely on government spending reductions were successful in achieving their goals, while countries that included significant tax increases in their fiscal consolidation plans failed to achieve their goals.

Fiscal consolidation plans based predominantly or entirely on government spending reductions not only increased economic growth over the long term, but also provided significant short-term boosts in many cases.

Today, we are releasing other JEC Republican staff commentary entitled "Maximizing America's Prosperity." This study examined what fiscal guardrails would keep Congress on track to reduce Federal spending relative to the size of our economy.

This study found several things:

A balanced budget amendment to the U.S. Constitution would not counteract the bias toward higher Federal spending unless it contains explicit spending limitations.

The Federal Government needs a statutory spending cap with a credible enforcement mechanism, regardless of whether a constitutional balanced budget amendment is ratified.

The item reduction veto has reduced the growth of State spending by strengthening the role of the Governor relative to the legislature in making spending decisions. Enhanced rescission authority would also help to control the growth of spending at the Federal level.

Sunset provisions, which have been effective in eliminating inefficient and unnecessary programs and agencies in U.S. States, would be helpful at the Federal level.

So long as the President and congressional Democrats continue to behave in politically expedient but fiscally irresponsible ways, American families and businesses will look to the future with trepidation.

Those are the concerns and the issues and the reasons we meet today. I look forward to hearing the testimony of our witnesses.

Senator Casey will be here at about a quarter after to give an opening statement, and we will recognize him when he enters.

[The prepared statement of Representative Kevin Brady appears in the Submissions for the Record on page 34.]

[Charts submitted by Representative Kevin Brady appear in the Submissions for the Record on page 40.]

[Study titled "Maximizing America's Prosperity" appears in the Submissions for the Record on page 53.]

Vice Chairman Brady. At this point, I would like to introduce our witnesses, and on behalf of the Committee, thank you all for being here.

We welcome the Honorable John B. Taylor, George P. Shultz, Senior Fellow in Economics at the Hoover Institution, and the Mary and Robert Raymond Professor of Economics at Stanford University. He also has taught economics at Princeton, Yale and Columbia Universities. Dr. Taylor has received the Bradley Prize for his intellectual achievements and the Alexandria Hamilton award for his overall leadership in international finance at the U.S. Treasury.

Dr. Taylor is a renowned expert on monetary policy and the creator of the Taylor rule for determining what the target rate for Federal funds should be for price stability. He served as the Under Secretary of the Treasury for International Affairs during the first term of President George W. Bush. Previously, he served as a member of the President's Council of Economic Advisers during the Ford and the George H.W. Bush administrations. He has also served on the Congressional Budget Office's Economic Advisory Panel.

Dr. Taylor has a long list of academic publications to his name, and a recent book entitled "Getting Off Track: How Government Actions and Interventions caused prolonged and worsened the Financial Crisis." He is a frequent contributor to the editorial pages of the Wall Street Journal and other widely read publications on the state of the economy. He earned his Ph.D. in economics at Stanford University. Welcome, Dr. Taylor.

Dr. Simon Johnson is a Ronald A. Kurtz Professor of Entrepreneurship at the Sloan School of Management at the Massachusetts Institute of Technology. He is a Senior Fellow at the Peterson Institute for International Economics and a member of the Congressional Budget Office's Economic Advisory Panel.

Dr. Johnson previously held the position of Economic Counselor at the International Monetary Fund and was the director of its research department. He is a codirector of the National Bureau of Economic Research Africa Project and works with nonprofits and think tanks around the world.

Dr. Johnson is a coauthor of the 2010 book "13 Bankers: The Wall Street Takeover and the Next Financial Meltdown." He is a regular Bloomberg columnist and frequently publishes economic opinion pieces in major national and international news publications such as The Washington Post, the Wall Street Journal, and the Financial Times. He is cofounder of the blog, The Baseline Scenario. He earned his Ph.D. in economics at MIT. Welcome, Dr. Johnson.

Kevin A. Hassett is a Senior Fellow and the Director of Economic Policy Studies at the American Enterprise Institute for Public Policy Research. Before joining AEI, he was a senior economist at the Board of Governors of the Federal Reserve system and an associate professor of economics and finance at the Graduate School of Business, Colombia University.

Dr. Hassett was a policy consultant of the Treasury Department during the George H.W. Bush and Clinton administrations. He served as an economic adviser to the George W. Bush 2004 Presidential Campaign and as Senator John McCain's chief economic adviser during the 2000 Presidential primary. He also served as senior economic adviser to the McCain 2008 Presidential Campaign. He is a columnist for National Review. Dr. Hassett earned his Ph.D. in economics at the University of Pennsylvania. Dr. Hassett, welcome.

And our fourth panelist today, Chad Stone, is the chief economist at the Center for Budget and Policy Priorities where he specializes in the economic analysis of budget and policy issues. Dr. Stone was the acting executive director of the Joint Economic Committee here in 2007, and before that staff director and chief economist for the Democratic staff of the committee from 2002 to 2006. He held the position of chief economist for the Senate Budget Committee in 2001 and 2002. Previously, he served on the President's Council of Economic Advisers as senior economist and chief economist from 1996 to 2001. His other congressional experience includes serving as chief economist to the House Science Committee.

Dr. Stone has also worked for the Federal Trade Commission, the Federal Communications Commission, and in the Office of Management and Budget. He has been a senior researcher at the Urban Institute and taught for several years at Swarthmore College. Dr. Stone coauthored the book entitled "Economic Policy in the Reagan Years." He earned his Ph.D. in economics at Yale University.

Dr. Stone, welcome today.
Dr. Taylor, we will begin with you.

STATEMENT OF HON. JOHN B. TAYLOR, Ph.D., GEORGE P. SHULTZ SENIOR FELLOW IN ECONOMICS, THE HOOVER INSTITUTION, AND THE MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

Dr. Taylor. Thank you very much for inviting me to testify. I appreciate the opportunity. I am going to refer to three charts during my opening statement.

Two years ago this month, the recession officially ended and the recovery officially began. However, it has been a very weak recovery by any historical comparison, and that is why the unemployment rate is still over 9 percent. I think if you in particular compare this recovery to the last deep recession we had in 1981 and 1982—and I show that in my first chart—it is quite striking.

Economic growth in the 2 years, seven quarters we have observed so far since the recovery began, has only been 2.8 percent average, and you can see in the bar charts, that is the blue line, quarter by quarter.

In contrast, during the recovery from the 1981–1982 recession, economic growth averaged 7 percent, so more than twice as high during that same corresponding period of time. Those are the red bars.

You can see how much of a difference there is. So this is a weak recovery by any definition.

I think the reasons for this in my view are policy—fiscal policy, monetary policy, and regulatory policy. Since the focus of this hearing is on fiscal policy, I will just mention the $862 billion stimulus package did not stimulate the economy. The increase in spending, Federal spending as a share of GDP from 19.7 percent in 2007 to over 24 percent now, did not stimulate the economy. Things like Cash for Clunkers, if anything, moved spending a few months further.

Instead what these policies did, along with taking our eye off the basic ball of controlling spending, was to raise U.S. debt levels to very high and they will continue to go high in the future. I think these high debt levels raise a great deal of uncertainty. There is even concern of a another crisis, but there are certainly concerns about higher inflation, higher interest rates down the road.

So I think the solution to this slow recovery, this weak recovery, nearly nonexistent recovery, is to what I call restore sound fiscal policy. I think it will bring attention and allow more private sector growth, and that is where the jobs will come from.

My second chart shows the quite striking correlation between private investment in the United States as a share of GDP and the unemployment rate. As you can see, when private investment goes up as a share of GDP, the unemployment rate comes down. Right now we have low levels of investment and high unemployment.

In contrast, if you look at the next chart, the third chart, you see that changes in government purchases, another component of GDP, have no such relationship. If anything, it goes the other way. But

I would say it is not existent, and so you should not be worried, in my view, about a credible plan to reduce government spending.

That brings me to the last part of my opening remarks: How do we restore sound fiscal policy?

I think it is very important to have a strategy to do that, a strategy that is credible and understandable to the American public. I would say it should have four parts:

First, a game changer which demonstrates a different attitude about spending, bringing spending down starting in the 2012 budget. That establishes credibility which is so important for the effectiveness of a program like this.

Number two, outline a path for spending.

Number three, as much as possible, legislate what is required to get that path accomplished. Don't simply rely on promises in the future. That doesn't restore credibility.

Number four, as you referred to, Mr. Chairman, some kind of caps on spending that correspond to the path of spending reductions.

My next chart, basically you mentioned in your opening, just represents what I think this amounts to. It shows you the share of spending by the Federal Government as a share of GDP, and you can see that has gone up so rapidly in the last few years. The first budget the President submitted didn't really deal with that. That is the top line.

The next line slightly below that is the CBO baseline. And the line at the lower part is the House budget resolution which does bring spending down as a share of GDP to levels that are consistent without increasing taxes.

So in my view, it is pretty clear that the credible strategy is the one closer to the bottom. The policy that doesn't deal with the problem is the one at the top. Right now people are looking to negotiate, I believe, something in between. And if we do negotiate something in between, that will be an important step of progress, but really not enough if it doesn't go all of the way.

Thank you very much.

[The prepared statement of Dr. John B. Taylor appears in the Submissions for the Record on page 68.]

Vice Chairman Brady. Thank you, Dr. Taylor.

Dr. Johnson.

STATEMENT OF DR. SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT AND SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, CAMBRIDGE, MA, AND WASHINGTON, DC

Dr. Johnson. Thank you very much.

I would like to make three points, if I may.

First, I fully support the goal of what I expect of everyone in the room, and that is we would like to bring the debt-GDP under control in the United States. The trajectory that we face going forward, if you look out, the IMF forecast horizon of 2016 or look at the CBO's longer-term projections to 2030 or 2050, the numbers in the baselines are not encouraging and we need to have medium-term fiscal consolidation, meaning that debt-to-GDP-level should come under control and be brought down.

The second point directly to the topic of the hearing is whether we could experience at this point in the U.S. cycle what is sometimes called an expansionary fiscal contraction, meaning that if we were to cut spending, for example, immediately, this would stimulate the economy and actually help with growth directly. This is a policy, for example, that the government of the United Kingdom is attempting to pursue at this moment.

Now, expansionary fiscal contractions, from experience around the world, and this has been studied very carefully by the International Monetary Fund recently, such fiscal contractions under some circumstances by expansionary, but I do not think that we currently have those circumstances in the United States for three reasons:

The first is fiscal contractions can help with the private sector economy if they restore confidence, if there is either a high perceived risk of sovereign default or some other concerns weighing on either consumer confidence or or firm's confidence. But I don't see evidence of that right now in the United States. Long-term interest rates remain low.

There certainly are plenty of problems with debt overhang from the credit boom, and those are difficult problems, and I think that is the main reason we are growing slowly in this case, but they are not going to be immediately and directly addressed by cutting spending, unfortunately.

The second thing that can happen, and this is very much I think the likely scenario in the United Kingdom, you can combine a restrictive fiscal policy with a more expansionary monetary policy. I would fully expect if the U.K. economy slips back towards recession, which is a real possibility, although the latest data are inconclusive on this, I would expect that the Bank of England would cut interest rates and otherwise increase its so-called quantitative easing policies.

Now, in the case of the United States, I doubt very much the Federal Reserve would feel it had the space to do that. Short-term interest rates are very low, it has already intervened a great deal through quantitative easing at the long end of the term structure. I also don't think it would be a particularly good idea for the Federal Reserve to continue its innovations in that direction. So monetary policy would not be able to offset fiscal policy.

The third way in which fiscal contractions can sometimes be expansionary is if they contribute to depreciation of the exchange rate. So if the value of the dollar were to fall, that would help our exports and help us compete against imports. Again, I think that may well turn out to be a factor in what we will see in the United Kingdom over the next 1 to 2 years. But in the United States, given the nature of the dollar as reserve currency, given the way that the world economy is developing, and particularly the problems in the euro zone—which are very severe, intending to push holders of reserve assets actually towards dollars, not away from dollars—it is again very unlikely that the dollar would depreciate, whether or not we have contractionary fiscal policy.

So taking all of that together and comparing that with the cross-country evidence, I do not consider us to have circumstances that would allow fiscal contraction, for example, in the form of spending cuts. I do not think that would help stimulate the economy.

The third point I would make, in conclusion, is that we should not lose track of how we got to these problems with debt. As you said, Mr. Chairman, to some extent these are longer-term problems, and I completely agree that we must deal with those issues over an appropriate time horizon. But at the same time, debt-GDP went up very sharply, as shown in Professor Taylor's pictures, for example, because we had a major financial crisis. Big risks were allowed to build up within the financial sector.

And coming from a meeting this morning at the FDIC, its new Systemic Resolution Advisory Committee, which is a public hearing, and I have to say the tenor of that conversation was not particularly encouraging. There are very big risks around the financial sector that pose fiscal risks and threaten if there is another crisis or when there is another crisis, to further push up government debt relative to GDP. I hope we don't lose track of the fiscal damage brought by past and potential future financial crises in our budget discussions today.

Thank you.

[The prepared statement of Dr. Simon Johnson appears in the Submissions for the Record on page 74.]

Vice Chairman Brady. Dr. Johnson, thank you very much.

Dr. Hassett.

STATEMENT OF DR. KEVIN A. HASSETT, SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, WASHINGTON, DC

Dr. Hassett. Thank you, Vice Chairman Brady.

Over the past several decades, many developed countries have undertaken fiscal adjustments in an attempt to reduce high debt levels. These countries' restructurings had varying degrees of success and failure, both in reducing debt and in stimulating growth. The economics literature is focused on answering two main questions in this area: What aspects of fiscal consolidations produce lasting reductions in debt; and what aspects encourage macroeconomic expansion?

The answer to the first question is clear. Based on a review of the economics literature and an analysis of 21 OECD countries, two of my colleagues and I recently found that cutting expenditures is more likely to produce a lasting reduction in debt than increasing revenues. It is also typical that the more aggressively a country cuts expenditures, the more likely it is to successfully reduce debt in the long term.

Averaging across a range of methodologies, the typical unsuccessful fiscal consolidation consisted of 53 percent tax increases and 47 percent spending cuts. The typical successful consolidation consisted of 85 percent spending cuts. In particular, cuts to social transfers and the government wage bill are more likely to reduce debt and deficits than cuts to other expenditures.

There is more debate over the second question: What aspects of fiscal consolidation encourage macroeconomic expansion? The essence of the debate hinges on the balance between two economic effects of fiscal consolidation, the expectational effect and the Keynesian effect. The expectational effect is the positive effect on consumption and investment that occurs when policy is put on a sustainable path. These likely surge after a consolidation because of expectations of lower future tax liabilities. In other words, an immediate consolidation will alleviate the hoarding that accompanies fears of a larger and largely tax-driven consolidation in the future.

Expenditure-based consolidations would provide stronger expectational effects because there is a better chance they are successful at reducing debt and because higher near-term taxes are hardly designed to ignite optimism in investors and consumers. The Keynesian effect reduces aggregate demand, and, therefore, GDP growth when government spending declines.

The controversy is over whether the expectational effects of fiscal consolidation can completely outweigh the Keynesian effects in order to create short-term growth. There is less controversy around the view that the long-term benefits of fiscal consolidation are substantial.

Two schools of thought have emerged in the debate. Harvard economist Alberto Alesina and his various coauthors argue that consolidation, especially expenditure cuts, can lead to a burst of growth starting immediately. A team of IMF economists, however, identified possible methodological flaws in Alesina's studies and claim that the typical fiscal consolidation would be contractionary.

It is beyond the scope of this testimony to resolve the dispute between the two corners of the literature. A fiscal consolidation optimist would believe that the Alesina work is correct, and then would expect a large fiscal consolidation would lead to near-term growth. But a pessimist would point to the alternative work at the IMF and argue that the growth effects are more uncertain. But it is important to note that, even in this case, the IMF study points to positive growth effects if the fiscal consolidation is correctly designed. That is, both sides of the literature find that reducing expenditures will provide a better growth outcome than increasing revenues.

Although the IMF finds that a tax-based consolidation would reduce GDP by around 1.6 percentage points 3 years following implementation, they find that the negative effects of a spending-based consolidation would be small and statistically insignificant. That is, even in the most pessimistic corner of the fiscal consolidation literature, there is little to dissuade us from pursuing a consolidation today.

Moreover, they find that spending-based consolidations that are focused primarily on transfer cuts could produce positive near-term growth effects, although we should add that those are statistically insignificant.

The latter point is especially interesting. Since the authors studied near-term cuts and entitlements, one might expect that these would have a relatively large short-run negative effect on consumption behavior. The fact that expectational effects dominate, even when entitlements are cut immediately, suggests that out-of-control entitlement spending has a profoundly negative impact on forward-looking sentiment and business and consumer confidence.

This result also suggests a policy opportunity. Given the massive imbalances that exist today, it is likely that consumers have very little faith that current programs will remain in place throughout the course of their lifetimes. Accordingly, cuts to entitlements that phase in gradually over time will likely have little impact on their perceived lifetime wealth as the benefit cuts are effectively already factored into consumers' expectations. If consumers don't expect promised benefits to be paid, government can reduce promised benefits without causing today's consumption to go down, which means, of course, that the expectational effects of a fiscal consolidation could easily be expected to dominate and produce significant near-term growth if there are few immediate cuts to benefits but significant longer-term cuts. If, in addition, the fiscal consolidation were paired with a tax reform that broadened the tax base and reduced marginal tax rates, then a significant growth spurt would be the natural expectation to draw from the economic literature.

Thank you.

[The prepared statement of Dr. Kevin A. Hassett appears in the Submissions for the Record on page 80.]

Vice Chairman Brady. Dr. Hassett, thank you.

We have been joined by Chairman Casey today. With his permission, we will finish Dr. Stone's testimony, and then he will be recognized for his full opening statement.

Dr. Stone.

STATEMENT OF DR. CHAD STONE, CHIEF ECONOMIST, CENTER FOR BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Dr. Stone. Thank you. Chairman Casey, Vice Chairman Brady, and other members of the committee, thank you for inviting me to testify before a committee where I have a strong personal connection, as my biography showed. I have a longer written testimony for the record which I will summarize here.

U.S. policymakers must make smart choices about taxes, spending, and deficits to craft the right set of policies to help the economy emerge from its current deep slump and achieve sustainable economic growth with high employment and broadly shared prosperity.

Making smart choices requires differentiating between: one, the longer-term policies needed to produce sustainable growth at high levels of employment; and, two, the short-term policies needed to restore high levels of employment in the wake of a deep recession. In particular, policies aimed at reducing the budget deficit are a key ingredient of longer-term policy but are likely to be counterproductive in the short run if implemented too precipitously.

This is the mainstream economic position as enunciated, for example, by Federal Reserve Chairman Ben Bernanke. In the quote in my statement, he observes that fiscal sustainability is a long-run concept, and achieving it requires a credible, practical, and enforceable long-run plan.

In current circumstances, he says, an advantage of taking a longer-term perspective is that policymakers can avoid a sudden fiscal contraction that might put the still-fragile recovery at risk. At the same time, there are advantages to acting now to put in place a credible plan for reducing future deficits. The Congressional Budget Office has made similar points, and we at the Center on Budget and Policy Priorities believe this is the right framework for thinking about deficit reduction and economic growth.

I recognize that one of the purposes of this hearing is to highlight a different point of view from what I regard as this mainstream economic consensus, but for the reasons that I will lay out, I think that some of the arguments that are produced to support that alternative view are unpersuasive.

The premise is that we are suffering from an unwarranted explosion of government spending that has produced an immediate debt crisis; that immediate sharp reductions in government spending are necessary and could even make the economy grow faster in the short term; and that deficit reduction is more likely to be successful if it is composed largely of spending cuts. I have questions about all three of those premises.

First, policies enacted since the 2008 election are not the main drivers of deficits and debt. The U.S. fiscal imbalance problem is a long-term problem that has little to do with the short-term imbalances that have emerged as a result of the financial crisis and the great recession. The main driver over the long term is unsustainable growth in health care costs throughout the U.S. health care system in the public and private sectors alike.

As the charts in my testimony show, increases in the deficit due to policies enacted over the past few years are temporary, and only their relatively modest associated interest costs add to the longer-term deficits. The reason government spending remains higher over the next decade than it was before the crisis is primarily long-standing trends in health costs and large interest costs on debt associated with deficit-financed tax cuts from an earlier era, deficit-financed wars, and deficits arising as a result of the economic downturn itself.

CBO estimates that discretionary spending as a share of GDP in the President's budget would be 2.1 percentage points lower in 2021 than it was in 2008 and that net interest costs, for the reasons I talked about largely, would be 2.1 percentage points higher.

Second, large intermediate cuts in government spending will hurt the still-fragile economic recovery. We have heard some discussion about the international evidence, and both the IMF and recently the Congressional Research Service in a new report have looked at this evidence, and we at the Center on Budget have also looked at it, and were surprised to see the extent to which, when you look into the data, the examples tend not to conform to conditions that we have in the United States.

The best circumstances for reducing deficits are if you are experiencing a debt crisis and interest rates are high, monetary policy has the ability to react, and as Simon Johnson said, if the exchange rate can react. That is not the situation in the United States. And I should say most importantly, when you have the degree of economic slack that the United States has, deficit reduction efforts that are short and sharp are unlikely to be successful.

Third, on the question of the composition of deficit reduction, international evidence has little to say about how much of U.S. deficit reduction should be spending cuts and how much should be revenue increases, because it is focused on the short term. It does not deal with the kind of long-term deficit reduction that we need.

It also does not come to grips with the fact that the United States is unique in the extent to which it relies on the Tax Code to do what other countries do directly through government spending. I'm referring to the trillion dollars a year of so-called tax expenditures, which are a prime place to go to find worthwhile budget savings, but it is not clear whether they should be regarded as spending or as revenues.

And, finally, it ignores lessons from the successful longer-term deficit reduction efforts such as the United States pursued in the 1990s when revenue measures were a significant component of the 1990 budget agreement and the Deficit Reduction Act of 1993, which were followed by the longest economic expansion in our history and a balanced budget by the end of the decade. Thank you.

[The prepared statement of Dr. Chad Stone appears in the Submissions for the Record on page 87.]

Vice Chairman Brady. Thank you, Dr. Stone.

Chairman Casey, thank you for joining us. You are recognized for your full opening statement.

OPENING STATEMENT OF HON. ROBERT P. CASEY, JR., CHAIRMAN, A U.S. SENATOR FROM PENNSYLVANIA

Chairman Casey. I have to apologize first for being late, but I appreciate the testimony of our witnesses, Dr. Taylor, Dr. Johnson, Dr. Hassett, and Dr. Stone. I know there are others who will be asking questions and maybe making statements. I will be brief.

I wanted, first of all, to make the following assertion. I don't think there is any disagreement on this committee, and actually throughout most of the country, about the need to reduce the deficit and have a strategy to do that. I think it is shared in a bipartisan manner, and we are all of one mind to do that.

The questions that we are trying to resolve here are the timing of that and what policies yield the best results. On these questions, I think there is honest disagreement, but also significant disagreement. We are having a robust debate about it, as we speak, and throughout the next couple of weeks and months. Today's hearing is part of that debate. It is important that we have this debate at this time.

We have a lot of able economists across the country and several here today who offer their perspective. I want to provide a little bit of context in terms of some of the assertions that have been made today and will be made today.

One assertion is that government borrowing is interfering with private investment. That is one assertion.

The second is that deficit reduction can promote economic growth in the short run.

And third, that deficit reduction is best achieved through spending cuts rather than revenue increases.

I think a number of us would have significant disagreement with one or more of those, or at least with part of those assertions. But

I think, at the same time, we can all come together and agree that we have to have more spending cuts and deficit reduction, but we also have to be mostly concerned, I believe, about job creation.

My main concern with any strategy that might be discussed today or that we would enact into law is that we don't take a step that would derail the recovery in what we do in the next couple of weeks and months. If we do that, if we take steps that will derail the recovery, it will worsen the long-term budget outlook, and it will reduce revenues and increase government spending on automatic stabilizers like unemployment insurance.

The U.S. economy is recovering, and we have recorded now seven consecutive quarters of growth, but the rate of growth that we have achieved so far has been modest. In the first quarter of 2011, GDP grew at less than 2 percent annual rate. The reality is that there are still major economic challenges in front of us. Fourteen million Americans are unemployed. Housing prices continue to decline. Consumers have been hit hard by rising gas prices, and businesses are waiting for demand to return before expanding their operations and hiring more workers. Small businesses, of course, are struggling as well, and the biggest challenge we face, I believe, is job creation, or at a minimum, increasing the pace at which jobs are created. So getting people back to work has to be our number-one priority.

We cut this year's budget substantially by tens of billions of dollars, but there is more to do. There is waste and inefficiency that we must cut. Rooting out that waste and inefficiency is a prime way to reduce Federal spending in the short run.

I was the Auditor General of Pennsylvania for 8 years and State Treasurer for 2. And in that decade, I spent a lot of those days, and my team did, locating and eliminating waste and fraud, so I know something about it. But I also believe making deep, indiscriminate cuts immediately—immediately—to proven strategies that we know will help our economy grow and create jobs could, in the end, be self-defeating. So I think that the question of timing is critically important.

Let me wrap up just with a reference to someone who has spent a lot of time analyzing these problems for many years, chairman of the Federal Reserve, Ben Bernanke. He said recently, "If the Nation is to have a healthy economic future, policymakers urgently need to put the Federal Government's finances on a sustainable trajectory. But, on the other hand, a sharp fiscal consolidation focused on the very near term could be self-defeating if it were to undercut the still fragile recovery." He goes on from there.

Chairman Bernanke has laid out the challenge that we must confront. We must have a credible plan to put our fiscal house in order, for sure, reducing the deficit in the medium and long term. A strong economy is critical to sustainable deficit reduction. We cannot reduce the deficit if we are not growing and creating jobs, and getting people back to work is the key to that.

I am grateful for the opportunity today to be part of this hearing. I am grateful to Chairman Brady for getting us here.

Vice Chairman Brady. Chairman, thank you very much.

I appreciate the testimony of all four witnesses today.

I recently held a round of town hall meetings with job creators, small- and medium-sized businesses, and asked for their input on how we jump-start this economy. And I dutifully set aside my debt crisis PowerPoint to focus on job creation, going through a list of ideas that had come from Washington, DC. They said, "Put away that PowerPoint, go back to the debt crisis," one, because in their view until we tackle the debt and deficits, they were not going to make the decisions to create jobs, at least in our 11 counties in Texas.

So I want to ask Dr. Taylor and Dr. Hassett—Dr. Taylor, a separate question. You talked about a game changer to restore credibility in our financial order. But we are oftentimes told that we can't do that; that introducing a fiscal consolidation program would mimic that of the Great Depression where spending reductions, they claim, created the recession of 1937 and 1938, and they use that analogy to apply to today.

What is your assessment of that analogy; and is it important for us to engage in a serious fiscal consolidation program now in order to spur the economy?

Dr. Taylor. I think it is essential to engage in a consolidation program now, and it will spur the economy. Again, since this recovery began, and it is, quite frankly, hardly a recovery, growth has been only 2.8 percent. So the low growth now, it is consistent with this pattern from the last 2 years since the recovery began.

As I said before, if you compare that with the last time we had a big recession, the growth is less than half as much. It was 7 percent at that point. When I look at it, I think that negative difference, that low growth we have now, is because of all of this fiscal activism. If you look carefully at the data, that increased spending that we have had—and it is huge over the last 2, 3 years—has not really stimulated—this is the weakest recovery we have had by comparison. So there is no evidence that it has.

So I think if you start undoing that, and after all, what is so draconian about bringing spending back to where it was in 2007? Why should that be so hard as a share of GDP? So when we use the words "draconian" or "deep," think about, for example, the 2011 budget—which you agreed to recently—that did reduce spending in terms of budget authority from what was originally asked for, but the outlays are only down by less than a billion. Less than $1 billion in 2011 compared to 2010.

So the focus should be on how do you get a game changer, get enough spending down so it is credible. The problem isn't trying to find ways to spend more, the problem is trying to find ways to spend less. So the more that you can go in that direction, the more you will demonstrate to the country that we can get our house in order and that will definitely be beneficial to people who are worried about the debt, who are worried by inflation and are worried about higher interest rates down the road.

So I think I would emphasize so much just taking the efforts now to get started, because if you don't, if it is just promises for the future, promises for the next 10 years, it will not be viewed as credible and it won't work.

Vice Chairman Brady. Thank you, Dr. Taylor.

Dr. Hassett, in your study, what types of cuts do governments undertake that bolster the economy in the short term, that restore confidence for those making private business investment, and also for consumers? What worked?

Dr. Hassett. The two biggest components of successful consolidations were entitlement reductions and reductions in the government payroll. I think that both of those show a kind of credible commitment to getting the fiscal house in order.

You both know, Mr. Vice Chairman and Mr. Chairman, how difficult such moves would be politically and would require broad bipartisan consensus. And to show that we can accomplish that would really create kind of a celebration in financial markets because people would think, oh, finally, the U.S. has solved this big problem.

I would point, Mr. Vice Chairman, also to the beginning of my testimony, and highlight the urgency of action. I think in a traditional recession that lasts 11 months or so, and then has a recovery, pre-1990s, that grows 5 or 6 or 7 percent in the year that we get out, that we launch out of the recession, then if you have a really well-timed Keynesian stimulus, that you might take a percent or 2 out of growth out of the recovery year and move it into the recession year, and if you are growing 5, 6, 7 percent, then that kind of a trade could be something that everyone on this committee would want to consider.

The difference this time is that we know from the work of Carmen Reinhart and Ken Rogoff and also Vincent Reinhart that the recovery from a financial crisis is a long slog. It lasts maybe a decade. So if we take a Keynesian approach, what is going to happen is the hangover from the Keynesian spending is going to be present in the slow-growth period, and maybe even—even if you are a Keynesian optimist about the effects of government on growth—pushes down toward a recession. And then we might have to have that argument that we need another stimulus because we don't want to have a recession this time.

I would urge members to consider leaving the Keynesian roller coaster and thinking about policies that can put us on a sustainable growth path without a hangover.

Vice Chairman Brady. Thank you.

Chairman Casey.

Chairman Casey. Dr. Stone, I wanted to ask you a question that relates to part of this debate. As you can tell from my statement, I want us to focus more on job creation.

Tell me what your sense is in terms of what is the optimal, or even if you have by way of a list, the optimal way to create jobs in the near term, meaning the next year or two, in terms of either a strategy that the Federal Government employs or just by way of tax policy?

We had, as you know, a tax bill at the end of last year, elements of which both parties really disliked and other elements which they embraced. But both sides were willing to look past their disagreement or their objection to parts of the bill in order to keep tax rates where they were and to add features like a payroll tax cut which put a thousand bucks in the pocket of the average American family. But when you think about either government action or a strategy that has been tried, or maybe has not been tried, in addition to tax policy, what do you think the best approach is to job creation and how would you itemize those, if you can?

Dr. Stone. Let me begin by endorsing the idea that, on the budget, a game changer would be really good; and my vision of a game changer is bipartisan, a bipartisan agreement that recognizes the reality that tax measures, starting with going after the tax expenditures perhaps, and spending cuts need to be part of a sustainable, believable, credible budget effort.

So there is no disagreement on the panel about the importance of putting in place a plan to get our fiscal house in order and that that matters. And it needs to be credible.

The issue is if you do it too fast, does that harm the recovery.

My first answer to your question is the Hippocratic oath: First, do no harm. Don't try to do too much too fast on the deficit reduction effort while the economy is still struggling to recover. That doesn't mean that you can't put a plan in place that is serious and begins to take effect a couple of years down the road.

The most recent economic news has been pretty disappointing; and, therefore, I think we should be considering whether we want to allow the payroll tax holiday to continue. And also, the unemployment rate is still extremely high, and unemployment insurance is one of the most effective measures of injecting demand into an economy that is suffering from inadequate demand. And yet the unemployment insurance benefits are scheduled to expire at the end of the year.

So I think those are two things that are already in place; probably it is worthwhile extending them into next year.

This is particularly true because the Fed is—it is not out of ammunition, but the ammunition that it would have to use to provide further demand stimulus to the economy would be very unusual measures that we don't have a lot of experience with.

So I think don't cut too fast, put a credible deficit reduction plan in place, and consider extending the payroll tax and the unemployment insurance.

Chairman Casey. Just very quickly, and I don't know if others have an opinion on this, but we had at least three really good private sector job growth months in a row, above 200; one was 230, 222, and a third that was maybe higher than that. But 225 or above for 3 straight months. And May came along, and every number is off. The net, the overall job growth, the private sector number was a lot lower. Anyone have a sense of why that happened in that particular month, A; and, B, do you think it will prevail or do you think we can get back in June, July and August where we were in January to April?

Dr. Johnson. I think the important point that Dr. Hassett made is that this is a fairly standard recovery from a serious financial crisis. That is why it is so different, the employment pattern is so shockingly different than what we have seen in all postwar recessions in the United States, including the one in the 1980s that Dr. Taylor was emphasizing. This is what happens when you take on a massive amount of debt, particularly in the housing sector, you will have some sort of stop-start on the job side. And, personally, I don't think that you should be throwing more Keynesian roller-coaster type stimulus at it. I don't think that works.

But I would emphasize that most of the increase in the debt-to-GDP that we have experienced in the short term is due to the automatic stabilizers. You have to let the automatic stabilizers work. Our automatic stabilizers, by the way, are relatively weak compared to almost every other industrialized country. That is a main reason why it made sense to supplement them at the beginning or the deepest part of the recession. But that is done now. That is history.

I agree completely with Dr. Stone; you don't want to derail the recovery now by overreacting. Sure, we want debt-to-GDP to come down, but it will come down as the economy recovers. If you try and cut spending too much, too soon, that will have counter-productive effects. Unless you think ownership policy can respond with a massive expansion, but I haven't heard anybody on the panel yet make a convincing case for that. And I don't think Mr. Bernanke also would be inclined to make that case.

Dr. Hassett. I just wanted to add that we did a recent calculation comparing the U.S. recovery in this financial crisis to the past financial crises that were studied by Carmen Reinhart and Ken Rogoff, and asked ourselves, if we have the typical experience of a country after a financial crisis, what will the unemployment rate in the U.S. be in 2018? And the answer is about 8 percent.

So we are in a base case that it is a really tough slog and a real painful challenge for America's workers. And if we don't get serious about doing something that is not going to jack up growth for one year, but really fix the problem—and I think that we need both a fiscal consolidation and a fundamental tax reform—then we are looking at a base case that is really terrible. And I think that is probably something that we all agree with on the panel.

Chairman Casey. Thank you.

Vice Chairman Brady. Senator Lee.

Senator Lee. Thanks to all of you for coming. I wanted to start with Dr. Taylor.

What do you think would be the impact of a tax rate increase on our economy at a time like this one?

Dr. Taylor. I think it would be very harmful to have a tax rate increase. In fact, I think Senator Casey asked about explanations for the sort of little pick-up in job creation. It occurred around the time of December when the deal was made to postpone the tax increases. I think that was quite significant. I wish it was permanently postponed. But there were tax increases on the books, and they had been postponed. I think that is positive. It gives you some sense of what you can get from agreeing not to increase tax rates. I think it would be very harmful to the economy.

Senator Lee. What if we limited the tax increases to the wealthy? Couldn't we forestall the problem by doing that?

Dr. Taylor. It is a very important step. Tax reform is also important, and I am glad to hear there is more interest in that on Capitol Hill at this point. But to me, the first step is don't increase taxes. Leave those tax rates alone.

Senator Lee. Even in the higher income brackets?

Dr. Taylor. Across the board. There is no reason to increase those tax rates. There is this phrase that people sometimes use, "It is a spending problem, not a tax problem." That is the truth, actually. If you look at the numbers carefully, it is hard to convey that to people without looking at the numbers; but when you look at the numbers, that is really what it is. And you don't want to risk the disincentives. There are enough disincentives now for firms to invest, with the regulations and the fear of the debt problems, and, for that matter, I think monetary policy. There are lots of reasons that investment is not as strong as it should be or could be. Of course, housing is part of that. Unless we get investment moving, unless firms start investing and expanding, unemployment is going to stay high. So I think that would drive that private investment, whether it is equipment, structures, and you will see jobs being created.

Senator Lee. And that investment, you would argue, is less likely to occur when those would-be investors have the promise, the assurance, that they will be able to keep less of that money?

Dr. Taylor. Right. You tax something more, you are going to get less of it. These days there is a fear of increasing taxes quite a bit because of the budget. I think if that could be clarified, that is part of the idea of being credible, predictable, is to recognize that the best way to do this is by not trying to raise tax rates. Quite frankly, I don't see there is much interest in doing that in the country anyway.

Senator Lee. Would it be fair to conclude that a supposed tax rate that affects only the rich is in fact a misnomer because it would end up impacting perhaps most acutely, most severely, those most-vulnerable people, those people who most desperately need jobs would be less likely to find them as a result of diminution of investment leading to less employment?

Dr. Taylor. Yes. If you reduce the incentives for firms to invest and expand, you are going to reduce the incentives for them to create the jobs, and that is where the jobs come from. The jobs are not coming from more government purchases, or even less government purchases. That will detract from the jobs. It is that private sector investment. That is what the data show. And to the extent you can encourage that by not raising the tax rates on those firms, there are a lot of small business firms, larger small business firms, to be sure, it is going to be counterproductive and we will have this high unemployment rate—which is a tragedy—for quite awhile.

Senator Lee. We hear a lot about the debt limit and about how the failure to raise the debt limit could result in this or that economic catastrophe. Is there not also an economic catastrophe that could and would await us if we were to raise the debt limit reflexibly, as it has been raised many times in the past, without any significant strings attached, without attaching it to significant, binding spending caps?

Dr. Taylor. I think tying the spending reductions to the debt limit increase is very important. I wrote in the Wall Street Journal about that a couple weeks ago. I think the position that has been taken there has been very productive. It has actually driven, I think, the talks in a good direction. So a clean, so-called clean debt limit increase, without spending, would damage credibility, especially at this point because we have had such a surge in spending. So I have argued strongly for tying these together. And I can see why they would just like to have a clean debt limit increase, but I think especially at this point in time it would be a mistake. Moreover, I think from what I hear about these budget negotiations we stand a good chance of tying those together, as the Speaker originally suggested.

Senator Lee. Thank you.

Vice Chairman Brady. Thank you, Senator. Congresswoman Sanchez is recognized.

Representative Sanchez. Thank you, Mr. Chairman. And thank you, gentlemen, for being before us. Oh, gosh. I always am amazed at the difference of opinions that we get to whomever we speak about the economy. And I am always amazed also when I am at events and people come up and think they know all about the economy and try to tell us what we should be doing. But what I have learned in the 15 years I have been here and in my studies when I graduated with an economics degree, and as an MBA, as a former investment banker, sometimes you just don't know.

You know, I would like to say something about the stimulus, because I think that it has been maligned a lot here, the stimulus package or the Recovery Act. Yes, it was $800 billion, but remember that a third of that was tax cuts, it was not spending, it was tax cuts. So you can't have it both ways. You can't say that the renewal of the tax—of the Bush taxes in December were not spending. You just can't say that. You just can't say—you can't count spending, a third of the spending package that were taxes as spending and not count the Bush continuation of tax cuts as not spending either. You can't have it both ways. So we either count it one way or we count it the other.

We were told in December that if we passed that package of tax cuts it would give stability and businesses would start using their $1.4 trillion that they sit on on their balance sheet. And you know what, they haven't. It has been a jobless recovery. So we hear all of these issues about keep the taxes low, don't collect, but the fact of the matter is that Bush's own Comptroller has stated that 70 percent of the debt and the majority of this debt was accumulated under George Bush, that 70 percent of that was due to the tax cuts over and over and over during that time. And we had a couple of other things, a couple wars I didn't vote for, a couple wars I think we should be out of, a couple of wars that we keep spending money on more and more to the point where it is taking away from investing in the future of our military because it is operational, and halfway around the world, and it is not money going in our pockets, it is money outside of our economy.

So, you know, I am hearing all sorts of information out there, but in the bottom line I think we need a little of both. We need to talk about some real spending reforms, and I think defense has to be on it. From the looks of the House bill passed on defense recently that was increased significantly. Everything else took a cut, but defense increased significantly. And by the way, it is not going to our people working back at home or our defense contractors trying to build systems. They are in fact being cannibalized and they are not being paid. And they are stopping their production lines, which is going to cost us more on the long run to retool and reset our military.

So I want to ask each of you, do you really think that it doesn't take a little of both, some spending cut, maybe in a moderate way, but with a firm commitment, and some increase in taxes to start to get this back? And maybe we will start with Dr. Stone and go down the list.

Dr. Stone. I did say that I think we do need a balance that has both. I think that is one of the things that is problematic about debating over the debt limit, which really has nothing to do with controlling deficits; it may be a way to get people talking, but when people are talking they have to be talking about something that can really happen, and that would require a balance of the two.

When you ask businesses what is the problem, they don't say—they always say it is taxes, but that stayed constant. What has really gone up is they say sales. And so to give businesses incentives to add to their capacity when they don't have customers in the stores is problematic. I think they need the customers in the stores first.

Dr. Hassett. Yes, Congresswoman, thank you. I in my testimony, I say that it should be both. I recommend modeling it after the typical successful consolidation which had a balance of both.

Representative Sanchez. Thank you, Doctor.

Dr. Johnson. I completely agree with you, Congresswoman, that military spending needs to be capped over the long run, but particularly health care spending as a percentage of GDP, if you look out to 2030 or 2050, that is a major problem. I would actually go further than Dr. Taylor just now. If you have the possibility of putting in place a credible limit on future health care spending as a percentage of GDP, by all means tie that to the debt cap discussion or implement it in some other way. That would have a major effect on fiscal credibility. That is mostly about spending, but I would emphasize it is not just government spending, not just Federal Government spending, you have to look at general government spending and you have to look also at private sector spending.

When I talk to entrepreneurs, which I do a great deal in my various jobs, they are worried about health care costs that they will face in 5 years, 10 years, and 20 years. That is a major burden that we have not yet seriously addressed. So I would put that front and center of the long-term fiscal consolidation needs.

Representative Sanchez. Thank you, Doctor.

Dr. Taylor. May I use a couple of my charts to answer this question? I guess not. Okay.

One of my charts shows that if we brought spending back—the next to last one, I believe. This is Federal spending as a share of GDP, going back a few years, and you can see how it grew a lot in 2008, 2009, 2010. It was 19.7 percent of GDP in 2007. And the House budget resolution, which is the line that brings us down, brings it back to about the same level, 19.7 percent of GDP. So that is roughly what you need, maybe a little bit less, depending on what we think is happening with taxes for budget balance, because the deficit was like 1 percent of GDP in 2007 or so. So that is why I think it is a spending problem, that is why I say it is that way.

If you look at the next slide, the next slide, that first slide divided everything by GDP because I think that is how economists like to think about it. But in fact we are not talking about cutting things. This is the total spending without just what it is. And you can see where it has been, and you could see where it would go with the President's first budget, and you could see where it goes with the House budget resolution. And they all increase, I mean these are all increases. I think you have to put that in perspective as well.

And then finally your question about the tax part of ARRA and the tax part of the 2008 stimulus is a very important question. When I look at the impact of the tax rebates or the one time payments, they seem to do very little good in terms of stimulating consumption. Both in 2008, February 2008, the Economic Stimulus Act, and 2009, the ARRA, the tax components of those were mainly just to send money to people, tax credits from previous earnings and mostly was spent. It did not jump start the economy. You can see that in the data.

When we talk about tax rates increasing, that is a different story. That is what is going to happen if you create a job or if you expand your business. The money you are going to get from doing that or the benefits from that. That is not a rebate from the past, which just tends to get wasted unfortunately in terms of stimulating the economy. But what is so important are these tax rates, and that is why in answer to Senator Lee's question I said raising tax rates would be a terrible mistake at this point in time.

Thank you.

Representative Sanchez. Thank you, gentlemen.

Vice Chairman Brady. Thank you. Mr. Mulvaney is recognized.

Representative Mulvaney. Thank you, Mr. Chairman. I will continue on what the Congresswoman was talking about and see if we can't find some similarities of opinion in what we are talking about today. I would like to start with taxes, following up with what the Senator said as well. If they would bring up slide number 1, please, which is the Federal income tax revenue and top income tax rate. This is a graph that shows two different things, which essentially, once they get it up, what you will see is a red line that shows the Federal revenue as a percent of GDP and a blue line that shows the top tax rate.

And as you can see, I think several of you may be familiar with this graph. Over the course of the last 60 odd years the Federal Government generally has taken out between 15 and 20 percent of GDP and tax revenues. I think the average over the course of the last years 50 years is roughly 18½ percent, but that during that period of time where the government's share of the economy was relatively stable, tax rates were all over the map. This is the top marginal tax rate.

What I heard just a moment ago from this panel as we went down and talked about the importance of having a mix between spending reduction and tax increases I did not hear anybody clamoring for dramatic increases in the income tax. What I heard Dr. Stone actually mentioning was tax expenditures. Dr. Hassett, I have read some of your work. I think you have done some work on other fiscal consolidations that focus on tax increases on consumption as opposed to productivity.

So I guess what I am looking for, gentlemen, is some consensus here that as we look our hand over and as we look at different options that are available to us, is it fair to say that increasing the top marginal tax rates is probably the least desirable way to go forward? And I will start with Dr. Stone.

Dr. Stone. I mentioned tax expenditures because that is something we ought to be able to agree on. Dr. Taylor is talking about how government spending has moved to a new higher level. I think that if we are realistic about the demographics in this country, about rising health care costs, and the increased interest that we are now paying because of the debt incurred as a result of the recession, we are not going to be go back to historic levels of spending as a share of GDP without more revenues. And the President's proposals would move us back to—would include some increases in tax rates in the income tax, that will move us back to the levels that we had in the 1990s when we really did not have—when we had our longest economic expansion and a balanced budget. So it is not prohibitive. Very high marginal tax rates are discouraging, but modest increases in tax rates I don't think we need to be so afraid of.

Representative Mulvaney. Thank you, Dr. Stone. I have heard this before, so I don't mean to interrupt and I will give everybody a chance, but I look at the rates during the late 1990s when they were increased, and while they did represent a slight, they did lead to a slight increase in the government's share of GDP, it was not marked at all. In fact, you could argue that it was actually the GDP growth that was experienced during that time that boosted the government's share of revenues. It wasn't the tax increases that actually boosted the revenues, it was the larger share of the overall economy.

Dr. Stone. I don't disagree that the strong economy helped and, importantly, those tax rates did not interfere with that very strong economy.

Representative Mulvaney. Thank you. Dr. Hassett.

Dr. Hassett. I agree with Mr. Mulvaney. I would add it is especially urgent, as Mr. Camp who is often in this room knows, to address the fact that we are about to have the highest corporate tax on earth. And if you are wondering why it is that it has been a long time since any of us has driven down the road and seen a new plant building growing there on the side of the road, it is because they are being located offshore to take advantage of much lower tax rates. And so I think that as we think about the fiscal consolidation then one of the urgent design problems will be finding the space to get to U.S. to at least the middle of the OECD in terms of corporate rates if we expect growth to renew here.

Representative Mulvaney. Dr. Johnson.

Dr. Johnson. I completely agree with the need for tax reform. I don't know the details of Dr. Hassett's proposal. We may differ on that. But I think shifting away from taxing and towards taxing consumption and doing that in a way that protect relatively poor people, which certainly can be done, and it is done in other industrialized countries, that is a good idea.

However, with regard to what you do about marginal tax rates within the existing code, just two points. First of all, I don't think anybody paid the very high rates that we had in the 1960s. There were many exemptions, as you know, many ways to manage your tax liabilities there. And I don't think anyone is proposing to go back to those levels. However, I for one did argue against extending the Bush tax cuts in December. In terms of the feasible ways, credible measures you can take to bring the budget under control, if you have ways to control health care spending, if you have ways to end foreign wars, I am completely open to that. I think those will be better. But given the feasible choices before us, addressing a little bit of discretionary domestic spending is not going to make a big difference. Addressing or not further extending the Bush tax cuts next time they come up in 2012 would make a first order of difference. And I think now is the time to start considering that.

Representative Mulvaney. Mr. Chairman, I would ask Dr. Taylor be given an opportunity to respond.

Vice Chairman Brady. Dr. Taylor.

Dr. Taylor. Your chart is very important to take into account when people are thinking about raising marginal tax rates, because history showed especially at the top end where people can avoid them or take actions not to pay them it doesn't raise the revenues people think. But I would also add that since spending is an issue here, too, that if you grab spending going way out into the future, along with what taxes would be even with a marginal tax rate increase, spending just dominates. Spending is like this exponential thing that eats you alive. And if you try to raise taxes and deal with this it may take you up just a little. It is hard to notice in a graph. It is hard to notice what it will do. So forget that for a while, you know basically that is not the thing to do in a weak recovery. Put that off to the side. Look for tax reform, broaden the base and reducing marginal rates is always good to try to do, but in the meantime it really seems like it is a spending problem, as people say.

Dr. Johnson. Mostly health care spending in the 2050——

Representative Mulvaney. Thank you.

Vice Chairman Brady. Thank you, Mr. Mulvaney. Let me ask, we hear a theme that spending cuts will endanger this recovery however weak it is. But as economists you are aware of a body of work of fiscal consolidation looking at our competitors around the world who in the last 40 years took on various forms of fiscal consolidation, as many of you mentioned. And in 26 instances they grew their economy in the short term as well. They spent less, controlled their fiscal policy, they owed less as a nation, reduced their debt, mainly through targeted spending cuts and grew the economy in the short term as well. Canada is a great example. You know, hobbling along at less than 1 percent growth, high debt levels. They went on a conscious effort to reduce their spending, lowered their country's debt by around 12 percentage points. Their economy went to a 3½ percent average growth rate that lasted for more than a decade. Sweden did the same. New Zealand had an even more interesting experience along the same way.

So to this theme that if we control spending it will harm this economic recovery, Dr. Taylor, Dr. Hassett, do you believe that to be the case? Do you think Congress is capable of such severe spending cuts that it will endanger this remarkable recovery?

Dr. Taylor. I don't think so based on the 2011 agreement which was good, but budget authority has shifted from plus 39 to minus 39 in the discretionary accounts, but outlays just down by less than a billion. So that is an example I think of why it is so hard.

I would say, quite frankly, I think that the credibility is very important to make sure it does have positive effects. Willy-nilly, unpredictable changes in government policy is not good. It makes for more uncertainty. So everything that you can do to say that what we are doing is part of this long-term path, caps on spending, tying it to debt increases, putting in legislation, everything that can make it a credible, believable deal will make it more powerful in a positive sense and mitigate the negative things that Dr. Stone is referring to. The credibility, to be able to plan for the future, to know that this is what government is doing, at least it is clearer now than it was. They are getting their house in order. That will enable businesses to expand. So I put a great deal of emphasis on credibility. It is going to be gradual almost for sure. That is the nature of the politics. It will be gradual. And I think to some extent the statements that it is going to hurt the economy if we go too fast, if it is too draconian, I don't think that helps the discussion because it puts up this thing which is like a straw man. That is not where we are going. Look at my charts. The charts don't have draconian—even with the most ambitious budget there are not draconian changes we are talking about.

Vice Chairman Brady. Thank you. Dr. Hassett.

Dr. Hassett. Yeah, Mr. Brady, one way I like to think about the potential scale of the near-term effects is that in present value maybe we guesstimate all of the things that we are short. It's something like $100 trillion if we just tried to in present value, you know, let Medicare run the way it is planned and so on. If businesses expect to have to pay their normal share of tax increases to cover that $100 trillion, then we are talking a tax liability in present value that is bigger than $10 trillion—bigger than 10 percent of that, which is closing in on the market cap for U.S. firms. And so the scale of the tax shortfall is humongous, and it is really large relative to the scale of U.S. corporations.

And so maybe they don't think that we are going to cover the whole thing with tax increases, but if they think even that half of it is going to be covered with tax increases then that is a significant liability, implicit liability that is on their books. And if you do something to relieve that, then that is good news today. You could set off an investment boom today.

And so I think the scale of the problem is such that this expectational effect that I talked about could be really large if it was credible, if the spending deal was accompanied by maybe some very clever new Gramm-Rudman style rules that made believe that the spending cuts are there to stay.

Vice Chairman Brady. Thank you, Doctor. I would point out we often talk about people looking to the Clinton years as the golden years of the economy. I would point out that President Clinton, working with the Republican Congress from 1993 to 2000, lowered the spending to GDP ratio from over 21 percent to around 18 percent, and the economy grew as we did it. So shrinking, spending less, owing less can spur this economy very much in the right direction.

Senator Lee.

Dr. Stone. Excuse me. May I?

Vice Chairman Brady. Absolutely.

Dr. Stone. A couple things. You point out what happened in the U.S. in the 1990s, and you mention the Canadian experience. I won't ask that the chart be brought up, but I have a chart in my testimony that talks about the Canadian experience. And two things are notable. One is that Canada is very sensitive to U.S. economic conditions. And Canada rode the expansionary boom of the 1990s that you talked about. Also Canada started with a higher level of spending than we had and came down but not all the way to the level of spending as us. And so I would be careful about Canada as an independent successful experience.

One other thing, you talked about the 26 episodes of expansionary contractions. Expansion was defined in that study by being in the top quarter of the 107 episodes that they studied. When you look at examples that were both expansionary and successful at bringing down the debt to GDP ratio, there are only 9 examples, and three of them are Norway, one is Sweden, one is the Netherlands, Scandinavian economies that looked quite different from ours.

Vice Chairman Brady. I would point out, too, if we could bring up another chart about Canada. This shows Canada's experience, total government spending, where government, as you can tell in a very struggling economy, took on a conscious effort to reduce their debt, including spending caps on each budget area where agencies that were run in effect by members of parliament could not increase spending without commensurate spending cuts elsewhere to keep it under those caps. They lowered their debt and grew the economy in a substantial way. It is as a neighbor, I think a very key example of how countries can consciously control their spending and grow their economy in the short term as well.

Senator Lee.

Senator Lee. Several of you have discussed the importance of credibility in the eyes of the public as we approach the debt limit increase and other decisions that will affect the spending of Congress as we move forward.

Dr. Hassett, a minute ago you referred to Gramm-Rudman, Gramm-Rudman-Hollings legislation. I was a big fan of that. I was in high school when it passed, and I had great optimism for it. I was disappointed when it ceased to do its thing because as we found over time Congress has a certain tendency to be a walking, breathing, living waiver unto itself. One Congress may not bind another Congress. We can't speak now for what successive Congresses will do. PAYGO was a great idea, but PAYGO has been waived so many times that it doesn't really do a whole lot.

But there is one way that we could bind a future Congress, which is by amending the Constitution to cap to a fixed percentage of GDP the level of our spending, to require a balanced budget and to put certain restrictions on what it would take to raise tax rates.

What would you think about that, Dr. Hassett, in terms of its credibility with the marketplace?

Dr. Hassett. I would very much support such a cap, a constitutional amendment. It could be that it is impossible, that it is so hard to change it.

Senator Lee. Nothing is impossible, Dr. Hassett.

Dr. Hassett. But a constitutional amendment with a spending cap, especially if the spending cap were relative to something like potential GDP so that we didn't have a kind of very procyclical effect of the budget rule, then I think it would be very easy to support.

Senator Lee. What potential GDP? Do you want to explain what you mean?

Dr. Hassett. So if we are at full employment then it would be say how much GDP we could make. And if that is the sort of metric that we use to say, well, how big should government be, then we won't have a problem that if suddenly GDP collapses then we are hitting this cap, then we have to really reduce everything government does in the middle of a recession, which would make it hard for automatic stabilizers to work.

Senator Lee. Thank you. Dr. Johnson.

Dr. Johnson. If you had an amendment that said you must hit a number in terms of government spending in terms of actual GDP, and sometimes that might work fine, but you could also have a calamity, financial crisis, or some other kinds of problems. So the GDP falls by 20 percent, this happens in many economies around the world. The U.S. fortunately hasn't had that experience recently. And then if you had to reduce government spending to hit constitutionally the target ratio, well, then you would have to do all kinds of things, including perhaps raise taxes at the worst possible moment, which would be in the economic freefall.

Then of course, once you start to define it around potential GDP, how do you define potential GDP. Who will be the arbiter of this? The cross country experience with very tough and hard budget rules of this kind is that is only as good, as you yourself have said, as the Congress will or the equivalent body because you can always find ways to redefine potential as circumstances change. So it is a little bit more elusive than you might think.

Senator Lee. Sure. And I understand why the task of defining potential GDP would be difficult, and that is one reason why basically all balanced budget amendment proposals, including that sponsored by all 47 Republicans in the Senate, have provisions in them allowing for these restrictions to be circumvented. It just requires a higher vote threshold.

Did have you something to add, Dr. Hassett?

Dr. Hassett. One thing I wanted to add short of a Constitutional amendment is that, as you know, there are a lot of States, almost every State has a balanced budget requirement, and they also often have things like supermajority rules to increase taxes. And mechanically it is often the case that a simplemajority could vote to ignore the supermajority rule, but it almost never happens. And so I think that, if you are thinking about a design short of a constitutional amendment that could accomplish your objective, you might try to think about whether something like a supermajority rule could create a taboo that Senators and Representatives would not want to violate.

Senator Lee. Thank you.

And I have one final question for Dr. Taylor. Interest rates are really low right now. They are substantially below the 40-year average, as I understand it, maybe as much as 350 basis points below the 40-year average. How high do you think interest rates could rise, let's say, in the next, I don't know, 18 to 24 months once quantitative easing, QE2, comes to an end and if other factors change. How much play do you think there is in the sort of intermediate term, meaning 18 to 24 months?

Dr. Taylor. Well, right now this weak recovery that I referred to before is one of the reasons why rates are low, so hopefully we will get the recovery moving with some of these policies and they will go back to normal levels. And a normal level is you could have a real interest rate of 2 percent, and if inflation is 2, then that is sort of 4 percent on the short end. That is kind of a normal level.

I think the fear and the concern is that when we might get behind the curve on dealing with inflation and that inflation would over—you know, go higher, if you like, overshoot any reasonable target. And of course that would drive interest rates up dramatically. That would be very harmful. So we haven't talked about monetary policy, but there is a concern with all this overhang of reserves and money whether the Fed will be able to pull it back out at a sufficient speed without also being disruptive as it pulls it out to prevent inflation from picking up down the road.

We have already had some movements up in inflation. I think they will probably come down a little bit, but the real concern is they are going to go back up again. That would be the main driver of interest rates down the road, and it is a concern to me.

Senator Lee. Thank you very much.

Vice Chairman Brady. Thank you. Congresswoman Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. I just wanted to read into the record because we were talking about—I think it was Dr. Taylor who was saying that is not draconian to go back from what we are today back to the 2007 fiscal numbers, for example. I had stated that in fact I think we have to have some spending cuts, and we have to look at them carefully and that in fact we had not cut spending on defense. In fact, my Republican colleagues continue to increase.

I just want to read into the record that in fiscal year 2007 the total for defense spending was $110 billion as a base and $109 billion because we were in the wars we are in, for a total a $219 billion. In the fiscal year 2012 bill NDAA, that was just approved in the last week or two, the authorized amount is $690 billion. So $690 billion is what they have set it at from the House, with a Republican controlled House; $219 billion are your 2007 numbers. Again I think there are a lot of places to cut, and I think that would be one of those that would show some credibility about how Congress feels about some of the spending.

I would also note for the record that with respect to PAYGO because it was brought up by one of my colleagues, I personally when I first arrived here at the Congress voted for the PAYGO rule almost 14 years ago as a Blue Dog. We were the ones who proposed it. We were the ones who helped to get it through. And I will remind my colleagues that it was actually when the Republicans controlled both the House and the Senate that they let the PAYGO rule expire.

So there can be a lot of talk about what we want to do. We actually had it and it was working, but because of the large spending that happened when the Republicans controlled both houses of the Congress they did not want to abide by PAYGO and they let it expire.

And I would just like to have those comments in the record, Mr. Chairman.

Vice Chairman Brady. Probably no chance I could deny that one.

Mr. Mulvaney.

Representative Mulvaney. Thank you, Mr. Chairman. And gentlemen, the chairman has informed me that I am last, which ordinarily is a bad thing, but it is actually good for me in this circumstance because he says that I can have more than the 5 minutes if need be, and it is a tremendous opportunity for me to sit here and get you all in one room together. I am a big fan of Dr. Hassett and Dr. Taylor's work. I am looking forward to reading more about Dr. Stone and Dr. Johnson's work after today.

So let me come at a couple different topics. We have talked about Canada, something that I have spent a little bit of time looking at.

Dr. Stone, you mentioned something that I hadn't thought about before, which was the fact that may have been along for the ride on the economic boom that we had during the 1990s and that may have contributed to their success. And I had not considered that and will going forward. I would encourage you to consider the fact they also dramatically reduced their automatic stabilizers, that's one of the things they did. The two major reductions they had to their spending was number one their health care, but also to their unemployment benefits, which I thought was interesting. We have heard a lot of talk about leaving the automatic stabilizers in place, but clearly if we do look to what Canada did, it is clear that they actually reduced their automatic stabilizers.

As I go out and I drive around and I talk to employers, I hear oftentimes they are finding difficulty finding people to go to work because of the stabilizers. I have several examples of them going back to folks they had laid off during the downturn, offering them their jobs back, and then being told that they have 8 months worth of benefits left and to please call them in 7½ months.

Do you gentlemen not think that maybe extending these automatic stabilizers—I heard, I think Dr. Johnson mentioned that in his testimony—would have a negative impact on job growth, that there are jobs out there that are going unfilled at this point simply because we are essentially incentivizing unemployment. So, Dr. Johnson, I put that to you to begin with.

Dr. Johnson. No, I don't think we incentivized unemployment in this country. Compared with any other industrialized country, this is a tough place to be unemployed. You get relatively low benefits, you are getting them for a relatively short period of time. And I am sure you are right that there are employers who have trouble finding the precise workers that they want.

In general the employment picture around the country is bleak, and that is actually another very disconcerting parallel or comparison with other postwar recessions. There is always—previously, for example, at the end of the S&L crisis, when Texas was in big trouble other parts of the country were booming and people were able to move to those booming parts of the country. That is not available right now, and we have the problems of house mortgages and people being underwater on their homes, making it even harder to move.

But no, I think overall our automatic stabilizers are weak, and I think with regard to Canada where I was just a couple of weeks ago meeting with finance people, the Department of Finance there, and the Treasury and Central Bank, it is true that there were some reforms. It is also true they had one of the greatest commodity booms of all times in a very commodity intensive economy. And their health care system is still far more generous to far more people than the U.S. And I am sure you were not proposing that we go in the direction of Canadian health care.

Representative Mulvaney. Thank you. Let's talk about jobs for a second, gentlemen, because I think it was Dr. Hassett mentioned why you don't see the plants built anymore as you drive down the road. And certainly I think there is a tax component to that. I also think there is a regulatory component to that. Unfortunately, I live in a textile area and a lot of what we used to do is simply illegal to do now, especially dealing with chemicals and dyes and so forth.

So the regulatory environment certainly I think explains why we are not seeing more job growth. But I had a discussion the other day with folks in the construction business. That is what I used to do. And the analysis that they go through on whether or not to build a new plant I think is insightful. Not only are they looking at the after tax returns, and so forth, there is no question about that, not only are they looking at the regulatory environment, but they are also looking at the net present value of their particular investment, which means that they have to focus relatively sharply on what the discount rate is going to be. And I think it was Dr. Johnson who said that one of the things they are concerned about is the long-term implications of what you are doing. And I think you are seeing that raise its head in the discount rates. We are assuming that inflation is zero, hear what Dr. Taylor says about some incipient inflation. They actually think it is higher than is reported simply because we took food and energy out. But I think businesses look at what we are doing and recognize that there is going to be inflation, that businesses look at us and say, look, they are either going to have to print money in order to get out of this. They are never going to be able to agree on tax cuts or increases, they are never going to be able to agree on spending cuts, and they are going to end up printing money. As a result the discount rates that businesses are looking at are dramatically different than we think from an academic standpoint.

Would you agree with me, gentlemen, that by us continuing to run up these dramatic deficits we are discouraging investment in this country? Is there anybody who disagrees with that statement?

Dr. Johnson. I agree completely, but the CBO forecasters are ambiguous, 2030, 2050 we have massive deficits, much higher debts, GDP much more than any country will get away with, including Japan, is due to uncontrolled health care spending. That is the primary driver of Federal Government, general government, and also the burden on the private sector, on the private business. That is what they are terrified of, with good reason. If you can fix that you will be heroes, whatever side the political spectrum you come from.

Dr. Stone. Can I also say about that, long run health care costs are the game. If you can control them in the economy, the deficit problems are manageable. If you can't, you won't. But the other thing that is driving those horrible long-term pictures, I guess CBO is going to come out with its long-term outlook tomorrow, is there is interest on the debt. So a huge amount of what is going on in the outyears is spending on interest payments. And if you control the deficits now, whether with taxes or with spending, you get rid of an awful lot of the spending problem that is due to interest in the outyears.

Representative Mulvaney. Lastly, at least I am getting ready to finish. If you could bring up, please, Dr. Taylor's figure number 3 and I can't get—I was trained as a Keynesian and I have come to see the light, and I disagree with you gentlemen philosophically, but I can't get two highly qualified Keynesians in a room and not ask them to explain to me where Keynes went on this graph. The top line is the unemployment rate, the bottom line is the Federal Government purchases as a percentage of GDP. And you can see unambiguously that those two lines move together. Government spends less, people go back to work. When the government spends less, people go back to work. There is another graph, by the way, the committee has come up with that shows the correlation between private fixed nonresidential investment and private payroll employment. And those two numbers are perfectly correlated. See if they can bring that up.

So tell me, gentleman, what I am seeing in the real world, and the reason I am no longer a Keynesian is that what I see is when the government spends less, business spends more, and when business spends more, people go back to work, and the exact opposite is true. So tell me why are we still clinging to this concept that the government needs to spend more in order to put people back to work?

Dr. Johnson. Look, you have to ask the question of causation. I am not by any means an unreconstructed Keynesian. As I said, I am not favoring generally fiscal stimulus left, right, and center. I am the former chief economist of the International Monetary Fund. I am a fiscal conservative by any reasonable standard around the world. But what happened in the United States in 2007, 2008, the financial system blew itself up. We had a huge crisis and we can argue for a long time about the consequences, but that is the fact of the matter.

A massive financial crisis at every country which that happens drives up unemployment and causes the economy to contract. And it was Dr. Hassett who told you, completely accurately, that when you have a calamity and GDP falls, you are going to naturally have government spending rise relative to GDP. Actually whether or not you have automatic stabilizers that is probably what is going to happen. And if you have some reasonable automatic stabilizers, that is usually what we have, not super strong and they are not zero, then that is the consequence certainly of the big change that you are seeing here.

Over longer periods every time I think it absolutely makes sense to keep tax burdens down to allow entrepreneurs to make good money, to allow them to get a better return on their investments, to have less uncertainty about the value of future taxes.

Representative Mulvaney. I don't mean to interrupt you, but you may have hit on exactly my point, and the reason I no longer am on maybe your side or Dr. Stone's side of the aisle, which is that we have been doing this forever. We have been in a Keynesian stimulus for the last 25 years. I guess I can agree philosophically what you said that if you get into a short term you could use a Keynesian stimulus in order to prevent the bottom from falling out, but we have been pumping this system full of Keynesian cocaine for the last 25 years.

Dr. Johnson. Well, seeing you brought it up, Congressman, let me be honest. Congress, when it was controlled by the Democrats and by the Republicans, has leaned away from balancing the budget towards big deficits and towards debt. That is absolutely true. Sometimes you have been helped by an administration and sometimes the administration has tried to pull back a little bit, but there is no question that spending has tended to outrun revenues in this country for a long time.

Actually, to be honest, the other point we haven't discussed at all today is how we finance these deficits. Increasingly we finance them by selling bonds to foreigners. So now we run 11 nuclear aircraft carriers around the world. Nobody else has a single one. We finance that by selling bonds to China. How does that make sense? If you want to make it something taboo, I would suggest you make that taboo, financing the U.S. military by selling debt to China because that surely is not going to prove ultimately sustainable.

Representative Mulvaney. Thank you, gentlemen. I could do this all day, but the tapping sound means that I have run out my patience with my chairman. So thank you, gentlemen. It has been a privilege.

Vice Chairman Brady. No, it was a good line of questions. You could have done that all day, but I think we all could have, the truth of the matter is. Yeah, this is a great discussion. We are all looking for a game changer, I think, in this country both for the economy and for spending questions. How do we do it, how do we do it smartly, and what are the best approaches? You all provide us very good ideas and input and insight as we go forward with that. Thank you for the testimony today. Thank you to our members for being here as well. And with that, this hearing is adjourned.

[Whereupon, at 3:43 p.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

VICE CHAIRMAN KEVIN BRADY
JOINT ECONOMIC COMMITTEE
June 21, 2011

Spend Less, Owe Less, Grow the Economy

Chairman Casey and I have agreed to share the task of organizing hearings for the Joint Economic Committee during the 112th Congress. Pursuant to our agreement, I convened this hearing because the once vigorous American economy is languishing.

A recent op-ed by Harvard University Professor Martin Feldstein entitled, "The Economy Is Worse than You Think," lamentsthat final sales grew at an anemic annual rate of 0.6 percent during the first quarter of 2011. The month of May witnessed the unemployment rate rising above 9 percent again and a collapse of payroll employment gains.Feldstein offers us another wakeup call.

President Obama's economic policies have failed to launch a vigorous expansion. Instead, his policies have increased the cost of doing business, heightened uncertainty, and deterred job-creating investment. Moreover, his policies have burdened our children with an enormous federal debt that continues to grow as a share of the economy.

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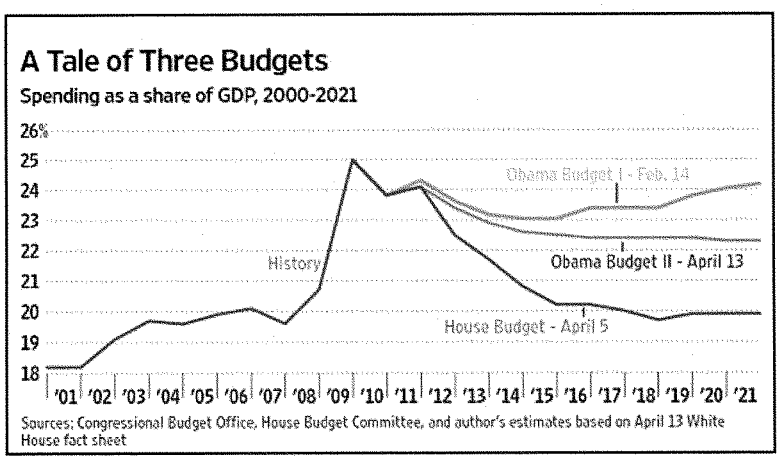
One of our witnesses, Stanford University Professor John Taylor, published a graph that depicts President Obama's last two spending proposals, his Budget in February, and his informal framework in April, and compares them with the Housebudget resolution. From this graph, it is clear that President Obama and Congressional Democrats want to make federal spending a permanently larger share of our economy, whereas Congressional Republicans want merely to return federal spending to its pre-recession share of our economy.

Returning to federal spending to a pre-recession share of the economy is normal and prudent. Nevertheless, President Obama and Congressional Democrats have embraced a radical, historically unprecedented expansion in the size and scope of the federal government.



Let me be clear. Excessive federal spending is our disease. Large federal budget deficits and accumulating federal debt are symptoms of this disease. If you cure ourspending disease, the symptoms will vanish. If you treat the symptoms, you may temporarily alleviate some of thepain, but over time our economy will continue to weaken, our international competitiveness will erode, and our children will become the first generation in American history that is poorer than the previous generation.

In response to these grave fiscal challenges, the House of Representatives passed a responsible budget resolution that would bring federal spending in line with revenue over time. Unfortunately, the Senate has failed to even consider, let alone pass, a budget resolution.

Congressional Republicans want to cure our spending disease, in part, by reforming entitlement programs to make them sustainably solvent for future generations. In contrast, President Obama and Congressional Democrats have reverted to the discredited notion that entitlement programs can largely continue as they are without reforms if we only "tax the rich" enough.

Congressional Republicans are demanding that any debt ceiling legislation must contain substantial spending reductions and new fiscal guardrails to ensure these reductions actually take place. In response, President Obama and Congressional Democrats have launched all-out political attacks, asserting cuts in federal spending would pushthe economy back into recession and destroy social programs. These false attacks must cease if Americans are to come together to reduce federal spending and grow our economy.

On March 15, 2011, I released a JEC Staff Commentary entitled *Spend Less, Owe Less, Grow the Economy*. This study examined other developed countries – our international competitors – that had large, persistent government budget deficits and a high level of government debt. This study found:

- Countries that adopted fiscal consolidation plans to reduce their government budget deficits and stabilize the level of government debt that were based predominately or entirely on government spending reductions were successful in achieving their goals, while countries that included significant tax increases in their fiscal consolidation plans failed to achieve their goals.

- Fiscal consolidation plans based predominately or entirely ongovernment spending reductions not only increased economic growth over the long term, but also provided a significant short-term boost in many cases.

Today, I am releasing another JEC Republican Staff Commentary entitled *Maximizing America's Prosperity*. This study examined what fiscal "guardrails" would keep Congress on track to reduce federal spending relative to the size of our economy.This study found:

- A balanced-budget amendment to the U.S. Constitution would not counteract the bias toward higher federal spending unless it contains explicit spending limitations.

- The federal government needs a statutory spending cap with a credible enforcement mechanism regardless of whether a constitutional balanced-budget amendment is ratified.

- The item-reduction veto has reduced the growth of state spending by strengthening the role of the governor relative to the legislature in making spending decisions. Enhanced rescission authority would also help to control the growth of spending at the federal level.

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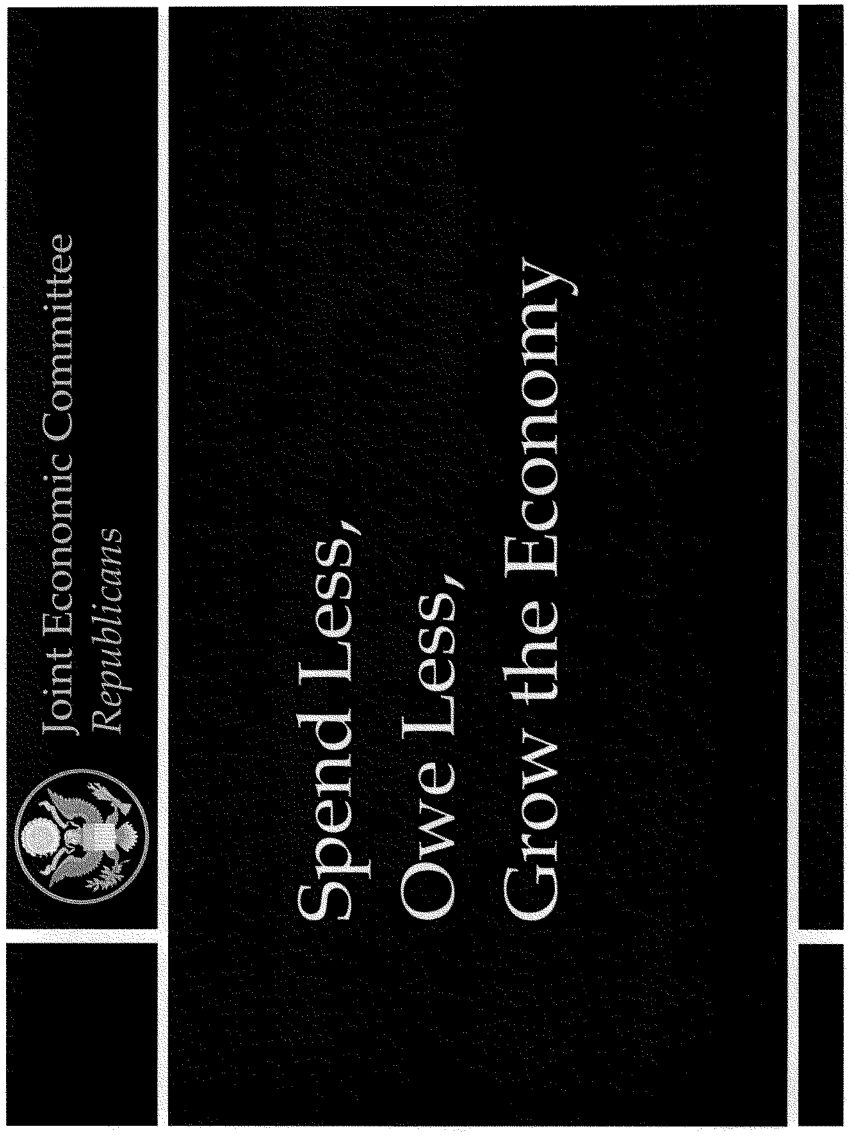
- Sunset provisions,which have been effective in eliminating inefficient and unnecessary programs and agencies in U.S. states, would be helpful at the federal level.

So long as President Obama and Congressional Democrats continue to behave in politically expedient, but fiscally irresponsible ways, American families and businesses will look to the future with trepidation.

I look forward to hearing the testimony of our witnesses.



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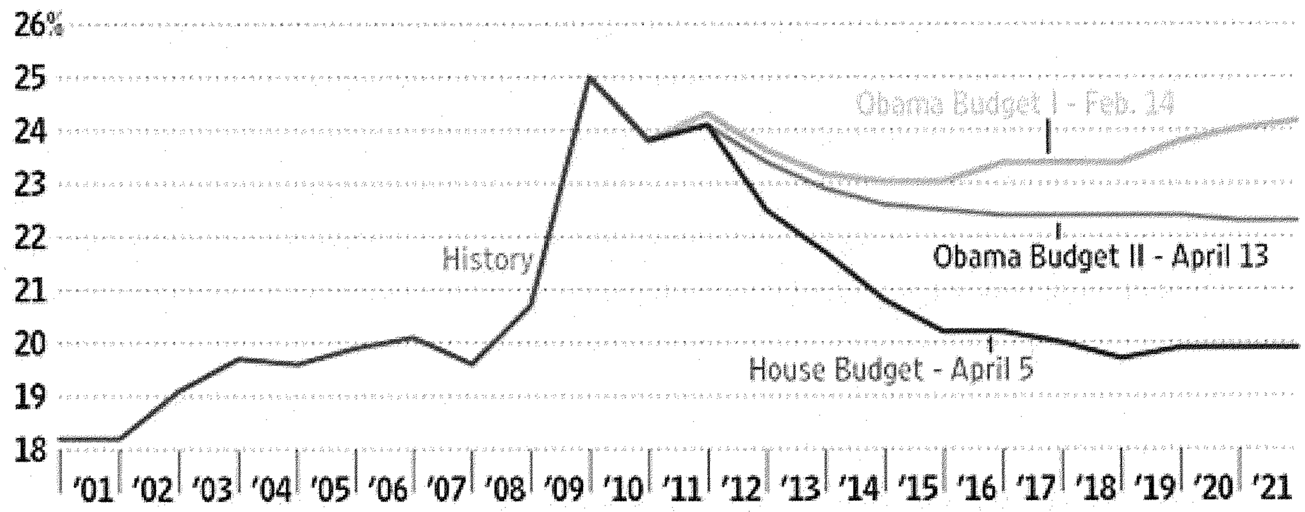
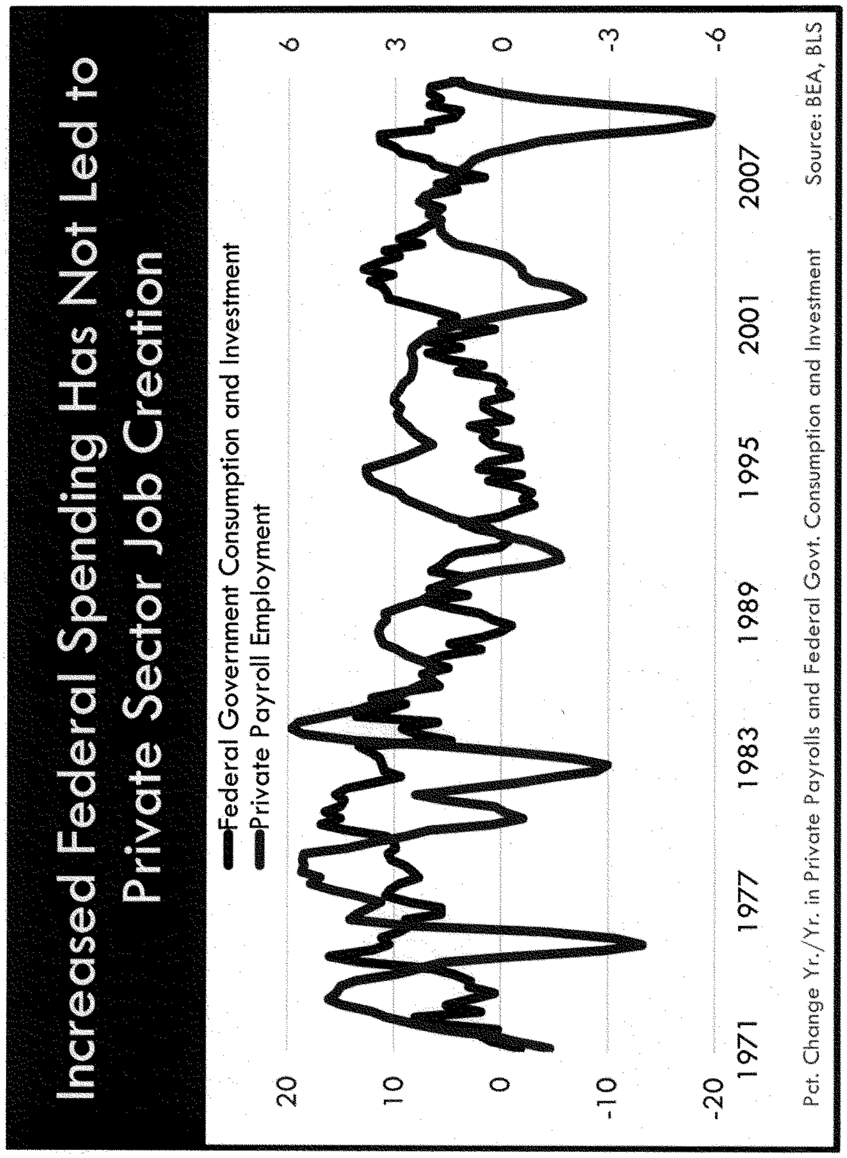
A Tale of Three Budgets

Spending as a share of GDP, 2000-2021

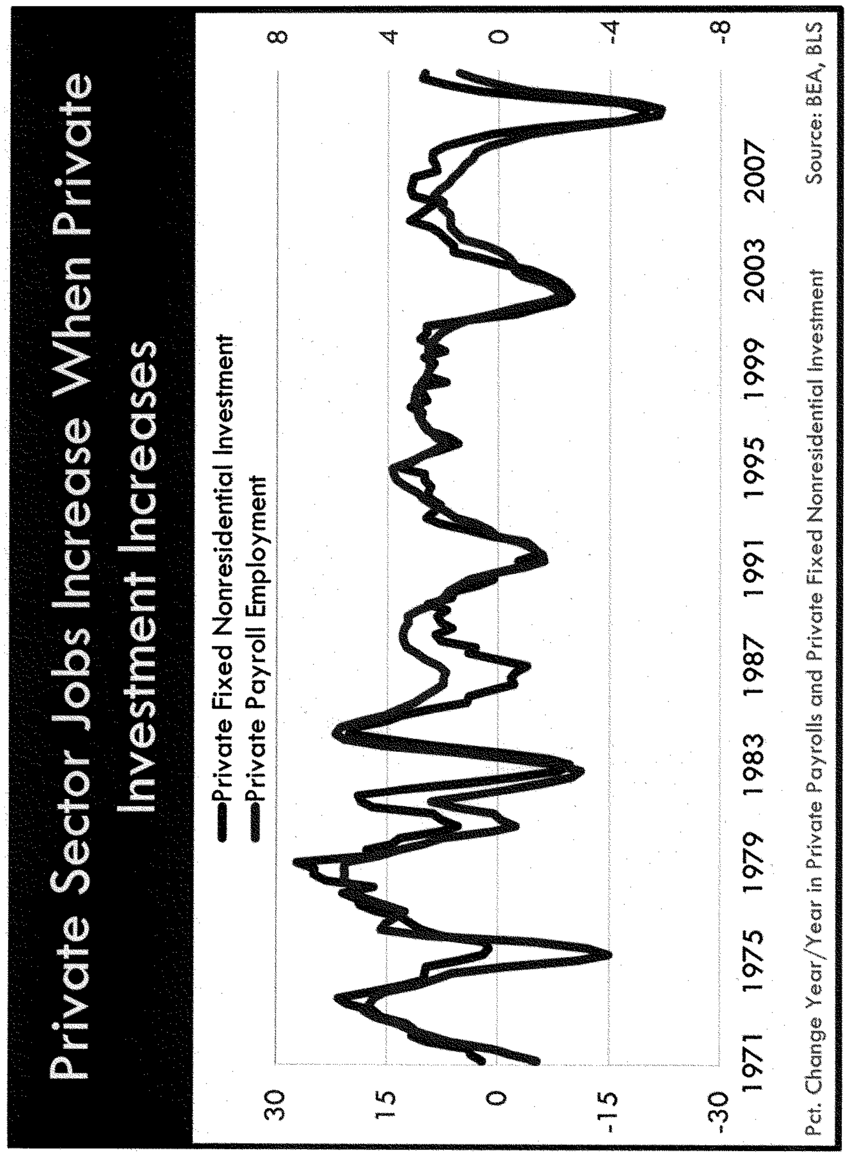


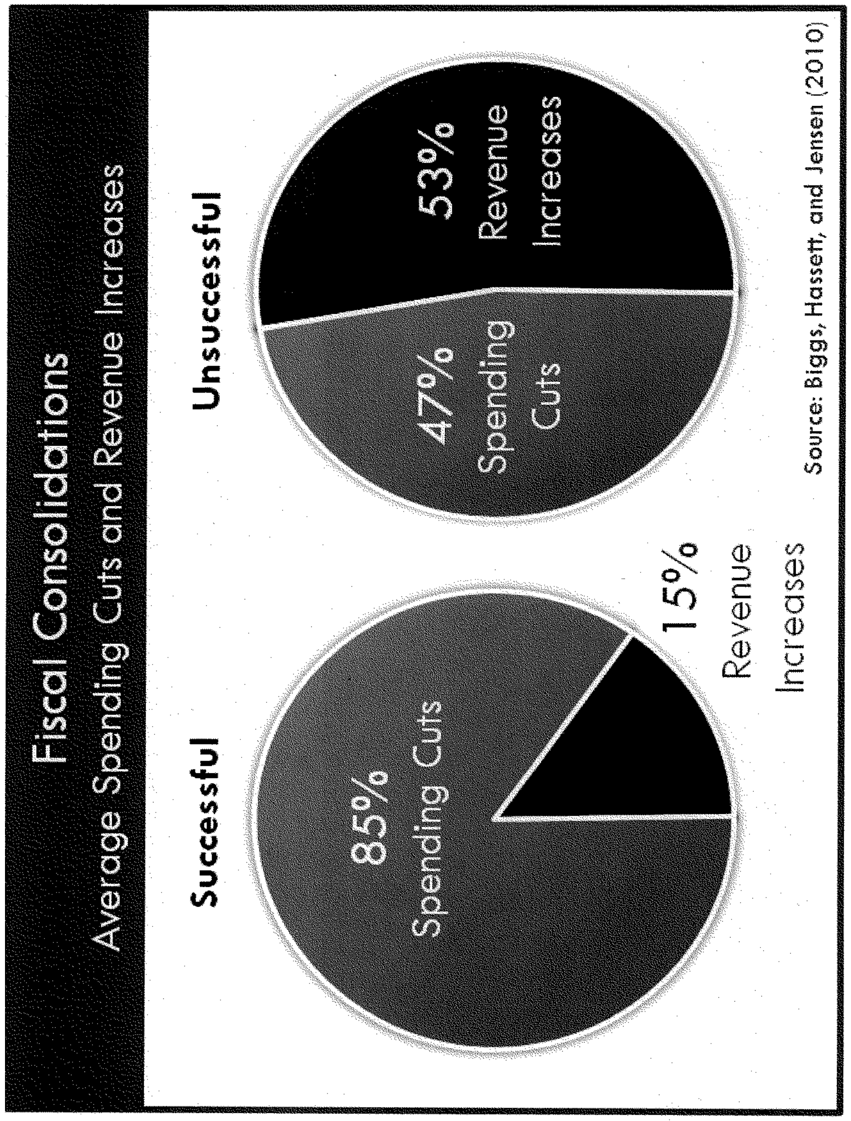
Sources: Congressional Budget Office, House Budget Committee, and author's estimates based on April 13 White House fact sheet

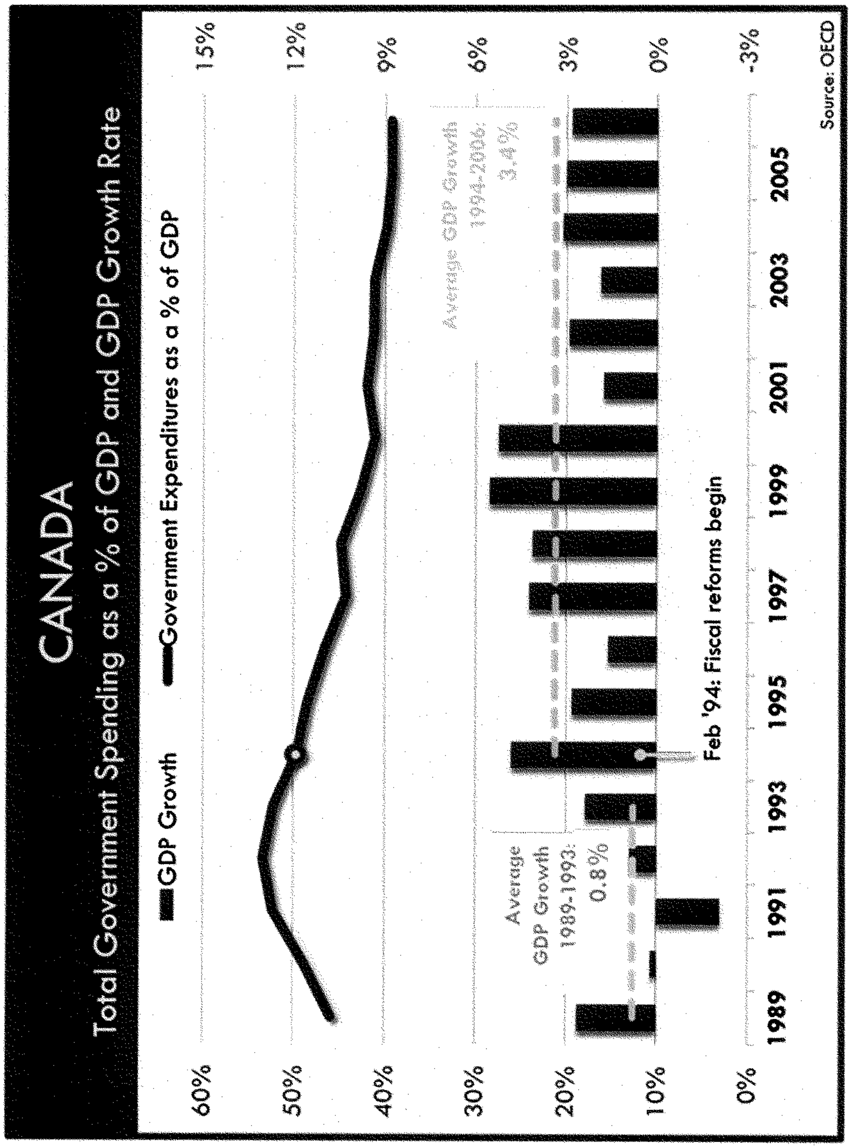
"Obama's Permanent Spending Binge," John B. Taylor, Wall Street Journal, April 22, 2011

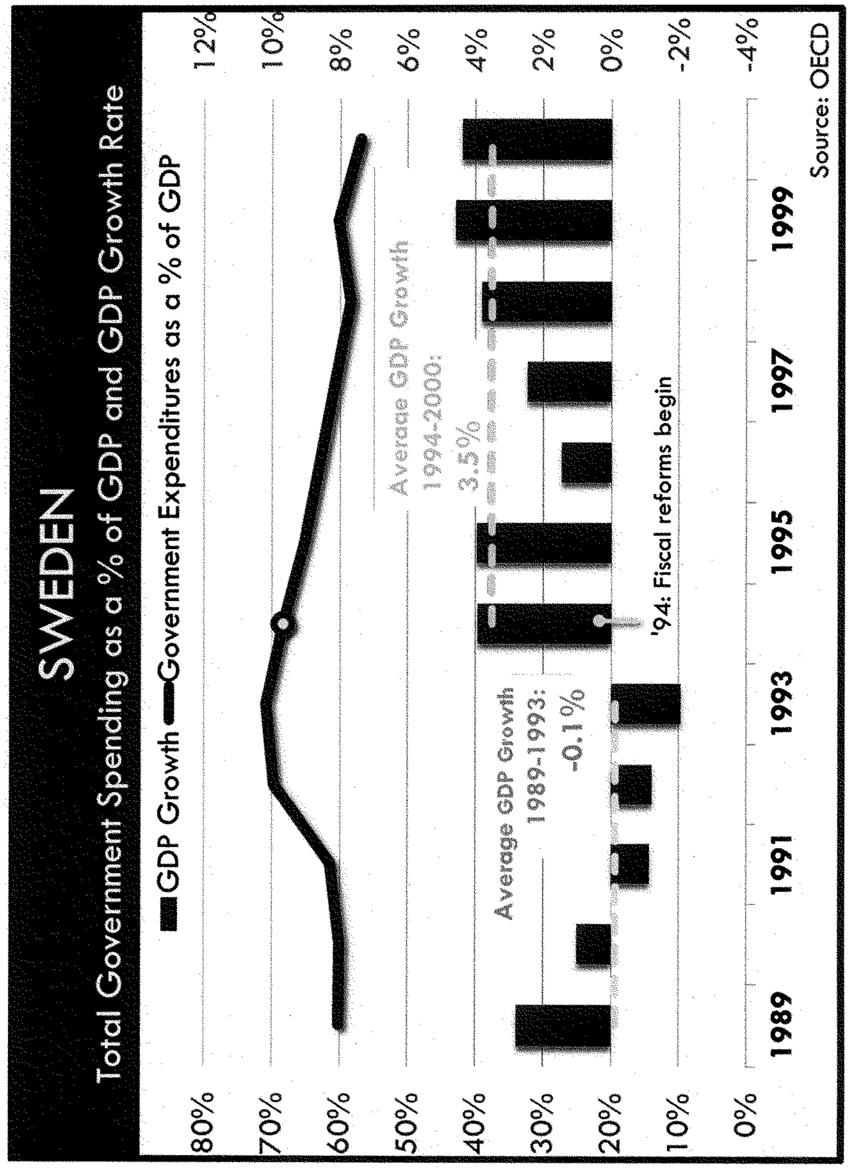


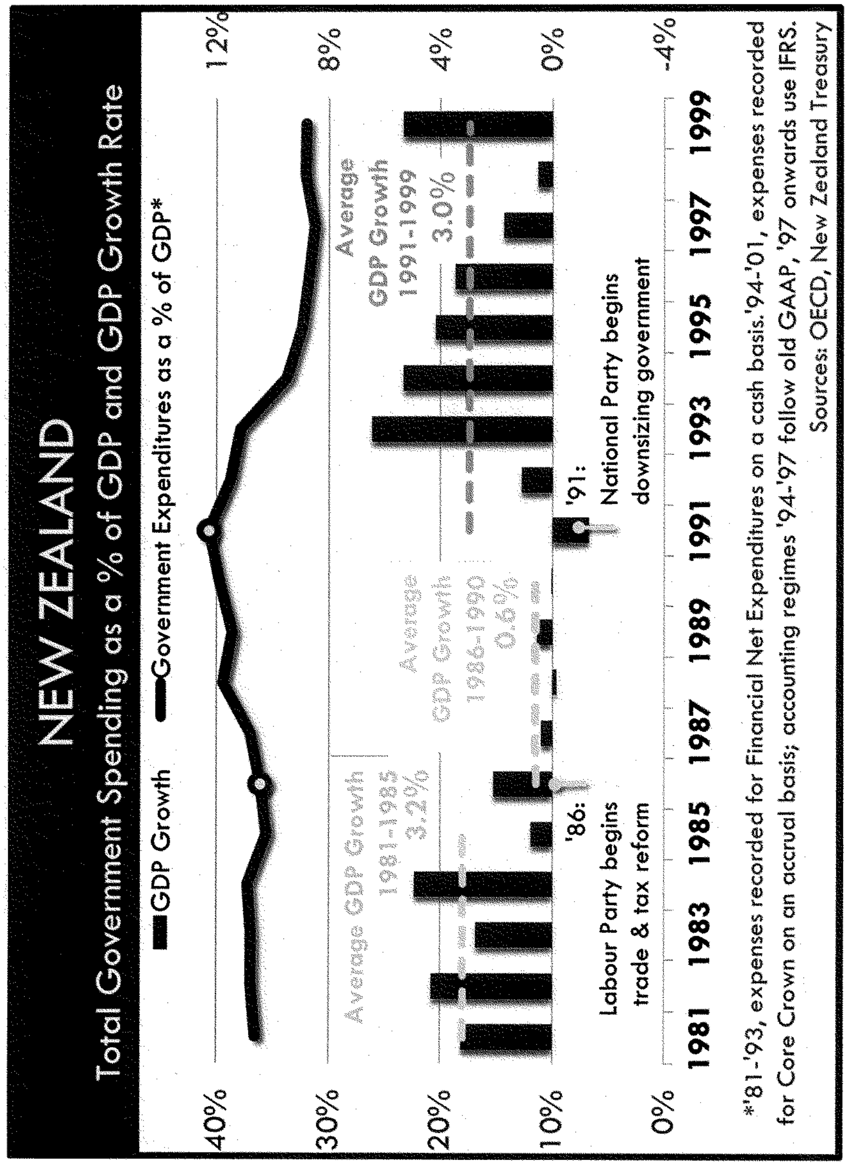
Increased Federal Spending Has Not Led to
Private Sector Job Creation
Federal Government Consumption and Investment
Private Payroll Employment
20
10
0
-10
-20
6
3
0
-3
-6
1971
1977
1983
1989
1995
2001
2007
Pct. Change Yr./Yr. in Private Payrolls and Federal Govt. Consumption and Investment
Source: BEA, BLS

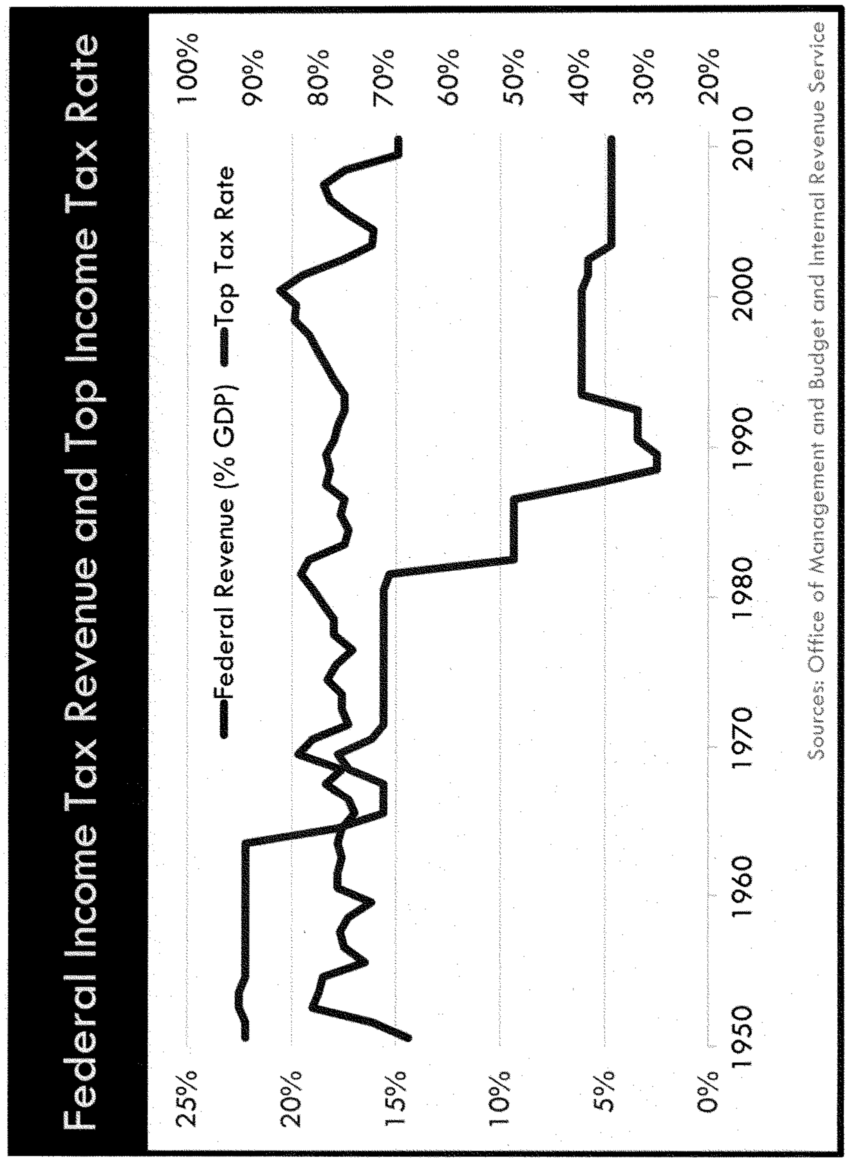

Private Sector Jobs Increase When Private Investment Increases
Private Fixed Nonresidential Investment
Private Payroll Employment
30
15
0
-15
-30
8
4
0
-4
-8
1971 1975 1979 1983 1987 1991 1995 1999 2003 2007
Pct. Change Year/Year in Private Payrolls and Private Fixed Nonresidential Investment
Source: BEA, BLS

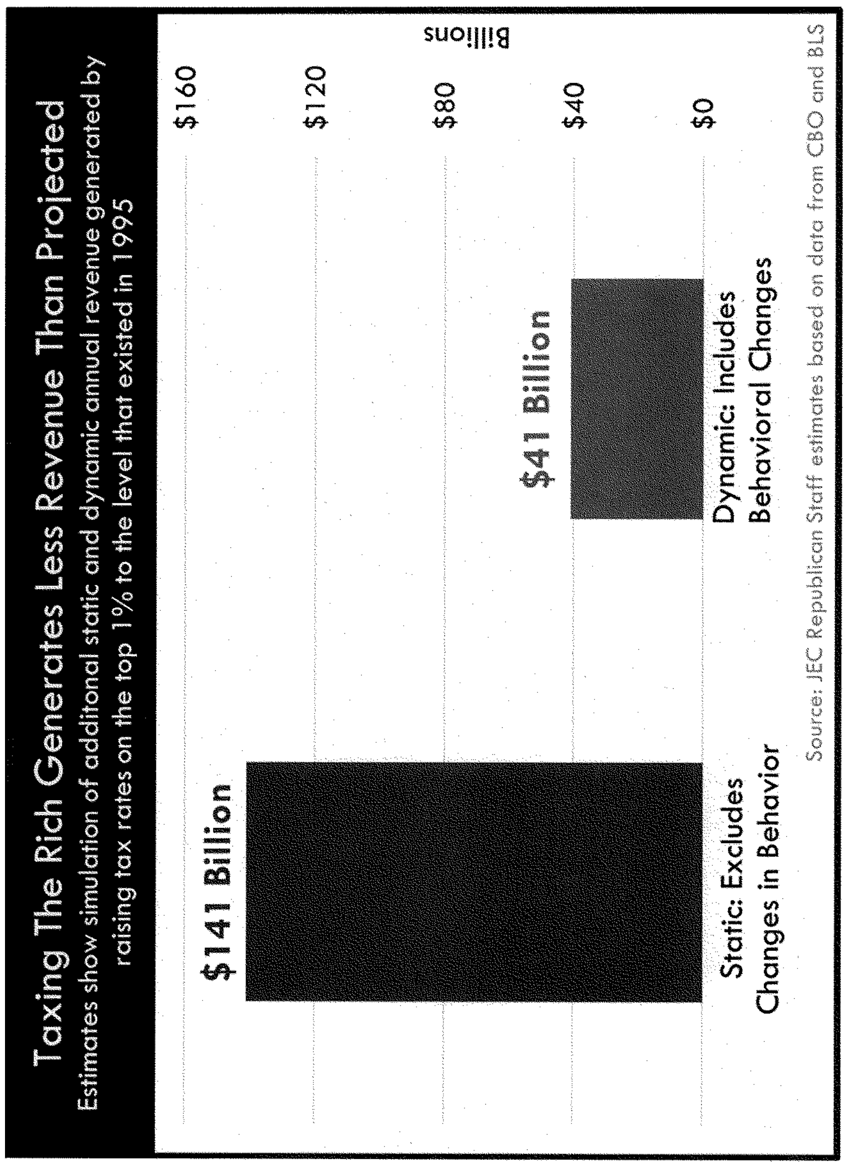

Fiscal Consolidations
Average Spending Cuts and Revenue Increases
Successful
85%
Spending Cuts
15%
Revenue
Increases
Unsuccessful
47%
Spending
Cuts
53%
Revenue
Increases
Source: Biggs, Hassett, and Jensen (2010)


CANADA
Total Government Spending as a % of GDP and GDP Growth Rate
GDP Growth
Government Expenditures as a % of GDP
60%
50%
40%
30%
20%
10%
0%
15%
12%
9%
6%
3%
0%
-3%
Average GDP Growth 1989-1993: 0.8%
Average GDP Growth 1994-2006: 3.4%
Feb '94: Fiscal reforms begin
1989
1991
1993
1995
1997
1999
2001
2003
2005
Source: OECD


SWEDEN
Total Government Spending as a % of GDP and GDP Growth Rate
GDP Growth
Government Expenditures as a % of GDP
80%
70%
60%
50%
40%
30%
20%
10%
0%
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
Average GDP Growth 1989-1993: -0.1%
Average GDP Growth 1994-2000: 3.5%
'94: Fiscal reforms begin
1989
1991
1993
1995
1997
1999
Source: OECD


NEW ZEALAND
Total Government Spending as a % of GDP and GDP Growth Rate
GDP Growth
Government Expenditures as a % of GDP*
40%
30%
20%
10%
0%
12%
8%
4%
0%
-4%
Average GDP Growth 1981-1985 3.2%
Average GDP Growth 1986-1990 0.6%
Average GDP Growth 1991-1999 3.0%
'86: Labour Party begins trade & tax reform
'91: National Party begins downsizing government
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
*'81-'93, expenses recorded for Financial Net Expenditures on a cash basis.'94-'01, expenses recorded for Core Crown on an accrual basis; accounting regimes '94-'97 follow old GAAP, '97 onwards use IFRS.
Sources: OECD, New Zealand Treasury


Federal Income Tax Revenue and Top Income Tax Rate
—Federal Revenue (% GDP) —Top Tax Rate
25%
20%
15%
10%
5%
0%
100%
90%
80%
70%
60%
50%
40%
30%
20%
1950
1960
1970
1980
1990
2000
2010
Sources: Office of Management and Budget and Internal Revenue Service



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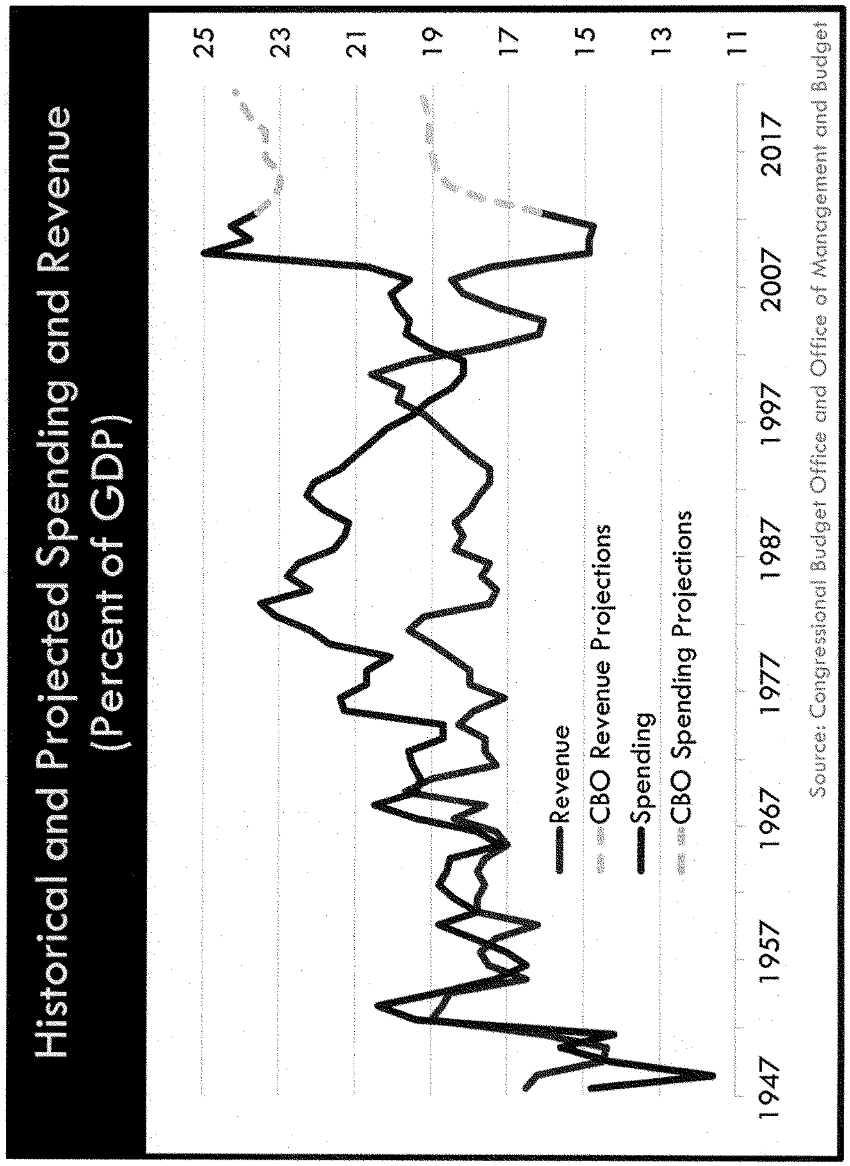
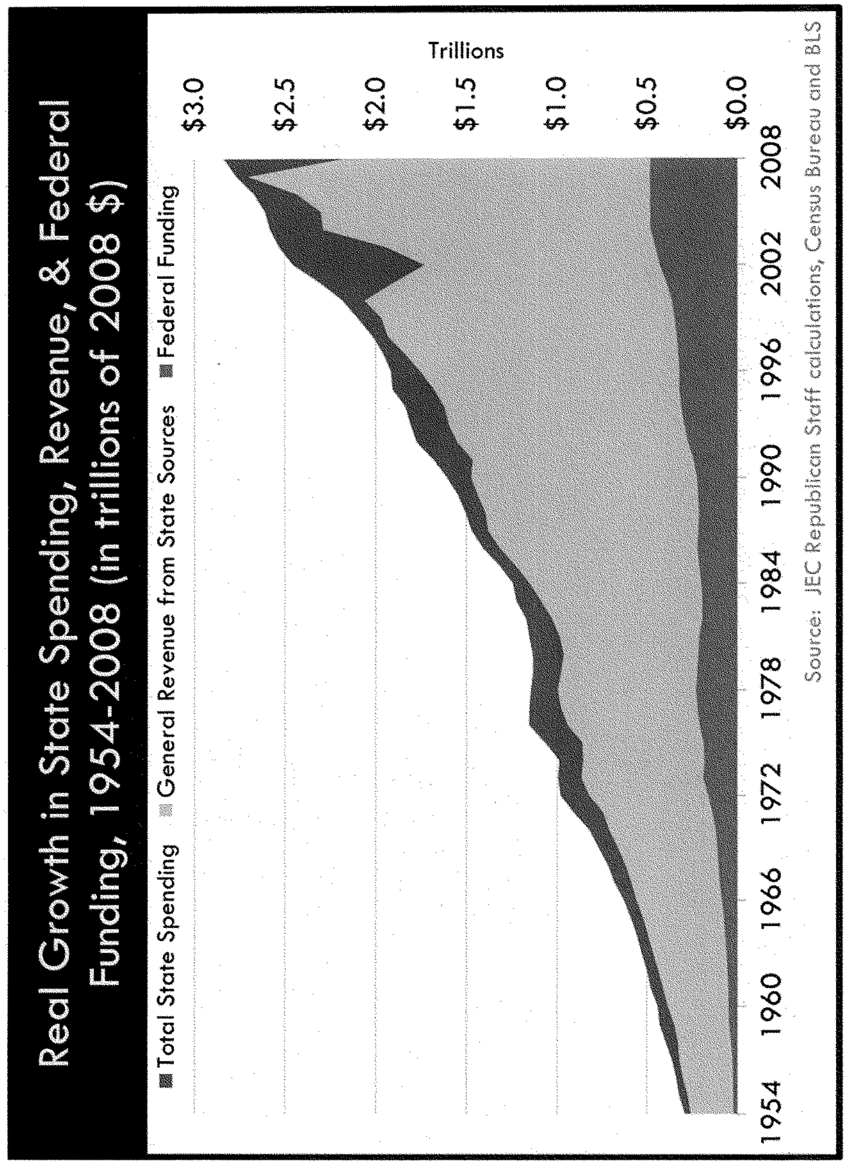
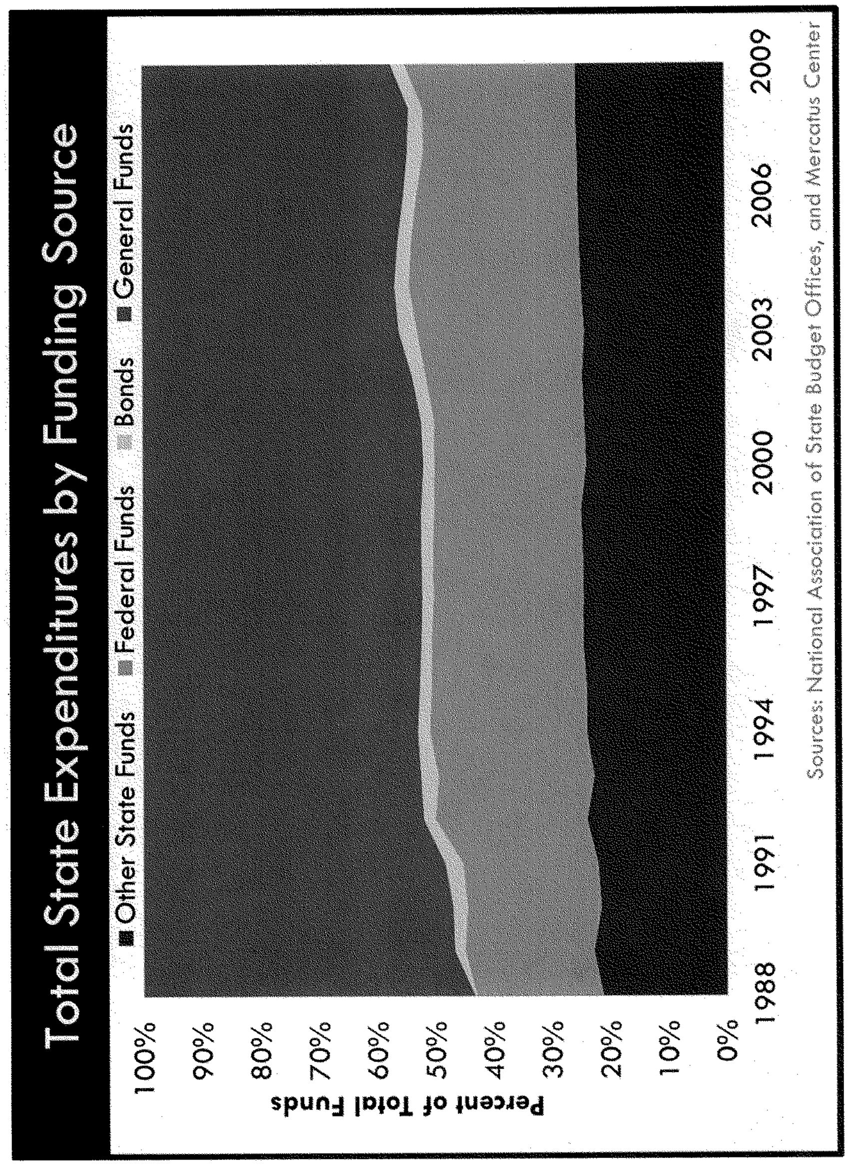

Historical and Projected Spending and Revenue
(Percent of GDP)
25
23
21
19
17
15
13
11
1947
1957
1967
1977
1987
1997
2007
2017
Revenue
CBO Revenue Projections
Spending
CBO Spending Projections
Source: Congressional Budget Office and Office of Management and Budget


Real Growth in State Spending, Revenue, & Federal Funding, 1954-2008 (in trillions of 2008 $)
Total State Spending
General Revenue from State Sources
Federal Funding
Trillions
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$0.0
1954
1960
1966
1972
1978
1984
1990
1996
2002
2008
Source: JEC Republican Staff calculations, Census Bureau and BLS


Total State Expenditures by Funding Source
Other State Funds
Federal Funds
Bonds
General Funds
Percent of Total Funds
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
1988
1991
1994
1997
2000
2003
2006
2009
Sources: National Association of State Budget Offices, and Mercatus Center

Joint Economic Committee
Republicans

Representative Kevin Brady
Vice Chairman

REPUBLICAN STAFF COMMENTARY

Maximizing America's Prosperity

Lessons on Fiscal Rules from Other Developed Countries and U.S. States

June 21, 2011

Highlights

- A balanced-budget amendment to the U.S. Constitution is unlikely to counteract the bias toward higher federal spending unless it is combined with explicit spending limitations.
- Constitutional balanced-budget provisions are not self-executing and must be supplemented by other statutory fiscal rules.
- Government spending caps expressed as a percentage of GDP have been successful in countries that have undergone fiscal consolidations.
- The U.S. government needs a **statutory spending cap with a credible enforcement mechanism** regardless of whether a constitutional balanced-budget amendment is ratified.
- The **item-reduction veto** has reduced the growth of spending in U.S. states by strengthening the role of the governor relative to the legislature in making spending decisions.
- **Sunset** provisions have been effective by eliminating inefficient and unnecessary programs and agencies in U.S. states.
- The effectiveness of **tax and expenditure limitations** in U.S. states has varied greatly based on their design.

INTRODUCTION

Spend Less, Owe Less, Grow the Economy

The Joint Economic Committee (JEC) Republican Staff Commentary *Spend Less, Owe Less, Grow the Economy* reviewed the economic evidence about fiscal consolidation programs (i.e., programs to reduce government budget deficits and stabilize government debt as a percentage of Gross Domestic Product (GDP)) in developed countries - our economic competitors - since 1970. *Spend Less, Owe Less, Grow the Economy* demonstrates that fiscal consolidations based entirely or predominately on government spending reductions are more successful in achieving their goals of reducing government budget deficits and stabilizing government debt as a percentage of GDP than fiscal consolidations in which tax increases play a significant role. *Spend Less, Owe Less, Grow the Economy* also demonstrates that fiscal consolidations based entirely or predominately on government spending reductions, in addition to laying the ground work for long-term economic growth, are likely to provide a significant short-term boost to economic growth. This JEC Republican Staff Commentary follows up by identifying the kinds of fiscal rules that would enable Congress to reduce federal spending, return to a fiscally prudent budget, and boost economic growth.

Biases Toward Higher Government Spending

Despite these economic benefits, the United States and other developed countries have often been unable to implement sustainable reductions in government spending as a percentage of GDP. For over 60 years, a school of economic thought known as public choice has attempted to explain this type of fiscally irrational behavior through applying the tools of economic analysis to elections, legislatures, bureaucracies, and politics. Public choice economists, including Nobel Laureate James M. Buchanan, George Mason University economist Richard Wagner, and Australian University economist Geoffrey Brennan, as well as others that also have a public choice perspective including Nobel Laureate Milton Friedman, Stanford University economist John B. Taylor, and Harvard University economist Martin Feldstein have identified a number of biases in fiscal decision-making that tend to cause democratic governments to increase spending relative to the size of the economy over time. Some of these biases include:

- **Concentrated benefits – dispersed costs.** The benefits of government programs are often concentrated on specific individuals and firms, while the costs of government programs are widely dispersed to all taxpayers either through current taxes or future taxes in the form of government debt. In practice, this means recipients of government largesse have a significant financial incentive to organize and spend resources lobbying policymakers to maintain or increase their benefits. While every taxpayer benefits, at least indirectly, from some government spending, there is less incentive to take any significant action to reduce or eliminate specific programs. The savings would be spread across all taxpayers, amounting to pennies on the dollar relative to the cost incurred. Consequently, it is easier for policymakers to agree to special interest demands for more government spending than adhere to the general public interest for spending restraint. For example, a NFL football team seeking taxpayer financing of a new football stadium is more likely to generate the funds necessary for a successful lobbying campaign than stadium opponents to defeat the effort.

- **Opaque opportunity costs.** Governments often separate spending decisions from taxing and borrowing decisions. Consequently, additional government spending may appear to the public to come at little or no cost. Many people believe that the $2.6 trillion of nonmarketable federal debt securities in the Social Security trust fund represent real assets when they are, in fact, merely claims on future federal tax revenues. This creates an impression that $2.6 trillion of funds are readily available to pay current and future benefits.

- **Progressive taxes and benefits.** A progressive income tax system, including refundable tax credits in excess of tax liabilities, reduces the number of individuals with "skin in the tax game," thus creating the illusion among the public that someone else – usually businesses or "the rich" – will pay for additional government benefits. A recent OECD study found that the top 1 percent of U.S. taxpayers pay a greater share of the tax burden than the bottom 90 percent combined. Moreover, the federal government's fiscal policies currently redistribute more than $826 billion annually from the top 40 percent of families to the bottom 60 percent.[1]

Fiscal Rules

To overcome these and other biases toward higher government spending, public choice economists advocate the adoption of fiscal rules that constrain the level of government spending, taxes, budget deficits, and debt, and force policymakers and the public to make trade-offs among competing priorities. Fiscal rules include both substantive limitations (e.g., a cap on government spending as a percentage of

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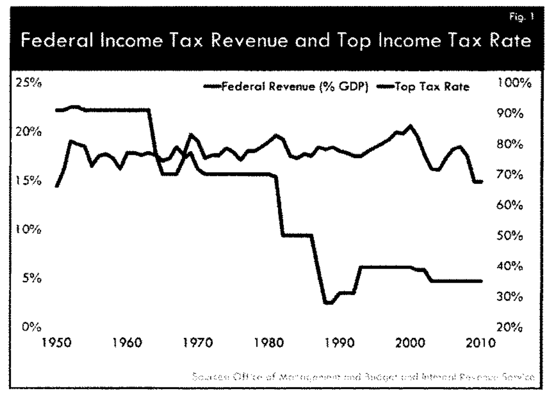
GDP) and procedural requirements (e.g., a requirement for a super-majority vote in a legislature to increase taxes). Fiscal rules may be constitutional or statutory.

Since the income tax had not yet been invented and government transfer payments were rare, these public choice biases toward higher spending were not readily apparent to many of our founding fathers when they drafted the U.S. Constitution and established the federal government during the late 18th century. Consequently, the U.S. government is relatively unconstrained by fiscal rules. However, other developed countries and U.S. states, many of whose constitutions were written or substantially revised after public choice ideas became apparent, have developed and implemented a number of different fiscal rules. The experience of other developed countries, as well as U.S. states, provides federal policymakers with "real world" knowledge to draw upon when crafting fiscal rules for the U.S. government.

CAUSE OF U.S. FISCAL PROBLEMS: EXCESSIVE FEDERAL SPENDING

Hauser's Law: Effective Limit on the Ability of the Present Federal Tax System to Raise Revenue



The result of behavioral responses to high marginal income tax rates is negative; it slows economic growth and job creation. In examining tax receipts as a percent of GDP over the years 1946 to 2007, Stanford University economist W. Kurt Hauser found an empirical relationship which became known as Hauser's law. He found that under a tax increase, the denominator, GDP, will rise less than forecast, while the numerator, tax revenues, will increase less than anticipated. Therefore the quotient, the percentage of GDP collected in taxes, will remain the same. Hauser found, "no matter what the tax rates have been, in postwar America tax revenues have remained at about 19.5 percent of GDP."[2] If Hauser's law holds that federal revenues are loosely constrained at a level of 19.5 percent of GDP, it is far better to collect 19.5 percent of a larger GDP buoyed by lower marginal income tax rates than to collect 19.5 percent of a smaller GDP depressed by higher marginal income tax rates.

Even though the top marginal federal individual income tax rate has been as high as 91 percent and as low as 28 percent, federal tax receipts in the United States have remained surprisingly stable at approximately 18.9 percent of GDP (the average from fiscal years 1947-2011) (see Fig. 1).

Fiscal and tax policy debates are often misleading because static budget analysis does not take into account dynamic behavioral responses to taxes. Large marginal income tax increases on the so-called "rich" can be wrongly perceived to increase federal receipts substantially. However, economists have provided strong evidence for the negative effects of high marginal tax rates on the productive behavior of individuals and firms. The result of higher income tax rates is slower economic growth, reduced employment, and lower-than-projected tax receipts.

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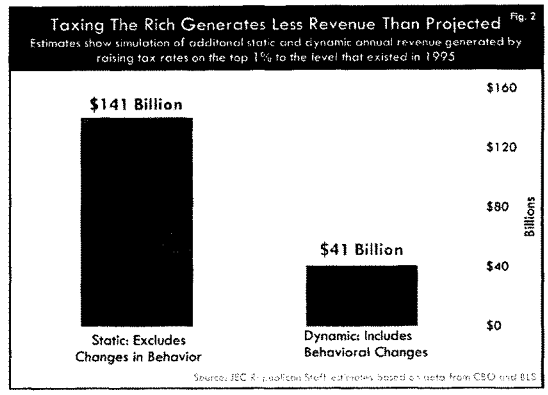
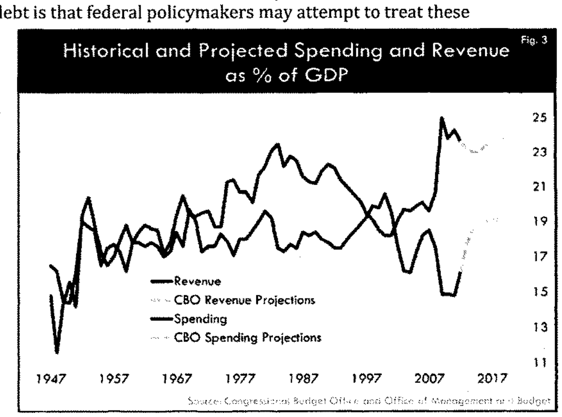
Analysis by the JEC Republican staff based on historical data confirms the negative effects of higher marginal tax rates.[3] If the effective tax rate on only the top one percent of earners were increased to the highest rate that existed under President Clinton, a static analysis (such as that done by the Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT), and upon which all official budget revenue projections rely) suggests that annual tax receipts would increase by $141 billion ($1.4 trillion over 10 years). However, taking into account changes in behavior, historical data suggests that revenues would increase by only $40 billion per year ($400 billion over 10 years) (see Fig. 2 on previous page). So, more than 70 percent of the projected tax receipts would <u>not</u> be realized because individuals would change their behaviors—they would work less, save less, invest less, shift taxable activities abroad, and do whatever they could to avoid taxes—and thus shrink the economy. Tax policy should aim to encourage, not discourage, productive behavior, which will help to grow our economy and create jobs.



The Disease—Excessive Federal Spending

Large persistent federal budget deficits and a rising level of federal debt as a percentage of GDP are often identified as the fiscal "illness" afflicting the United States. However, federal budget deficits and federal debt are merely the symptoms of the real disease - excessive federal spending. A danger of focusing on federal budget deficits and federal debt is that federal policymakers may attempt to treat these symptoms while leaving the underlying disease to fester.

During fiscal years 1947 to 2008, federal budget deficits averaged 1.7 percent of GDP (See Fig. 3). During the last three fiscal years, however, federal budget deficits have skyrocketed, reaching an expected 9.3 percent of GDP in the current fiscal year. Federal budget deficits over the next ten fiscal years are projected to average 3.4 percent of GDP under the CBO baseline, and 4.8 percent of GDP under the President's proposed budget.[4] Whereas gross federal debt has



exceeded 100 percent of GDP in only three fiscal years (during and immediately after WWII), CBO projects that gross debt will reach 100 percent of GDP this year and will continue to rise thereafter.[5] As economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University show, gross government debt in excess of 90 percent of GDP reduces economic growth.[6] And lower economic growth produces lower tax revenues, further exacerbating budget deficits.

How did the United States get into such a precarious fiscal situation? The recent recession certainly hastened the fiscal crisis, but the nature of the U.S. political process and the lack of effective fiscal rules are what have enabled federal policymakers to enact irresponsible budgets that appease special interests at the expense of future generations. The problem is not that the U.S. government collects too little in taxes—indeed, federal tax receipts are expected to grow over the long term. Rather, the problem is excessive and unsustainable federal spending.

Table 1. From CBO Projected Federal Budget Surpluses to Actual Federal Budget Deficits (Fiscal Years 2002-2011)

	$ Billions	Percent of Swing
CBO Projection of Cumulative Federal Budget Surpluses for Fiscal Years 2002-2011 in January 2001	$5,610	
Tax Reduction	-$2,809	24%
Spending Increases	-$5,629	48%
Economic and Technical Changes*	-$3,330	28%
Actual Cumulative Federal Budget Deficits Fiscal Years 2002-2011	-$6,241	
Total Swing	-$11,851	

*Economic changes are mainly due to March 2001 to November 2001 recession and the December 2007 to June 2009 recession. Technical changes are due to errors in assumptions about such factors as what proportion of eligible individuals and families will participate in benefit programs, how sound financial institutions will be, and how health care providers will behave.

In January 2001, the CBO projected cumulative federal budget surpluses of $5.6 trillion for fiscal years 2002 to 2011. However, these projected cumulative federal budget surpluses rapidly turned into cumulative federal budget deficits of $6.2 trillion for fiscal years 2002 to 2011, a swing of $11.9 trillion (see Table 1). Some critics blame President Bush's tax cuts in 2001 and 2003 for upending these surpluses. According to the CBO, however, tax reductions (including tax reductions enacted or renewed under President Obama) accounted for only 24 percent of the swing from projected federal budget surpluses to actual budget deficits during fiscal years 2002 to 2011. Higher federal spending accounted for 48 percent of the swing from projected federal budget surpluses to actual deficits during fiscal years 2002 to 2011, while other economic and technical factors, including the effects of 2001 recession, accounted for another 28 percent of the swing from projected federal budget surpluses to actual deficits. Clearly, federal spending must be cut in order for the United States to secure fiscal stability in the future.

Even absent President Obama's proposed tax increases, revenue under his budget proposal is projected to be $37.9 trillion over the next ten fiscal years.[7] However, President Obama's budget would spend $46.2 trillion during same period.[8] The President claims his budget "lays out a path for how we can pay down [the] debt."[9] With such an incomplete solution to a very real problem, and with the extreme opposition and criticism towards serious solutions, federal policymakers are unlikely to restore the fiscal discipline necessary to save our country from economic deterioration or demise. The U.S. government needs clear, enforceable fiscal rules that will force federal policymakers and the public to make tough choices to constrain federal spending. Establishing clear and enforceable fiscal policy rules and creating

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the tools needed to enforce those rules will help restore confidence in the U.S. fiscal outlook and will force federal policymakers to make the tough decisions necessary to maintain America's prosperity.

FISCAL RULES IN OTHER DEVELOPED COUNTRIES

Fiscal rules—the constitutional provisions and laws under which governments plan, approve, and implement their budgets—can play an important role in the size and composition of budgets, and in the likelihood of persistent budget deficits. Laws that prescribe numerical targets or limits and laws that prescribe procedural rules can help improve budget outcomes.[10]

Evidence shows that the most effective fiscal rules are predicated on three conditions: (1) public understanding of the need for such rules, including education and outreach to achieve this understanding (e.g., Argentina, Brazil, New Zealand, European Union) ; (2) political debate leading to broad consensus for the introduction of such fiscal rules (e.g., Germany, Switzerland, United States); and (3) a clear, well-planned, and preannounced path of convergence in key economic indicators (e.g., Argentina, New Zealand, Peru, Switzerland, European Union).[11]

In a parliamentary system, fiscal decision-making is centralized in the prime minister and his or her cabinet. Votes on fiscal matters are always confidence votes. If the legislature does not approve the prime minister's budget exactly as presented, the prime minister must resign or call a new parliamentary election. A straight "up-or-down" vote on the budget severely limits the ability of individual legislators to add local "pork barrel" projects. In a parliamentary system, the majority party or parties in the legislature are fully responsible for the budget and accountable to the voters for its economic effects.

Fiscal rules are even more important in the United States than in other developed countries. In our separation-of-powers system, the President and the Congress share the responsibility for fiscal decision-making. Shared decision-making and differing election cycles for Representatives, Senators, and the President encourage legislative logrolling, force compromises, and blur accountability for the economic effects of the budget to the voters. It is far more difficult for the United States to make rational fiscal decisions that limit the growth of spending in the absence of fiscal rules than it is in other developed countries with parliamentary systems.

Canada's Experience: Large Spending Reductions

In 1993, Canada faced a fiscal situation similar to what the United States faces today. After more than two decades of high federal budget deficits, Canada's net federal debt reached 67 percent of GDP (the U.S. projected federal debt held by the public for the end of fiscal year 2011 is 69.4 percent).[12] Convinced that cutting federal spending was the key to solving Canada's fiscal crisis, then-Finance Minister Paul Martin relied upon increased transparency to raise public awareness about the need for serious spending reductions.[13] With the support of Prime Minister Jean Chretien, Martin announced federal spending limits and implemented aggressive spending cuts that went beyond just trimming the rate of growth in programs and instead cut spending below the previous fiscal year's level. To assure that the spending and budget deficit reduction goals were met, Canada relied on conservative assumptions and created a contingency reserve in case the economic forecasts proved too optimistic.

Contrary to Keynesian beliefs, massive cuts in federal spending from 22.3 percent of GDP in Canadian fiscal year 1993 (begins on April 1, 1993 and ends March 31, 1994) to 16.2 percent in Canadian fiscal year 2000 and federal budget deficits from a $29.8 billion deficit in Canadian fiscal year 1993 to a surplus of $13.3 billion in Canadian fiscal year 2000 were not economically catastrophic. Instead, GDP growth averaged more than 4 percent from 1994 to 2000 compared with an anemic 0.8 percent average from 1989 to 1993.[14]

While some argue that the federal government must increase taxes on the rich to confront its unsustainable fiscal outlook, Canada demonstrates that this is not the case. The Canadian deficit reduction consisted of six dollars in spending cuts for every one dollar in tax increases, and those tax increases resulted from the elimination of some "nickel-and-dime" special interest tax preferences, not from increases in marginal income tax rates.[15] Ultimately, the deficit reduction measures were so successful that Canada was able to cut the corporate tax rate by 7 percent, reduce income taxes and the share of capital gains subject to taxation, and raise the contribution limit for retirement accounts.[16] For federal policymakers seeking to enhance U.S. competitiveness by reducing the federal corporate tax rate, the Canadian experience serves as an ideal example of how federal spending and budget deficit reduction can allow for such a policy course.

Other Developed Countries

A comprehensive study by the Mercatus Center comparing the fiscal stability efforts of 26 countries found that while fiscal rules can effectively restrain political incentives for excessive government spending and budget deficits, fiscal rules do not guarantee success.[17] For example, although most member-states within the European Union originally adhered to the limits for annual government budget deficits of 3 percent of GDP and government debt of 60 percent of GDP set forth in the Stability and Growth Pact, many member-states began to ignore the limits because they lacked the necessary enforcement mechanisms. Hence, rules of the pact, such as a "no-bailout" policy, have been violated.[18] However, IMF economist Paolo Manasse found that government budget deficit limits are particularly helpful in achieving fiscal discipline if the limits are tight and the expected sanctions for exceeding them are high.[19]

FISCAL RULES IN U.S. STATES

U.S. states with reputations for fiscal prudence enjoy higher and relatively more stable growth.[20] The following is a list of policy options and fiscal tools from U.S. states that our federal government might emulate to get the United States back on track towards sustainable fiscal prudence.

Line Item-Reduction Veto

A line item-reduction veto allows a governor to either (1) veto a particular item within an appropriations bill like a line-item veto, or (2) reduce the amount of funding for a particular item within an appropriations bill, unlike a line-item veto, without vetoing the entire appropriations bill. Economic studies have found that the item-reduction veto is an effective tool for controlling excessive increases in state spending.[21] Just fourteen states have the line item-reduction veto, while 29 states have the line-item veto.[22]

A line item-reduction veto strengthens a governor's power relative to the state legislature in making spending decisions. The flexibility to trim an appropriations item without vetoing the underlying bill altogether makes a governor more likely to use an item-reduction veto than to use either an entire bill veto or a line-item veto. Because governors are elected statewide, while state legislators are elected by smaller geographically-segmented constituencies, governors have a statewide perspective. Over time, governors are more likely to focus on their state's overall fiscal status and are less tolerant of local pork projects than state legislators.[23]

In a study spanning all 50 states over eight years (1979 to 1986), economists Mark Crain and James C. Miller demonstrate that among all the institutional controls identified as reducing spending, line item-reduction veto cuts the rate of state spending growth over a two-year period by 2.7 percent. Alternatively, the simpler line-item veto had an insignificant effect on spending growth. Crain and Miller further estimate that if Presidents Carter and Reagan had an item-reduction veto, the real growth rate of federal spending would have been cut in half over the same eight-year period.[24]

Sunset Provisions

State-level sunset provisions demonstrate the effectiveness of this tool as a method to curtail growth in the size, scope, and cost of government and reinforce performance-based budgeting decisions. Though their designs vary considerably, twenty states have active sunset provisions in place to continually reevaluate programs and determine whether the continued existence of each government program is justified.[25]

The design of a sunset process is important. Broadening the reach of a sunset process increases its chances of success; no program or agency should be considered exempt from periodic review. Establishing a regular review process administered by a commission with clear performance measures and transparent reporting methods also increases the effectiveness of a sunset process. Furthermore, in designing an effective sunset process, an agency undergoing sunset review that is recommended to be abolished should be automatically abolished unless the legislature passes a bill to preserve it.

Texas has proved to have the most successful sunset provision among the states. Since its inception through 2009, the Commission has abolished 58 agencies and consolidated another 12, accruing $784 million in savings. In 2009 alone, Texas' Commission reviewed 25 state agencies, recommended significant changes to 21 continuing agencies, abolished two agencies outright, and abolished two agencies by transferring their functions to other agencies. The Texas Legislature adopted all of the Commission's recommendations.

In Texas, a 12-member Sunset Advisory Commission (a combination of legislators and public members appointed by the Lieutenant Governor and Speaker of the House), established in 1977, regularly reviews over 130 state agencies, with 20-30 agencies undergoing the sunset process each legislative session. The Commission's report on a particular agency must include a recommendation to abolish or continue the agency, and if recommending to continue, draft legislation for the Legislature to continue the agency for up to 12 years. Otherwise, a state agency is automatically abolished unless the Legislature passes legislation sustaining it. For every dollar spent on the sunset process, Texas taxpayers have received $27 in net benefit due both to increased revenues and decreased costs.[26] The Texas experience has been largely positive due to several key elements: broad reach, strong legislative support, clear performance measures, and transparent reporting methods.

While there are many studies that suggest performance-based measures would help the federal government to operate efficiently at lower costs, federal policymakers have been immobilized when it comes to adopting such suggestions. A sunset commission at the federal level could bring about the mechanism needed to shed duplication and waste while saving money. Because a sunset commission is not a one-time consolidation effort, it can continue to hold agencies at the federal level accountable to perform services identified as crucial and cost-effective.

Balanced-Budget Rules

Nearly all states have a balanced-budget rule, but there is much variation in the institutional design, including whether they are constitutional or statutory. Forty-four states require the governor to submit a balanced budget (32 of which are constitutionally-mandated), 37 states require the governor to sign a balanced budget (31 of which are constitutionally-mandated), and in 41 states, legislatures must pass balanced budgets (34 states are constitutionally mandated to do so).[27]

In general, balanced-budget rules appear to improve fiscal sustainability and are associated with smaller state budget deficits, lower state debt, higher credit ratings, more rapid adjustment to fiscal shocks, and deterring political manipulation of budgets. Roughly half of all states possess the most stringent form of a balanced-budget rule, the "no-carry-forward" rule prohibiting carrying forward a deficit into the following budget year. Prior studies have demonstrated that a no-carry-forward rule, applied to the entire budget, reduces fiscal balance cyclical variation by approximately 40 percent. Further, constitutionally-mandated no-carry-forward rules are associated with smaller deficits.[28]

A strict, enforceable, and constitutionally-mandated balanced budget at the federal level will increase the credibility of a fiscal consolidation plan. As University of Rochester political scientist David Primo describes, however, Congress faces three factors that work against reform: (1) "creeping risks" in the federal budget; (2) benefits of securing funding for one's state or district that outweigh the benefits associated with fiscal responsibility; and (3) promises made today are hard to keep tomorrow. For the federal level, Primo recommends that budget rules be constitutional, apply to the entire federal budget, focus on spending, take care when constructing "starting points" (increases pegged to inflation for example), resist compromise on rule design, use carefully constructed and limited exit options, and create precise rules lacking loopholes and opportunity for budget gimmicks.[29]

Tax and Expenditure Limitations

The implementation of a tax and expenditure limitation (TEL) can improve the effectiveness of fiscal rules by limiting growth in government spending and increasing overall budget stability. TELs offer an effective mechanism for overcoming the concentrated benefits – dispersed costs bias toward higher spending by limiting the ability of special interests to press for higher outlays. TELs typically work by indexing revenues or expenditures to certain rates of growth. For example, TELs may be linked to personal income or a combination of population and inflation (wages, consumer prices, producer prices). The index can be a moving average of earlier years, or based on the last year's growth figures. Currently, thirty states have at least one form of a TEL.[30] Twenty-three states have spending limits, four have tax limits, and three have both. About half are in the form of constitutional provisions, and the other half are required by statute. Maine, Ohio, and several other states have statutory spending or tax limit mechanisms, while states such as Colorado, have TELs embedded in their state constitutions.[31] Yet like other fiscal rules, the design and institutional setting of such a limit is imperative to its success. The state-level experience with TELs has yielded mixed results.

Poorly constructed TELs enable legislators to use evasive measures to get around the limitations. California passed its first TEL (Proposition 13) in 1978, limiting appropriations to personal income growth and population. Within the following year, it passed a second TEL (Proposition 4)—known as the Gann Limit—limiting appropriations on tax proceeds. However, the effectiveness of these limitations has diminished over time due to the ability of California voters to directly alter via ballot measures the types of taxes subject to the limit and even the benchmark of the limit.[32] Colorado's TEL, once considered the strictest in the country, succumbed to a similar fate in the referendum process.[33]

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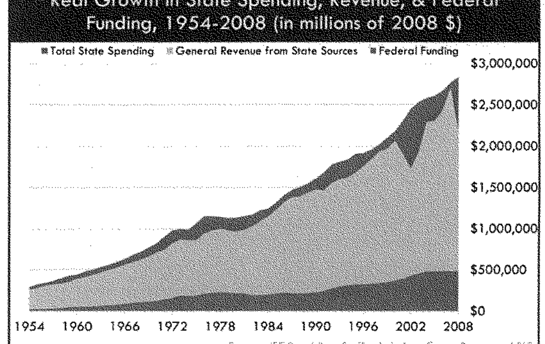
Studies that examine the various structures of TELs have found that certain TELs can be effective, but the details are critical. For example, a study by University of Alabama economist Michael J. New, an expert on state government budgets, identified three particular characteristics associated with effective TELs: (1) it limits spending growth to inflation and population growth; (2) it refunds surpluses to taxpayers automatically; (3) it adjusts automatically when states pass power to other levels of government.[34] Furthermore, studies have shown that a TEL in combination with a strict balanced-budget requirement can increase the TEL's effectiveness. In fact, if the states with the worst budget gaps in the last two years had restrained per capita spending growth to inflation-adjusted 1995 levels, 12 of the bottom 14 states would have had no gap for fiscal year 2009.[35] In general, this variety of TEL results in 3 percent less state and local spending as a share of state income relative to the average state and local spending share.[36]

Concerns about the effectiveness of TELs led to additional measures such as the use of super-majorities for tax and expenditure increases. A super-majority (sometimes referred to as an extraordinary majority) requires a higher percentage of member votes to pass than a simple majority (one-half plus one of the members voting). Super-majority requirements increase the difficulty of taking action by requiring a three-fifths, two-thirds, or three-fourths majority vote. Sixteen states currently require super-majorities to pass tax increases. Empirical studies by Crain and Miller (1990) found that super-majority requirements on state fiscal programs reduced the growth of state spending by about 2 to 4 percent. Crain (2003) found that super-majority voting requirement for a tax increase lowers per capita spending by 4 percent.[37]

Real Growth in State Spending, Revenue, & Federal Funding, 1954-2008 (in millions of 2008 $)

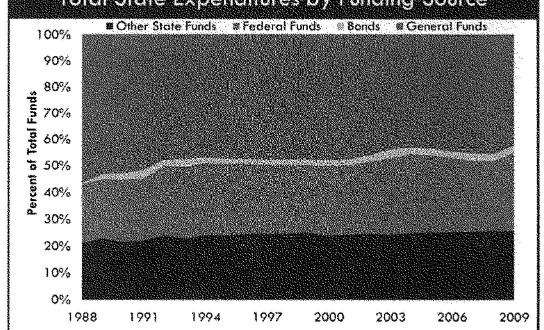
Fig. 4



Source: JEC Republican Staff calculations, Census Bureau and BLS

Total State Expenditures by Funding Source

Fig. 5



Source: National Association of State Budget Offices, and Mercatus Center

Making Fiscal Rules More Effective

In spite of the many rules in place amongst the states, a decades-long trend in growth in state spending exists relative to many measures. Over the past 50 years state spending has increased nearly tenfold (see Fig. 4). Since World War II, state and local spending has increased 34 percent faster than the private sector and 37 percent faster than the federal government.[38]

Much of this is due to a greater reliance on federal funds for specific programs requiring fund matching and mandates such as Medicaid rather than relying on general funds. In 1988 general funds accounted for 56.7 percent of total state expenditures, in 2009 general funds only accounted for 42.5 percent. Meanwhile federal funds have increased from 21.7 percent to 29.5 percent from 1988 to 2009 (see Fig. 5).[39]

The standard "ratchet theory" suggests that the federal government permanently grows larger in the long term; however, research reveals that current federal expansion also causes permanent expansion in the size of state and local governments. State and local governments tend to fill the void in funding once federal grants end by increasing taxes and other revenue sources, making for a large, long-term burden on state taxpayers. Estimates from West Virginia University economists Russell S. Sobel and George R. Crowley suggest that future state tax burdens are "ratcheted up" as high as 42 cents for every dollar of federal aid received by a state.[40]

All levels of government must address this phenomenon to slow government spending and size, and by doing so, enable state fiscal rules to be more effective. Recognizing these effects, however, many governors are now refusing federal funding. Governors Rick Scott of Florida, Scott Walker of Wisconsin, and John Kasich of Ohio have all refused a combined $3.6 billion in federal funds relating to high speed rail projects, citing exorbitantly higher costs that their respective states cannot afford.

Conclusion

Recent experience confirms the bias in democratic governments in developed countries toward higher government spending as a percentage of GDP over time. To correct for this bias in fiscal decision-making, public choice economists advocate fiscal rules to constrain policymakers.

Governments in other developed countries and U.S. states have implemented a variety of fiscal rules. Their experiences provide federal policymakers with a guide to the fiscal rules that may effectively constrain the federal government.

- **Spending caps.** A spending cap expressed as a percentage of GDP is one of the most effective tools for correcting the bias toward higher spending. By directly addressing the problem of excessive spending, a spending cap forces advocates for various programs to compete against each other for available funds instead of allowing legislators to logroll to increase overall government spending.

- **Enforcement procedure.** Spending caps are important, but absent a viable enforcement mechanism, they will do little to control the growth of government spending. The enforcement procedure should be automatic if the spending cap is breached. The enforcement procedure must be perceived by policymakers and the public as fair (generally all agencies and programs should be treated equally with few, if any, exceptions) and reasonable (any additional spending reductions imposed by the enforcement procedure should not be so large as to threaten the existence of an agency or a program or unduly harm program beneficiaries). If the enforcement procedure is both fair and reasonable, it will be credible. A credible enforcement procedure strengthens a spending cap, making it more likely that federal policymakers will make the tough decisions necessary to abide by it. This procedure should also be politically difficult to ignore or change. Ideally, any enforcement procedure should require a super-majority vote of both House of Congress to waive or change it.

- **Line item-reduction tool.** In a government based on separation of power, strengthening the role of the executive relative to the legislature in budgetary affairs reduces the growth rate of government spending over time. In U.S. states, one of the most effective means of constraining spending growth has been the item-reduction veto, which allows a governor to eliminate or reduce an item in an appropriations bill without vetoing the entire bill. While giving the President a line item-reduction veto would require a constitutional amendment, Congress can effectively create a similar line item-reduction tool for the President through enhanced rescission authority.

- **Sunset provisions.** In many U.S. states, sunset laws require state legislatures to review all existing state agencies and programs on a periodic basis. Agencies and programs that the legislature does not reauthorize before their sunset date are automatically terminated. These sunset provisions help governments identify and eliminate ineffective or duplicative programs and unnecessary agencies. Recent General Accountability Office (GAO) reports indicate the potential for savings from sunset legislation. The GAO was required to identify federal programs or functional areas where unnecessary duplication, overlap, or fragmentation exists; the actions needed to address such conditions; and the potential financial and other benefits of doing so. The GAO was also required to highlight other opportunities for potential cost savings. For example, GAO found the Department of Defense could save $460 million annually by restructuring its military health care system. The GAO also developed a range of options that could reduce federal revenue losses by up to $5.7 billion annually by examining potentially duplicative policies designed to boost domestic ethanol production. Collectively, these savings and revenues, as well as similar findings in other agencies, could result in tens of billions of dollars in annual savings, depending on the extent of actions taken.

- **Balanced-budget requirements.** While nearly all U.S. states have some form of a balanced-budget requirement, their effectiveness in restraining the bias toward higher government spending varies. The most effective requirements for balanced budgets (1) are constitutional rather than statutory, (2) require both the governor to submit a balanced budget and the legislature to enact appropriations bills that comply with the requirement, and (3) prohibit any unanticipated budget deficit from being carried forward into the next fiscal year.

  - An inherent problem with balanced-budget requirements is that they target government budget deficits rather than government spending. Under balanced-budget requirements without an explicit cap on government spending, government spending may continue to increase relative to GDP. Instead of higher government debt, rising government spending would instead be financed through higher taxes that slow economic growth and job creation.

  - Constitutional provisions for balanced budgets are not self-executing. They require statutory fiscal rules to be implemented successfully.

- **Tax and expenditure limitations.** The effectiveness of tax and expenditure limitation provisions in U.S. states varies greatly depending on their design. At the federal level, a constitutional requirement for a super-majority vote for Congress to levy new taxes or increase existing taxes would be beneficial.

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If federal policymakers are sincere in their stated desire to address the United States' looming fiscal crisis, they will seize the opportunity to implement a series of well-designed, workable, and automatically enforceable fiscal rules.

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Why a Credible Budget Strategy Will Reduce Unemployment and Increase Economic Growth

John B. Taylor*

Testimony Before the
Joint Economic Committee of the
Congress of the United States

June 21, 2011

Chairman Casey, Vice Chairman Brady and other members of the Committee, thank you very much for the opportunity to testify at this hearing on "Spend Less, Owe Less, and Grow the Economy."

Fiscal Policy and the Weak Recovery

Though the recession officially ended two years ago this month, the unemployment rate is still unacceptably high at over 9 percent. The main reason for the high unemployment is that the recovery has been very weak, and it has been weak from the start, not just during this year. For example, Figure 1 compares GDP growth during this recovery with the recovery after the 1981-1982 recession. Economic growth in this recovery has averaged only 2.8 percent, compared with 7.0 percent in the comparable period in the 1980s. In my view government policies in the fiscal, monetary, and regulatory areas are responsible for this weak recovery.

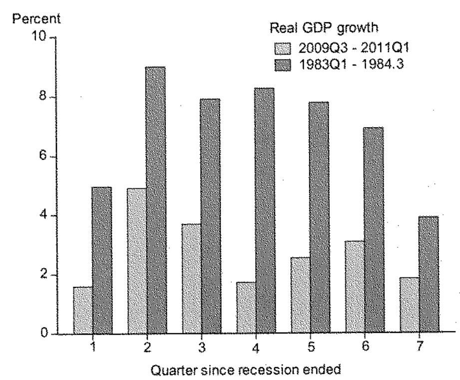

Figure 1 A Comparison of Two Recoveries

* Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford University's Hoover Institution

In the area of fiscal policy we have seen an $862 billion stimulus package and a surge in federal spending from 19.7 percent of GDP in 2007 to over 24 percent now. These interventions had little or no effect in stimulating the economy or reducing unemployment. The stimulus payments to people did not jump-start consumption. The stimulus payments to the states did not increase infrastructure spending. The cash for clunkers program merely shifted consumption a few months forward. At the same time the deficit and the debt have exploded raising the risks of higher inflation, higher tax rates, higher interest rates and a major fiscal crisis—all impediments to private investment and job creation.

The highest priority now is to end the high growth of spending and the large deficits, and thereby return to sound fiscal policy with a balanced budget and without an increase in taxes. This will remove the risks, which are holding back private investment and job creation. We do not need another Keynesian fiscal stimulus package; we need a transition to a sounder fiscal foundation that promotes private investment and creates jobs.

Figure 2 illustrates how increases in private investment are associated with reductions in unemployment. In 2006, investment—business fixed investment plus residential investment—as a share of GDP was 17% and unemployment was 5%. By 2010 private investment as a share of GDP had fallen to 12% and unemployment went up to more than 9%. These ups and downs in unemployment and investment are due both to supply and demand factors, and they are part of a regular correlation going back for many decades, and they exist in other countries.

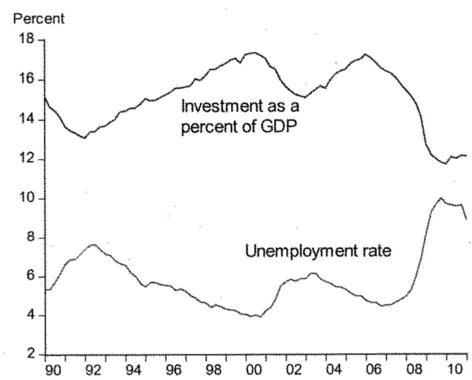

Figure 2 The Unemployment Rate in the United States and Total Fixed Investment as Percent of GDP From 1990Q1 To 2011Q1

In contrast, Figure 3 shows that higher federal government purchases of goods and services as a share of GDP are not associated with decreases in unemployment. Federal purchases are the part of federal expenditures that are a component of GDP; they do not include

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transfer payments and interest payments. When government purchases of goods and services came down as a share of GDP in the 1990s, unemployment did not rise. And the increase in government purchases as a share of GDP since 2000 was not associated with lower unemployment. To the extent that government spending crowds out job-creating private investment, it can actually worsen unemployment.

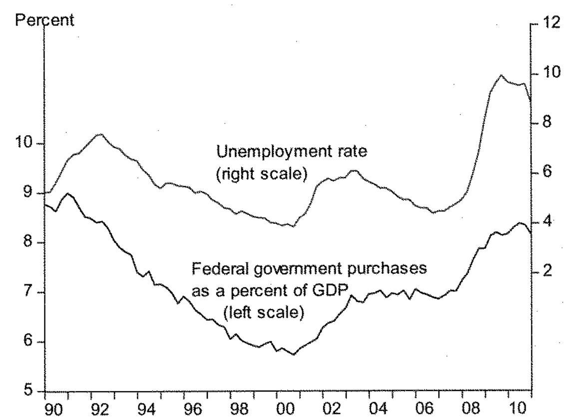

Figure 3 The Unemployment Rate in the United States and Federal Government Purchases of Goods and Services as a Percent of GDP From 1990Q1 to 2011Q1

A Credible Strategy to Restore Sound Fiscal Policy

The best way to reap the benefits of a return to a sound fiscal policy is with a credible and transparent budget strategy. Having a strategy is important because it enables the private sector to know what to expect in the years ahead and allows businesses to bolster their hiring and investing accordingly. Credibility is important because it helps alleviate people's concerns about higher future taxes or higher debt; if people are not confident that the government will follow through on promises to reduce spending in the future, then they will remain reluctant to move ahead. Economic simulations with forward-looking econometric models demonstrate the importance of credibility in budget consolidation plans.

What should such a credible budget strategy consist of? First, it should include a game-changer to demonstrate credibility; the most effective game changer would an agreement to remove the spending bulge of the past few years before it gets entrenched in government

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agencies, preferably with a down-payment in the 2012 fiscal year. The strategy should also lay out a longer term path for spending which gradually brings government outlays into equality with the amount of tax revenues generated by the current tax system; the expectation that tax rates will not increase will be an immediate stimulus. The strategy should include instructions to appropriations subcommittees that will turn the spending goals into legislation as well as reforms of entitlement programs. And the strategy should include an enforceable budget rule to keep spending as a share of GDP moving along on the path stipulated in the strategy and incorporated in the legislation.

To illustrate these points, consider Figure 4 which shows outlays as a share of GDP under several budget scenarios. The top line shows the budget submitted by the Administration in February. The graph indicates that it does not have the characteristics outlined above; it does not bring spending down as a share of GDP at all, let alone to levels needed to balance the budget without tax increases, though more recent proposals from the Administration do apparently have more reductions as a share of GDP. The lower line shows the House Budget Resolution, which does have the characteristics of the strategy outlined above, at least under the assumption that taxes will settle in the 19 percent of GDP range under current tax rates.

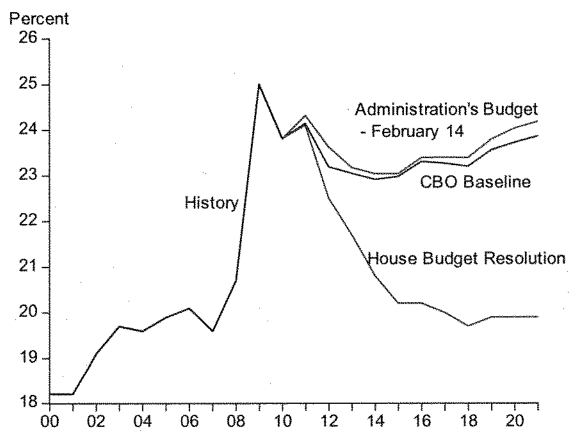

Figure 4 Federal Government Outlays as a Percent of GDP

Explaining the basic economics behind the strategy to people is essential. In my view, the strategy should be accompanied by a detailed yet simple economic explanation of why the strategy will increase economic growth and create jobs. The economic explanation should counteract claims that a strategy to restore sound fiscal policy will reduce growth or should be postponed because of the weak economy. For example, an economic explanation would show why most government agencies—such as Treasury and Commerce—can get by with the same amount of funding as a share of GDP that they had in 2007. It also should show that attempts to stimulate the economy with higher deficits and more government spending have not worked.

And it should emphasize that the strategy simply slows down the growth of total spending rather than actually cuts it.

For example, as shown in Figure 5, with the House Budget Resolution government outlays actually would grow at 2.8 percent per year over the ten years from 2012-2021 under the CBO projection that nominal GDP will grow at 4.6 percent per year. Faster GDP growth than 4.6 percent will bring a balanced budget more quickly by increasing the growth of tax revenues.

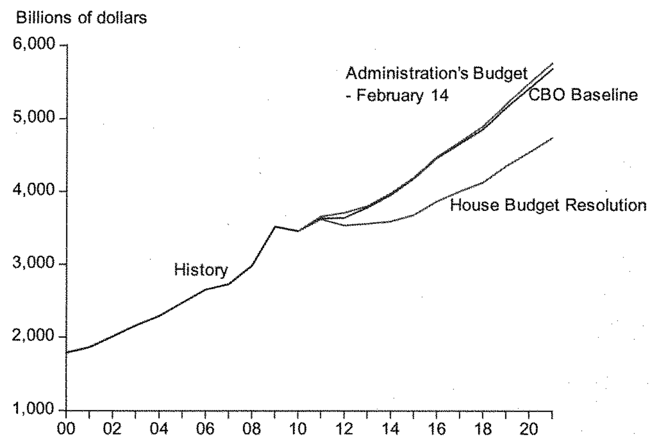

Figure 5 Federal Government Outlays

Finally, the economic explanation should emphasize that the budget strategy is one part of a larger pro-growth, pro-employment government-reform strategy which also includes monetary reform, tax reform and regulatory reform.

A Two Step Implementation

Figure 4 (or Figure 5) illustrates the difficulty of laying out a budget strategy in the current political environment. The gap between the upper and lower budget lines in Figure 4 represents huge differences of opinion on how much to reduce spending and deal with the deficit. The size of the gap between the upper and lower lines in Figure 4 is over $6 trillion. So how can one lay out a credible strategy in such a situation?

One suggestion which would preserve the idea of such a strategy in this environment would be to implement the strategy in two steps. Under step one, which would be part of the ongoing debt limit increase negotiation, there would be an agreement to reduce spending growth by about $2½ trillion over ten years, which is the amount of the debt increase needed to get through 2012. The path would be somewhere between the lines in Figure 4 or 5, but closer to the

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top line. Nevertheless, linking the slowdown in spending growth to the debt limit increase, would increase credibility in the process, as would making sure that a material part of the spending growth reductions occur in 2012, not just in the out years.

Step two of the strategy would then wait until the outcome of the elections in November of next year, and would center on whether the remaining gap of about $3½ trillion would be filled by spending growth reductions, as I have argued for here, or by tax rate increases as others have argued. Though the entire outcome would still be uncertain, the degree of uncertainty would be reduced compared to the current situation.

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Testimony submitted to the Joint Economic Committee of Congress, hearing on "Spend Less, Owe Less, Grow the Economy", June 21, 2011 (embargoed until 2pm)

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

Main Points

1) The United States needs to embark on a program of medium-term fiscal consolidation that will stabilize and, in the foreseeable future, bring down government debt relative to GDP.

2) The precise limit on debt relative to GDP for the United States is not known and hard to estimate precisely given the reserve currency status of the US dollar, the nature of alternative reserve assets (the euro, Swiss franc, Japanese yen, and British pound), and the high level of savings around the world that official and private sectors want to hold in foreign currency.

3) The best way to bring debt-GDP under control is to limit future spending increases and boost revenue while the economy continues to recover. In particular, health care spending needs to be credibly constrained. There is also a pressing need for tax reform – to reduce complexity, lower distortions, and in particular roll-back the subsidies for household and corporate debt that have crept into the system. Excessive private sector debts pose a significant systemic and fiscal risk to the economy.

4) Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."[2]

5) The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today

   a. If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently one the lowest perceived risk countries in the world – hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

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[1] This testimony draws on joint work with Peter Boone and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

[2] *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

b. It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 5 percent below its pre-crisis level. The US still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

c. If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the US today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again – for example because fiscal contraction involves laying off government workers.

d. Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency – thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control – and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

6) The available evidence, including international experience, suggests it is very unlikely that the United States could experience an "expansionary fiscal contraction" as a result of short-term cuts in discretionary federal government spending.

7) The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-GDP level at which a crisis is triggered, but with debt relative to GDP in or above the range of 90-100 percent, a country becomes much more vulnerable to external shocks – particularly if it is relying on foreign investors to buy a substantial part of its debt.

8) If such a shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect – as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious – or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

9) It is important not to oversimply fiscal concerns into precise cut-offs for "dangerous" debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

a. Greece ran into trouble in 2010 with gross debt relative to GDP of 142 percent; its debt levels in 2006 and 2007 were around 105 percent. This is a classic case of too much debt by any measure – although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece.

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b. Portugal faces a fiscal crisis with gross debt at 90.6 percent of GDP in 2011, but its debt was only 62.7 percent in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits – the markets have become unwilling to support debt that continues to increase as a percent of GDP.

c. Ireland, the third eurozone country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25 percent of GDP in 2006-07 for gross debt) but there was a big build up in off-balance sheet obligations – in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 114 percent of GDP in 2011 and debt levels will reach at least 125 percent (in our estimates, even higher) before stabilizing.

10) Within the set of industrialized countries, Japan stands out as an extreme. Government debt-relative to GDP is expected to reach 229.1 percent in 2011 (on a gross basis) and rise to 250.5 percent in 2016. On a net basis – taking out government debt held by other parts of the public sector – the equivalent figures are 127.8 percent in 2011 and 163.9 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents – and, at least for the time being, Japanese household and business savings remain high. Countries with greater reliance on foreign savers, such as the US (where nonresidents held over 30 percent of general government debt in 2010) and the UK (nonresidents held 26.7 percent of general government debt in 2010) need to be much more careful. Within the eurozone, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40-90 percent of all outstanding government debt (mostly held by other eurozone financial institutions).

11) The increase in debt relative to GDP in industrialized countries from 2007 to 2011 was about 28 percent (of GDP; unweighted average across countries, as calculated by the IMF) – most of which was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

12) Seen in that context, the increase in the US gross debt – from 62.2 percent of GDP in 2006 to 91.6 percent at the end of 2010 – was very much in line with experience in other countries. But the current trajectory of debt now, rising to 111.9 percent in 2016, is on the high end (the average debt-GDP for industrialized countries is projected to rise by about 5 percent over this period.)

13) In terms of net general government debt held by the private sector, at the end of 2011, the US is expected to have around 72.4 percent of GDP – up from 42.6 in 2007. This is not yet at a dangerous level but the future projections are not encouraging – this number will rise to 85.7 percent in 2016, according to the IMF. And in the Congressional Budget Office's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

14) In addition, the United States continues to face very large implicit liabilities in the form of implicit support available to the financial sector, both directly – if "too big to fail" global banks get into trouble – and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

15) If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector managers and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage. If sharp spending cuts follow that reduce public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

16) There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for "too big to fail" global financial institutions. Such firms are likely to damage themselves with some regularity – their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce.

17) The remainder of this testimony takes up the issue of how fast we should aim to make a fiscal adjustment in the United States.

Speed of Fiscal Adjustment: Three Scenarios

There is a growing consensus that the US faces some sort of fiscal crisis that will force an adjustment – implying some combination of lower spending and higher revenue. But there are at least three kinds of fiscal adjustment around the world today: those forced by the market, typically involving sharp spending cuts (e.g., Greece); those undertaken by governments trying to get ahead of the market, often placing greater weight on moderate tax increases (e.g., the UK); and those involving the need the control future spending on health care (almost all countries are in this boat to some degree). Where does the US fit in this comparison?

Greece

Greece, the UK, and the United States all had headline fiscal deficits around 10 percent of GDP in 2010. Their "general government balances", from the International Monetary Fund's latest *Fiscal Monitor* (http://www.imf.org/external/pubs/ft/fm/2011/01/pdf/fm1101.pdf, p.121), showed deficits of 9.6 percent of GDP, 10.4 percent, and 10.6 percent respectively. (This measure consolidates all levels of government; in a federal system, this can be misleading – but for the broad US budget picture these data are still a helpful).

Greece is in the midst of a very big fiscal adjustment. Its primary deficit – which measures the budget taking out interest payments, thus reflecting the underlying fiscal policy stance – moved from a deficit of 10.1 percent in 2009 to a deficit of 3.2 percent in 2010 and, according to the IMF (p.122), is on its way to a small primary surplus in 2012 (0.9 percent of GDP).[3] The Greeks were forced into this adjustment by the market being unwilling to continue to finance a string of

[3] The Greek program is currently being adjusted and renegotiated, so these numbers may change. But the scale and speed of fiscal adjustment will likely remain similar.

deficits – once the perception took hold that general government gross debt at 126.8 percent of GDP in 2009 and 142 percent in 2010 was simply not sustainable.

The Greek program, if it stays on track with IMF and EU support, is mostly about spending cuts relative to the size of the economy. Over 2009-2016, Greek general government expenditure is forecast to fall by more than 13 percent of GDP, from 53.2 percent to 39.6 percent of GDP (IMF, p.125). General government revenue, in contrast, will remain about the same – it was 37.8 percent in 2009 and will be 37.6 percent in 2016 (p.126). Whatever you think of whether Greece will continue to pay all its debts, in the IMF's baseline scenario, this kind of fiscal crisis leads to massive spending cuts.

United Kingdom

The UK is also making a significant fiscal adjustment from a primary balance that peaked at a deficit of 8.5 percent of GDP in 2009. The primary deficit is forecast at 5.5 percent of GDP in 2011, moving to a small primary surplus in 2015; its net debt, which does not count government debt held by other parts of the public sector, will not break 80 percent of GDP.

Despite the current rhetoric around austerity in the UK, this fiscal adjustment is actually more about increasing revenues. Over 2009-16, spending will rise slightly, from 36.8 percent of GDP in 2009 to 37.4 percent in 2016. Taxation will increase by more: it was 30.8 percent of GDP in 2009 and will be 35.4 percent in 2016.

United States

The US is still struggling to recover from a massive financial crisis, which directly reduced revenue and increased spending as employment fell sharply. The fiscal costs of banks blowing themselves up in this way are huge and the additional debt incurred will take a long time to pay off. Net general government debt will increase from 48.4 percent in 2008 to 85.7 percent in 2016.

But despite the devastating blow, the economy should return to potential output and much higher employment levels soon.

The right way to adjust for the recession and its aftermath is to look at the cyclically adjusted primary balance, i.e., what our fiscal policy stance would be if unemployment were back around 5 percent. In the US, this will move from a deficit of 2.7 percent in 2008 to a deficit of 1.6 percent of GDP in 2016. Assuming global savings continue to flow towards the United States, the short-term risks posed by this deficit level are manageable – as long as some responsible medium-term fiscal adjustment actually takes places.

US general government revenue is forecast to rise from 33.8 percent of GDP, where it was in 2006 and 2007, to 35.4 percent in 2016 – presumably the IMF expects the Bush tax cuts to be repealed at some point. US general government spending will rise from 36.6 percent of GDP in 2007 to 41.4 percent in 2016.

It's this future increase in spending that needs to be constrained in the United States. Most of this is not about discretionary spending, at least not about its domestic components – spending on overseas wars continues to be a significant issue. And not much is about pensions either; the IMF's projections of net present value of pension spending change over 40 years, 2010-50, are 23.5 percent of GDP, one of the lowest in the industrialized world.

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But the US is definitely at the bad extreme of the charts when it comes to future health care spending. The net present value (NPV) of the change in health care spending, 2010-50, is 164.5 percent of GDP, the highest in the industrialized world (p.129). Among comparable countries, Sweden seems to have this under control at 11.7 percent. Greece and the UK have looming problems – NPV of 106.9 percent and 113.3 percent respectively – but most industrial countries have this number contained in the range of 30-80 percent of GDP (still, not good news for anyone).

US healthcare costs incurred by the government will increase by 5.1 percent of GDP between 2010 and 2030, according to the IMF projections (p.129). This is the clear and present danger – which is somehow lost in the rhetoric of the current fiscal debate.

There are three ways to deal with the real US fiscal crisis: ignore it, which would be a bad mistake; transfer rising health care costs off the government budget and onto individuals and firms, which would seriously impede private sector growth; or really find ways to limit future increases in health care costs.

American Enterprise Institute for Public Policy Research

Testimony before the Joint Economic Committee

Regarding Fiscal Consolidations

Kevin A. Hassett

Director of Economic Policy Studies

American Enterprise Institute

June 21, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

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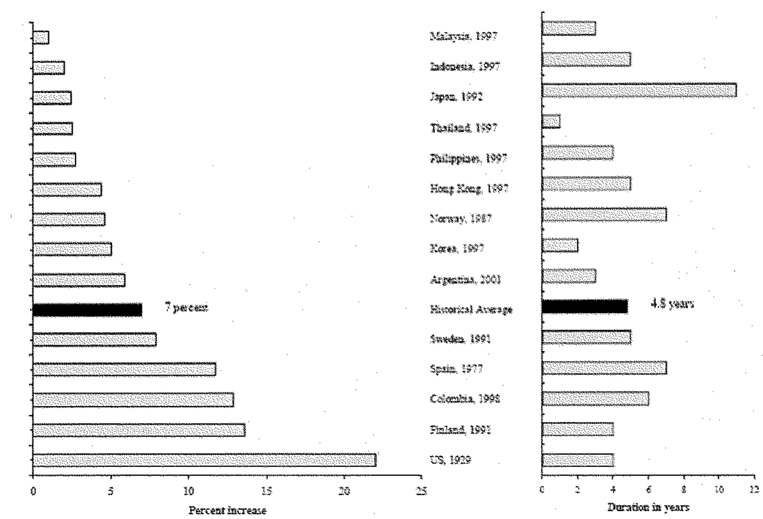
As we gather today, the third anniversary of the collapse of Lehman Brothers approaches. Even after all of that time, the U.S. economy continues to disappoint, and the U.S. labor market has hardly made any progress at all. The latest economic data suggests that growth has moderated considerably, while inflation is picking up, and fears of stagflation, not seen since the 1970s, are renewed.

The sorry state of the current economy is the predictable result of a serious policy error that appears to have been motivated by a fundamental misunderstanding of the economic challenges we face as a nation.

Those challenges should have been clear. Economists Carmen Reinhart and Kenneth Rogoff have studied the history of financial crises and found that they inevitably create lengthy periods of slow economic growth. As can be seen in Figure 1, which is taken from their study, the typical duration of the employment downturn after a financial crisis is 4.8 years.[1] Another study found that economic growth rates tend to be lower for as much as a decade after the crisis.[2]

Figure 1:

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



[1] Reinhart and Rogoff (2009)
[2] Reinhart and Reinhart (2010)

Given that such a lengthy period of slow growth is the challenge, it was a mistake to address it with short term Keynesian stimulus. Here is why.

While there is debate about the size of the multiplier effects of a Keynesian stimulus, let us assume, for the sake of argument, that they are substantial. Even then, the effect of the stimulus is to increase GDP when the higher spending is present, reduce GDP in an approximately equal and opposite manner when it is removed, and then reduce GDP again when taxes are raised to pay for the endeavor. The key observation is that the total effect is negative. The near term positive effect on growth is paid for in the long run with two hangovers.

Such a policy might be defensible if the economy were in a typical post-war recession, which can be expected to last a bit less than a year, and be followed by a recovery with sharply higher growth. In such a case, adding a percent or two of growth during the recession might well be worth having three percent growth instead of five percent growth in the recovery. But in the lengthy, slow-growth slog out of financial crisis, the hangovers arrive before growth has lifted off. Indeed, Keynesian stimulus in this circumstance will inevitably run the risk of tossing the economy back into recession even if one adopts the view that it is "effective."

What's worse, the reliance on stimulus can easily become addictive. As each stimulus wears off, the economy inches perilously closer to recession and then calls for another stimulus emerge. But at some point, and I believe we are close to that point, the process threatens our solvency.

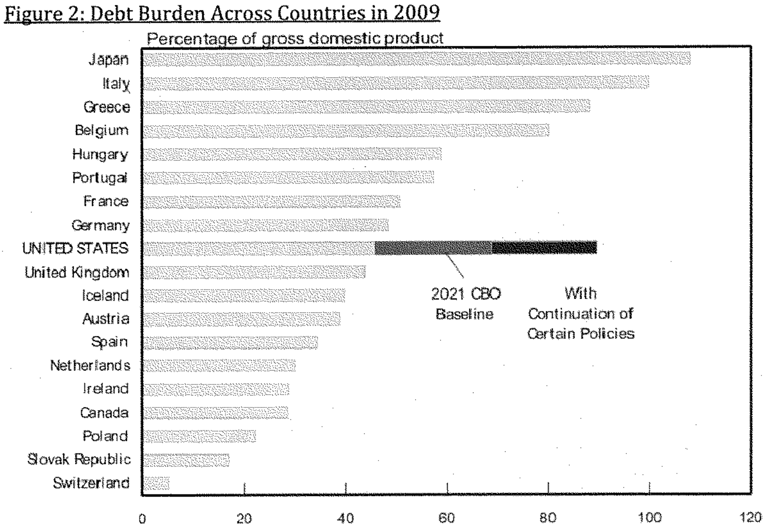
The U.S. public debt to GDP has risen from 53 percent in 2009 to 69 percent in 2011 (as reported by the CBO). The deficit under current law assumptions will total approximately $7 trillion over the next ten years, and debt to GDP will reach nearly 77 percent by 2021.

However, the current law forecast does not include the continuation of certain policies such as adjustments to the alternative minimum tax and maintaining current Medicare physician payment rates, which have become expected conventions. Nor does it account for possible extension of the Bush tax cuts beyond 2013.

CBO Director, Doug Elmendorf remarked in February "If those policies were extended permanently, deficits over the coming decade would average about 6 percent of GDP and would cumulate to nearly $12 trillion. Debt held by the public in 2021 would rise to almost 100 percent of GDP, the highest level since 1946."[3] From the director's chart, Figure 2 below, such a scenario would put the U.S. at roughly the same share of debt as Greece in 2009.[4]

[3] Congressional Budget Office Director's Blog, February 25, 2011
[4] Elmendorf presentation to the National Economists Club, February 24, 2011

Figure 2: Debt Burden Across Countries in 2009



Notes: For the United States, debt held by the public net of financial assets. For other countries, general government debt net of financial liabilities as reported by the Organisation for Economic Co-operation and Development (OECD).

That means that the painful process Greece is going through today may be around the corner for us. The day of reckoning may be even sooner if we pursue yet another deficit-financed spending binge. The good news is that there is substantial reason to believe that there is a way out of this destructive Keynesian cycle.

Over the past several decades many developed countries have undertaken fiscal adjustments in attempts to reduce high debt levels. These countries' restructurings had varying degrees of success and failure, both in reducing debt and in stimulating growth. The economics literature has focused on answering two main questions in this area: what aspects of fiscal consolidations produce lasting reductions in debt, and what aspects encourage macroeconomic expansion?

The answer to the first question is clear. Based on a review of the economics literature and analysis of 21 OECD countries, two of my colleagues and I recently found that cutting expenditures is more likely to produce a lasting reduction in debt than increasing revenues.[5] It is also typical that the more aggressively a country cuts expenditures, the more likely it is to successfully reduce debt in the long term. Averaging across a range of methodologies, the typical unsuccessful fiscal consolidation consisted of 53 percent tax increases and 47 percent spending cuts. The typical successful fiscal consolidation

[5] Biggs, Hassett, and Jensen (2010)

consisted of 85 percent spending cuts.[6] In particular, cuts to social transfers and the government wage bill are more likely to reduce debt and deficits than cuts to other expenditures.

There is more debate over the second question: what aspects of fiscal consolidation encourage macroeconomic expansion? The essence of the debate hinges on the balance between two economic effects of fiscal consolidation, the expectational effect and the Keynesian effect. The *expectational* effect is the positive effect on consumption and investment that occurs when policy is put on a sustainable path. These likely surge after a consolidation because of expectations of lower future tax liabilities.

In other words, an immediate consolidation will alleviate the hoarding that accompanies fears of a larger and largely tax-driven consolidation in the future. Expenditure based consolidations would provide stronger expectational effects, because there is a better chance they are successful at reducing debt, and because higher near term taxes are hardly designed to ignite optimism in investors and consumers. The Keynesian effect reduces aggregate demand and therefore GDP growth.

The controversy is over whether the expectational effects of fiscal consolidation can completely outweigh the Keynesian effects in order to create short-term growth. There is less controversy around the view that the long-term benefits of fiscal consolidation are substantial. Two schools of thought have emerged in the debate. Harvard economist Alberto Alesina and his various coauthors argue that consolidation, especially expenditure cuts, can lead to a burst of growth starting immediately.[7] A team of IMF economists, however, identified possible methodological flaws in Alesina's studies and claim that the typical fiscal consolidation would be contractionary.[8]

It is beyond the scope of this testimony to resolve the dispute between the two corners of the literature. A fiscal consolidation optimist would believe that the Alesina work is correct, and then would expect that a large fiscal consolidation in the U.S. would lead to significant positive growth effects even in the near term.

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[6] Many papers from the peer-reviewed literature confirm these results. Alesina and Perotti (1996) report that successful consolidations were 64 percent expenditure cuts and 37 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Alesina and Ardagna (1998) report that successful consolidations were 62 percent expenditure cuts and 38 percent revenue increases. Unsuccessful consolidations were -79 percent expenditure cuts and 178 percent revenue increases. Alesina and Ardagna (2009) report that successful consolidations were 135 percent expenditure cuts and -35 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Von Hagen and Strauch (2001) report that successful consolidations were 52 percent expenditure cuts and 48 percent revenue increases. Unsuccessful consolidations were 12 percent expenditure cuts and 88 percent revenue increases. Zaghini (1999) reports that successful consolidations were 77 percent expenditure cuts and 23 percent revenue increases. Unsuccessful consolidations were 2 percent expenditure cuts and 98 percent revenue increases. McDermott and Wescott (1996) found that expenditure based consolidations have a 41 percent chance of success; whereas revenue based consolidations have a 16 percent chance of success.

[7] Alesina and Ardagna (2009), Alesina and Ardagna (1998), and Alesina and Perotti (1996)

[8] Leigh, et at. (2010)

A pessimist would point to the alternative work of the IMF and argue that the growth effects are more uncertain. But it is important to note that even in this case, the IMF study points to positive growth effects if the fiscal consolidation is correctly designed.

That is, both sides of the literature find that reducing expenditures will provide a better growth outcome than increasing revenues. Although the IMF finds that a tax-based consolidation would reduce GDP by around 1.6 percentage points three years following implementation, they find that the negative effects of a spending-based consolidation would be small and statistically insignificant. That is, even in the most pessimistic corner of the fiscal consolidation literature, there is little to dissuade us from pursuing a consolidation today. Moreover, they find that spending-based consolidations that are focused primarily on transfer cuts could produce positive near-term growth effects.

The latter point is especially interesting since the authors study near-term cuts in entitlements. One might expect these to have a relatively large short-run negative effect on consumption behavior. The fact that expectational effects dominate even when entitlements are cut immediately suggests that out-of-control entitlement spending has a profoundly negative impact on forward-looking sentiment and business and consumer confidence.

This result also suggests a policy opportunity. Given the massive imbalances that exist today, it is likely that consumers have very little faith that current programs will remain in place throughout the course of their lifetimes. Accordingly, cuts to entitlements that phase in gradually over time will likely have little impact on their perceived lifetime wealth, as the benefit cuts are effectively already factored into consumer expectation. If consumers don't expect promised benefits to be paid, government can reduce promised benefits without causing today's consumption to go down.

Which means, of course, that the expectational effects of a fiscal consolidation could easily be expected to dominate and produce significant near-term growth if there are few immediate cuts to benefits but significant longer-term cuts. If, in addition, the fiscal consolidation were paired with a tax reform that broadened the tax base and reduced marginal tax rates, then a significant growth spurt would be the natural expectation to draw from the economic literature.

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June 21, 2011

TESTIMONY OF CHAD STONE
Chief Economist, Center on Budget and Policy Priorities

Before the
Joint Economic Committee
United States Congress

Hearing on "Spend Less, Owe Less, Grow the Economy"

Vice Chairman Brady and other members of the Committee, thank you for inviting me to testify. I feel especially privileged to be appearing as a witness before the Joint Economic Committee, which together with the President's Council of Economic Advisers — both established by the Employment Act of 1946 — provided (in stimulus language) about 14 full-time-equivalent-years of employment for me personally, but more important provided me with a valuable education in economic policymaking.

I commend the JEC for holding this hearing on the critical economic policy concern of our time — one that echoes the concerns underlying enactment of the Employment Act over six decades ago — and that is finding the right set of policies to help the economy emerge from its current deep slump and achieve sustainable economic growth with high employment and broadly shared prosperity.

U.S. policymakers must make smart choices about taxes, spending, and deficits to meet this challenge. Making smart choices requires differentiating between 1) the longer-term policies needed to produce sustainable growth and broadly shared prosperity at high levels of employment and 2) the short-term policies needed to restore high levels of employment in the wake of a deep recession. In particular, policies aimed at reducing the budget deficit are a key ingredient of longer-term policy but are likely to be counterproductive in the short run if implemented too precipitously.

This is the mainstream economic position, as enunciated by Federal Reserve Chairman Ben Bernanke a week ago, speaking at the Annual Conference of the Committee for a Responsible Federal Budget:

> Fiscal sustainability is a long-run concept. Achieving fiscal sustainability, therefore, requires a long-run plan, one that reduces deficits over an extended period and that, to the fullest extent possible, is credible, practical, and enforceable. In current circumstances, an advantage of taking a longer-term perspective in forming concrete plans for fiscal consolidation is that policymakers can avoid a sudden fiscal

contraction that might put the still-fragile recovery at risk. At the same time, acting now to put in place a credible plan for reducing future deficits would not only enhance economic performance in the long run, but could also yield near-term benefits by leading to lower long-term interest rates and increased consumer and business confidence.[1]

The Congressional Budget Office has made similar points in its Economic and Budget Outlook:

> To prevent debt from becoming unsupportable, policymakers will have to substantially restrain the growth of spending, raise revenues significantly above their historical share of GDP, or pursue some combination of those two approaches. The longer the necessary adjustments are delayed, the greater will be the negative consequences of the mounting debt, the more uncertain individuals and businesses will be about future government policies, and the more drastic the ultimate policy changes will need to be. But changes of the magnitude that will ultimately be required could be disruptive. Therefore, policymakers may wish to implement them gradually so as to avoid a sudden negative impact on the economy, particularly as it recovers from the severe recession, and so as to give families, businesses, and state and local governments time to plan and adjust.[2]

At the Center on Budget and Policy Priorities, we have enunciated a recommended framework for measures to achieve fiscal sustainability.[3] We believe the United States should enact policies to put deficits and debt on a sustainable path, which in practical terms means reducing the budget deficit over the coming decade to no more than about 3 percent of GDP in order to stabilize the debt-to-GDP ratio. Like the Fed and CBO, we believe that policymakers should meet this fiscal stabilization goal in a reasonable period of time, but it is important to avoid a sudden negative impact on a still-fragile recovery by implementing it too precipitously.

I recognize that one of the purposes of this hearing is to highlight a different point of view from what I regard as this mainstream economic consensus. This alternative point of view appears to be based on three premises: that the United States faces an immediate debt crisis due to an unwarranted explosion of government spending; that immediate sharp reductions in government spending are necessary and could even make the economy grow faster in the short run; and that deficit reduction is more likely to be successful if it is composed largely of spending cuts rather than tax increases.

In the remainder of my testimony I will discuss why I find all three of these arguments unpersuasive, with the empirical support for them being weak and largely irrelevant to current U.S. economic conditions. In addition, I am concerned that insistence on large *immediate* budget cuts, and

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[1] Ben S. Bernanke, "Fiscal Sustainability: Remarks at the Annual Conference of the Committee for a Responsible Federal Budget," Board of Governors of the Federal Reserve System, June 14, 2011: http://www.federalreserve.gov/newsevents/speech/bernanke20110614a.pdf.

[2] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021," CBO, January 2011: http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf

[3] Robert Greenstein, "A Framework for Deficit Reduction: Principles and Cautions," Center on Budget and Policy Priorities, March 24, 2011: http://www.cbpp.org/files/3-24-11bud.pdf

opposition to any kind of revenue-raising measures — including raising revenues by narrowing unproductive economically inefficient tax expenditures — constitutes a barrier to enacting the kind of credible, practical, and enforceable deficit reduction plan that we should be striving to implement.

The remainder of my testimony is organized into three sections that make the following key points:

- **Policies enacted since the 2008 election are not the main drivers of deficits and debt.** The U.S. fiscal imbalance problem is a long-term problem that has little to do with the short term imbalances that have emerged as a result of the financial crisis and Great Recession. The main driver over the long term is unsustainable growth in health care costs throughout the U.S. health care system, in the public and private sectors alike. Increases in the deficit due to policies enacted over the past few years are temporary and only their relatively modest associated interest costs add to longer term deficits.

- **Large immediate cuts in government spending will hurt the still-fragile economic recovery.** Economic and budget conditions in the United States are very different from those in countries deemed to have had successful fiscal adjustments. Looking at the empirical literature on "expansionary austerity," the International Monetary Fund found little empirical support for the idea that immediate sharp reductions in government spending strengthen an economic recovery. The Congressional Research Service found that fiscal adjustments beginning in a slack economy such as the United States is now experiencing have a low probability of success.

- **International evidence has little to say about how much of U.S. deficit reduction should be spending cuts and how much should be revenue increases.** The United States needs a long-term deficit-reduction plan and most of the empirical literature is about short-sharp fiscal consolidations under very different economic and budget circumstances from those we face. The literature on short, sharp adjustments has nothing to say about the composition of a long-term deficit reduction package or the proper size of government. It also does not come to grips with the fact that the United States is unique in the extent to which it relies on the tax code to do what other countries do directly through government spending – the so-called tax expenditures. Finally, it ignores lessons from successful longer-term deficit reduction efforts such as the United States pursued in the 1990s, when revenue measures were a significant component of the 1990 budget agreement and the deficit reduction act of 1993, which were followed by the longest economic expansion in our history and a balanced budget by the end of the decade.

What's Driving Deficits and Debt?

As Fed Chairman Bernanke said in the speech cited earlier,

> The nation's long-term fiscal imbalances did not emerge overnight. To a significant extent, they are the result of an aging population and fast-rising health-care costs, both of which have been predicted for decades.[4]

[4] Bernanke, 2011

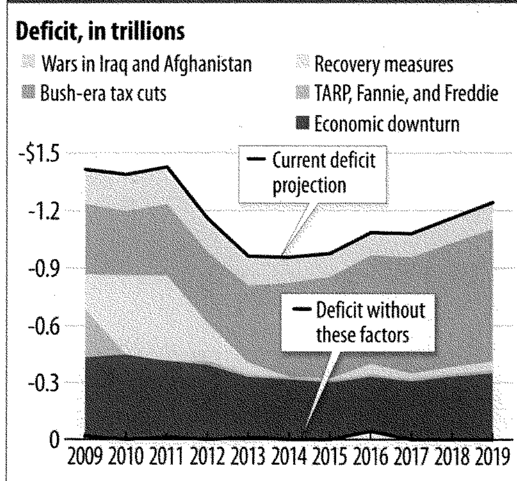
CBO, we at CBPP, and other budget experts were warning that federal budget deficits and debt were on an unsustainable long-run path well before the recent financial crisis and recession and that the main driver over the long term is unsustainable growth in health care costs throughout the U.S. health care system, in the public and private sectors alike.

Most recently, the sharp increase in budget deficits and debt reflects temporary effects of the financial crisis and deep recession and the policies implemented to keep the economy from plunging into an even deeper economic hole.[5] But analysis shows that other factors are driving projected deficits and debt over the next decade.[6]

The accompanying charts are based on CBO's latest budget projections, with adjustments to show projected deficits and debt under current policies (including the extension of all the Bush-era tax cuts and AMT relief through the end of the decade). The charts also show our estimates of the budgetary impact (including associated interest costs) of the economic downturn and various policy changes enacted over the past decade. Those estimates of specific budgetary impacts are also based on information from CBO and the Joint Committee on Taxation.

Figure 1 focuses on the projected deficit going forward. It shows that the economic downturn, tax cuts enacted under President Bush, and the wars in Afghanistan and Iraq explain virtually the entire federal budget deficit over the next ten years. The economic downturn added about $300 billion chiefly from the operation of the automatic stabilizers (declining revenue and increased outlays for unemployment insurance and other pro-cyclical spending) and associated interest costs. Both the financial-market measures enacted under President Bush and largely implemented under President Obama such as the Troubled Asset Relief Program (TARP), and the Recovery Act tax cuts and increases in spending enacted under President Obama, were important drivers of the surge

FIGURE 1:
Factors Driving Budget Deficits, 2009-2019



Source: CBPP analysis based on Congressional Budget Office estimates

[5] Alan S. Blinder and Mark Zandi, "How the Great Recession Was Brought to an End," July 27, 2010: http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf

[6] Kathy A. Ruffing and James R. Horney, "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits," Center on Budget and Policy Priorities, May 10, 2011: http://www.cbpp.org/files/5-10-11bud.pdf

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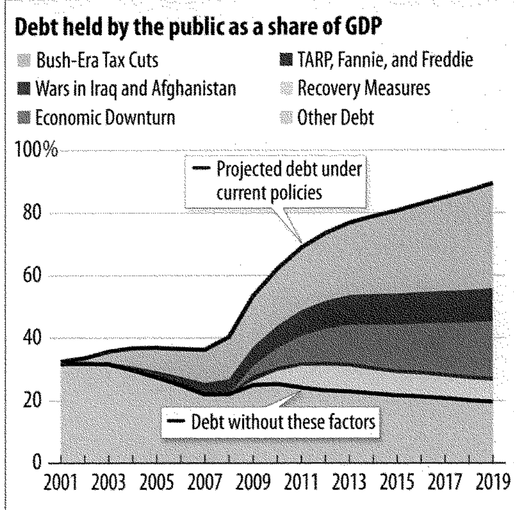
in deficits in 2009-11, but those measures will largely have phased out by the end of this year, leaving only associated interest costs in subsequent years.

FIGURE 2:
Factors Driving Debt, 2001-2019



Source: CBPP analysis based on Congressional Budget Office estimates

The second, complementary, chart (Figure 2), shows that the Bush-era tax cuts and the Iraq and Afghanistan wars — including their associated interest costs — account for almost half of the projected public debt in 2019 if we continue current policies. Taken together, the economic downturn, the measures enacted to combat it (including the 2009 Recovery Act), and the financial rescue legislation play a significant — but considerably smaller — role in the projected debt increase over the next decade. Public debt due to all other factors than those specifically identified in Figure 2 falls from over 30 percent of GDP in 2001 to 20 percent of GDP in 2019.

The debt chart (Figure 2) looks at debt held by the public, which reflects funds that the federal government borrows in credit markets to finance deficits and other cash needs. Debt held by the public is basically the cumulative sum of all past budget deficits minus surpluses. It's the proper measure on which to focus because it's what really affects the economy.[7] Analysts compare it to GDP because stabilizing the debt-to-GDP ratio is a key test of fiscal sustainability.

This economically and financially meaningful measure of the debt is different from the seriously flawed measures more likely to crop up in discussions of the debt problem: gross debt and its close cousin, *debt subject to statutory limit*. These measures are larger, and therefore perhaps viewed as more scary, than debt held by the public, because they include debt the government *owes to itself*, such as the money the Social Security trust fund has lent to the Treasury in years when Social Security's earmarked revenues exceeded expenditures. As CBO explained in a recent report,[8] however, gross debt "is not a good indicator of the government's future obligations," and the Treasury securities held by trust funds "represent internal transactions of the government and thus have no direct effect on credit markets."

[7] James R. Horney, Kathy A. Ruffing, and Paul N. Van de Water, "Fiscal Commission Should Not Focus on Gross Debt," Center on Budget and Policy Priorities, July 21, 2010: http://www.cbpp.org/files/7-21-10bud.pdf

[8] Congressional Budget Office, *Federal Debt and Interest Costs*, December 2010, Chapter 2: http://www.cbo.gov/ftpdocs/119xx/doc11999/12-14-FederalDebt.pdf

To sum up this discussion of drivers of deficits and debt, these charts refute the notion that ongoing increases in deficits and debt arise mainly as a result of policies instituted since President Obama was elected. Take away the Bush-era tax cuts, and budget deficits are significantly smaller over the rest of this decade and the debt is stable (rising only about as fast as the economy is growing) over the second half of this decade. Of course, the serious long-term budget deficits associated with rising health expenditures and an aging population would still be there and the imperative to stabilize the longer-term deficit would remain.

The bottom line is that the recession and actions taken to combat it added temporarily to the deficit and bumped up the *level* of the debt, but the long term problems that were evident in 2007 remain the major drivers of the long term deficit. We could stabilize the debt-to-GDP ratio over the coming decade by taking actions like those recommended in CBPP's deficit-reduction principles paper.[9] We would still have to come to grips with rising costs throughout the U.S. health care system, however, to keep the debt-to-GDP ratio stable over a longer horizon.

The False Promise of Expansionary Austerity

Mainstream economic policy analysis has identified various clear symptoms of a debt crisis, and of economies in which excessive government spending or stimulus crowds out private economic activity. When a debt crisis hits, interest rates spike because investors are worried about financial losses on their holdings of government securities, through either inflation or outright default, and seek to liquidate their holdings or at least demand a higher risk premium. In the case of crowding out, interest rates and inflation rise due to the strain of surging aggregate demand on the economy's productive capacity.

There are numerous instances of countries experiencing one or the other (or both) of these situations, as evidenced in the large set of historical data on industrialized countries compiled by the Organization for Economic Cooperation and Development (OECD). But the United States right now is *not* one of them. Interest rates are very low, core inflation (which excludes volatile food and energy prices) remains low, and there is a substantial gap between the output that the economy would be able to produce with full utilization of its existing labor force and productive capacity ("potential output") and the output it is actually producing.

Under these circumstances, and with the economic recovery still struggling to gain the traction it needs for the United States to make strong progress toward restoring high levels of employment and shared prosperity, I take the warnings from Fed Chairman Bernanke and the CBO about trying to reduce budget deficits too quickly just as seriously as I take their warnings about the perils of failing to seriously address the budget deficit. We learned in the 1990s that a strong economic recovery makes deficit reduction easier. Accepting larger budget deficits in the short term in order to put the recovery on a sounder footing is fully consistent with putting in place a credible plan for achieving longer-run fiscal sustainability, although there is a tension.

[9] Greenstein 2011. That paper suggests a combination of reasonable savings in discretionary programs, some tax loophole closures, and various entitlement reforms that can be enacted now (for example, in farm subsidies and some other programs, along with some relatively modest additional savings in Medicare that can be taken now) — in conjunction with letting the Bush tax cuts expire after 2012 (or paying for those tax cuts that are extended).

That tension is absent in the conclusion that people are apt to draw from the JEC Republicans' study that gives this hearing its title or from the American Enterprise Institute paper co-authored by my fellow witness Kevin Hassett. The JEC Republican Study, "Spend Less, Owe Less, Grow the Economy" states that "a growing body of empirical studies *proves* that fiscal consolidation programs based predominantly or entirely on government spending reductions are far more likely to be successful" at stabilizing deficits than programs based on tax increases [emphasis added]. The report argues that "quick, decisive government spending reductions" are a key to success and that deficit-reduction programs focusing on spending cuts "may even boost the real GDP growth rate in the short term under certain circumstances."

The studies on which these conclusions are based, most prominently one by Harvard economists Alberto Alesina and Sylvia Ardagna, examine disparate countries facing disparate economic and budget situations under disparate global economic conditions. The limitations of this work, many of them self-acknowledged, deserve much greater scrutiny. I want to make the following points, which also are made in an important report on these issues that the Congressional Research Service recently issued:[10]

- *Evidence that cutting spending increases GDP in the short term is very weak.* The International Monetary Fund has concluded with regard to Alesina and Ardagna's study, "The idea that fiscal austerity triggers faster growth in the short term finds little support in the data."

- *Evidence that a deficit-reduction program focused on spending cuts can promote short-term growth and long-term fiscal stability is slim.* Alesina and Ardagna identified 107 episodes of "large" deficit-reduction programs. Among these, we count only nine that they characterized as both "successful" (i.e., the program stabilized the debt) and "expansionary" (i.e., it did not harm economic growth in the short term). All nine occurred in small, mainly Scandinavian economies: Finland, Ireland, the Netherlands, New Zealand, Norway, and Sweden. All are much smaller economies than the U.S., and the Scandinavian countries have significantly larger public sectors.

- *U.S. macroeconomic and budget conditions aren't right for sharp spending cuts.* When analysts began to examine the specific episodes Alesina and Ardagna found in which spending cuts boosted short-term growth, they found that *none* of them took place in a country still feeling the effects of a large recession as the United States is now, with substantial economic slack, low interest rates, tepid economic growth, and high unemployment. [11] The CRS study reached similar conclusions and found, in addition, that "Almost nine out of ten fiscal adjustments beginning when actual output was below potential output were unsuccessful — fiscal

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[10] Jane G. Gravelle and Thomas L. Hungerford, "Can Contractionary Fiscal Policy Be Expansionary?" Congressional Research Service Report R41849, June 6, 2011.

[11] Arjun Jayadev and Mike Konczal, "The Boom Not the Slump: The Right Time for Austerity," The Roosevelt Institute, August 23, 2010: http://www.rooseveltinstitute.org/sites/all/files/not_the_time_for_austerity.pdf and Dean Baker, The Myth of Expansionary Fiscal Austerity, Center for Economic and Policy Research, October 2010: http://www.cepr.net/documents/publications/austerity-myth-2010-10.pdf

adjustments beginning in a slack economy (such as the current situation in the U.S.) appear to have a low probability of success."[12]

The IMF's reading of the international evidence is that immediate sharp deficit reduction harms short-term economic growth, whether it is achieved primarily through spending cuts or through tax increases. While the IMF finds that growth falls less in episodes dominated by spending cuts, that's mainly because the monetary policy response (how much interest rates are cut) has tended to be greater in such episodes than in those dominated by tax increases. That's all a far cry from saying that the best thing for the U.S. economy is to cut spending immediately or that future U.S. deficit-reduction efforts should consist mostly or entirely of spending cuts.

The countries that boosted growth could do so because falling interest rates from an expansionary monetary policy stimulated investment, because a depreciating currency stimulated net exports to cushion the drop in consumption stemming from the spending cuts, or some combination of the two. *The United States does not have these options now*: interest rates are already very low, and our major trading partners are still feeling the effects of the financial crisis and recession themselves.

The CRS summarizes its report this way:

> The findings in the Alesina and Ardagna study that successful debt reductions were associated with higher growth when spending cuts were used was based on 9 observations out of 107 instances of deficit reduction, or less than 10% of the sample. In addition, most of the countries where debt reductions were successful were at or close to full employment, while the United States remains well below full employment, raising questions as to whether this evidence is applicable to current U.S. conditions. Thus, both methodological questions and questions of applicability to current circumstances can be raised for the Alesina and Ardagna, and similar, studies.

The claim that government spending is crowding out productive private investment at a time when the economy has considerable economic slack goes as much against mainstream economic analysis as the arguments that deep budget cuts in a weak economy will trigger stronger growth and job creation. For government spending to crowd out private spending, the workers, factories, and machines needed to meet the demand generated by the government spending would have to be diverted from other productive activities. To be sure, that can occur in a high-employment economy with no economic slack. But the current situation is very different. For example, when the government provides additional unemployment insurance (UI) benefits to workers struggling to find a job, businesses are helped rather than harmed: the benefits increase consumer demand for goods and services and thereby enable businesses to put unemployed workers back to work and put idle capacity back into production (or to refrain from cutting workforces and production even further).

The crowding out argument would have more force if the economy today looked more like the economy in the 1990s expansion — the longest in our country's history and the last time we had a

[12] Gravelle and Hugerford, p.12.

balanced budget. But in today's economy, weak demand, not competition for funds, is the much more plausible explanation for inadequate investment and job creation.

The premise of the "Spend Less, Owe Less, Grow the Economy" view is that the United States is already in the midst of a debt crisis and immediate action is imperative. Yet investors believe otherwise, as demand for U.S. securities remains strong and interest rates remain at historic lows. Similarly, the Federal Reserve remains more concerned about slack resources and high unemployment than an outbreak of inflation, and Chairman Bernanke is cautioning against immediate sharp spending cuts.

Expansionary Austerity Literature No Help for Long-Term Deficit Reduction

Since the United States doesn't have sharply rising interest rates or other symptoms of an imminent debt crisis, we shouldn't be debating which immediate deficit-reduction steps would be least destructive to the economic recovery. Instead, we should be debating how to strengthen the recovery in the short run while putting in place a sound long-run deficit-reduction program. International evidence on short, sharp adjustments offers no help in that regard, and offers no insight on what the composition of deficit reduction between spending cuts and revenue increases should be. That should not be surprising to anyone who has noted the caveats in the austerity literature. The following two are notable:

- Alesina and Ardagna say in their widely cited study: "Thus, the study of these episodes *gives a clue* on what happens with *sharp and brief* changes in the fiscal stance." (emphasis added). How much can a "clue" about "sharp and brief" changes in fiscal stance tell us about the appropriate composition of a *long-term* deficit reduction strategy?

- In their study, revealingly titled "Limiting the Fall-Out from Fiscal Adjustment," Goldman-Sachs analysts Ben Broadbent and Kevin Daly say:

> It is easy to misinterpret the result as a commentary on the — inherently political — question of what constitutes an appropriate level of taxes and government spending in the long run. In this regard, we emphasize at the outset that the results in the literature, and what we add to that here, are only about the *transition* to fiscal sustainability, not about the size of the government once you arrive at that position. The empirical evidence is much more equivocal with regards to the appropriate size of government in the long run and we do not attempt to comment on this.[13]

As CRS observes, "The mix of policies (tax increases, spending cuts, and the types of either) depend on many factors including preferences for public programs and distributional objectives, as well as growth."[14]

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[13] Ben Broadbent and Kevin Daly, "Limiting the Fall-Out from Fiscal Adjustment," Goldman-Sachs Global Economics Paper No: 195, April 14, 2010, p. 4: http://www2.goldmansachs.com/ideas/global-economic-outlook/limiting-the-fallout-doc.pdf

[14] CRS 2011

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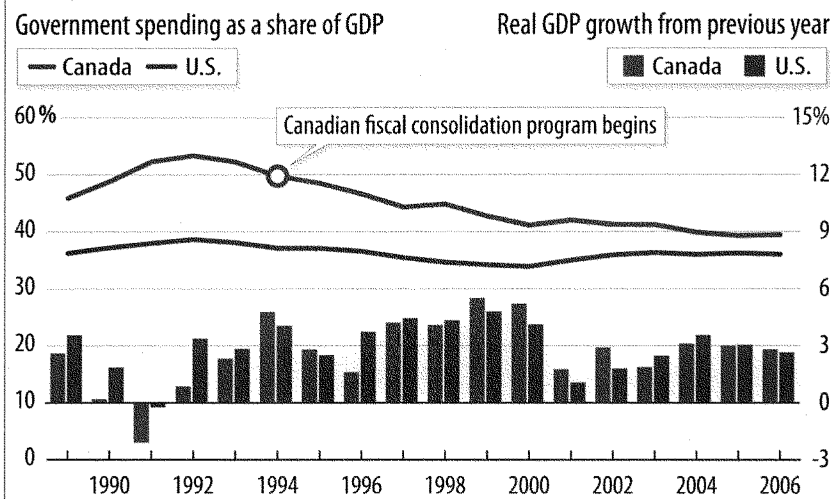
It is also instructive to delve deeper into specific case studies to see how well the case for expansionary austerity holds up. The JEC Republican study, for example, offers Canada in the 1990s as a case study of a country that turned around a deteriorating budget situation by cutting government expenditures while enjoying stronger economic growth than it had prior to enacting those cuts. But that account leaves out critical details, including the fact that, historically, Canadian economic performance has been closely tied to U.S. economic performance. The chart below reproduces data for Canada from the report on government expenditures at all levels as a share of gross domestic product (GDP) and economic growth and adds comparable U.S. data. Two things stand out:

FIGURE 3:
Strong U.S. Economy Big Factor in Canada's Success in the 1990s



Source: OECD

- The pattern of economic growth is very similar in both countries, with growth falling in the slumps of the early 1990s and 2000s and rising in the subsequent expansions. The Canadian economy expanded at an average annual growth rate of 3.4 percent from 1993 to 2006, nearly identical to the 3.3 percent U.S. growth rate.

- Yet the two countries' budget policies were quite different. Government expenditures were much larger as a share of GDP in Canada than in the United States in the early 1990s and remained larger even after Canada's budget cutting. And unlike Canada, the United States achieved impressive budget balancing *without* especially sharp reductions in government spending — in part by raising taxes on high-income taxpayers in both 1990 and 1993.

Canada started with a level of expenditures significantly higher than the United States and then reduced expenditures at a time when its major trading partner was experiencing a strong economic boom — after raising taxes. The more plausible narrative is that the Canadian economy performed well in this period primarily because the U.S. economy was growing so robustly rather because of Canadian budget cuts.

It is worth emphasizing that the United States experience in the 1990s is a good example of successful deficit reduction followed by a sustained economic expansion. Bipartisan negotiations produced a budget agreement in 1990 that included both tax increases and spending cuts as well as sensible budget enforcement procedures that provided a useful for framework for achieving meaningful deficit reduction.[15] The 1993 deficit reduction act was passed without bipartisan support and amidst dire warnings from opponents that the tax increases on the richest 2-3 percent of taxpayers would throw the economy back into recession. In fact, the United States enjoyed its longest economic expansion on record and the budget was balanced for the first time since 1969.

Finally, I would like to note that the budget contains many revenue measures that are in fact better thought of as spending measures — hence the name "tax expenditures." In 2010, the tax code included over $1trillion a year in tax expenditures. This far exceeded the cost of Medicare and Medicaid combined ($719 billion), or Social Security ($701 billion), or non-security discretionary programs, which stood at $589 billion or a little over half the cost of tax expenditures. Martin Feldstein, the Harvard economist who served as Chairman of President Ronald Reagan's Council of Economic Advisers, wrote last summer that tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and should be the first place that policymakers go to restrain spending.

Nothing in the literature on international episodes of short-sharp deficit reductions or in our own history of successful deficit reduction tells us that revenue measures cannot or should not be an important component. As a practical matter they must be part of achieving sustainable deficit-reduction that is large enough to do the job, and done right, there is no reason to think they will be an obstacle to achieving sustainable long-term growth with shared prosperity.

Conclusion

The United States faces a serious long-term deficit problem and an immediate short-term problem of slow growth and high unemployment. Current economic and budget conditions in the United States do not look at all like the conditions in countries that have experienced successful deficit reduction through short, sharp fiscal contractions. Non-partisan experts like Fed Chairman Bernanke and the Congressional Budget Office warn against cutting deficits too fast. And as the non-partisan Congressional Research Service concludes from its analysis of the international evidence, cutting budget deficits too rapidly under current U.S. economic conditions is most likely to hurt the economy and ultimately be unsuccessful. If we go down this path, I'm afraid the lesson will be "Spend Less, Grow Less, Slow the Economy."

[15] See Greenstein 2011 for a discussion of the difference between the budget caps in that legislation and the kinds of caps currently being discussed.

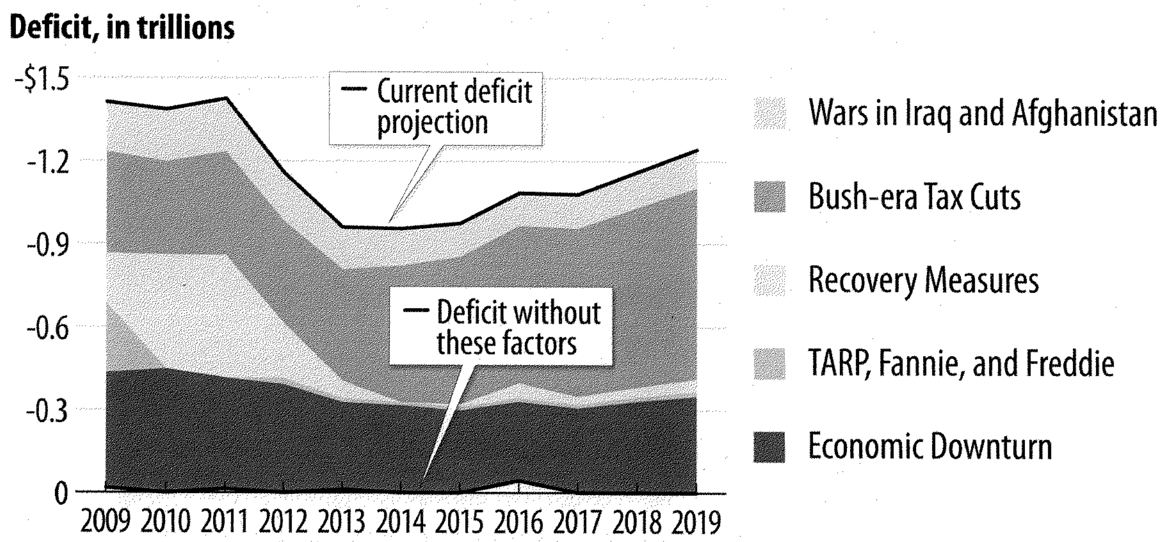
Joint Economic Committee Testimony

June 21, 2011

Chad Stone
Chief Economist

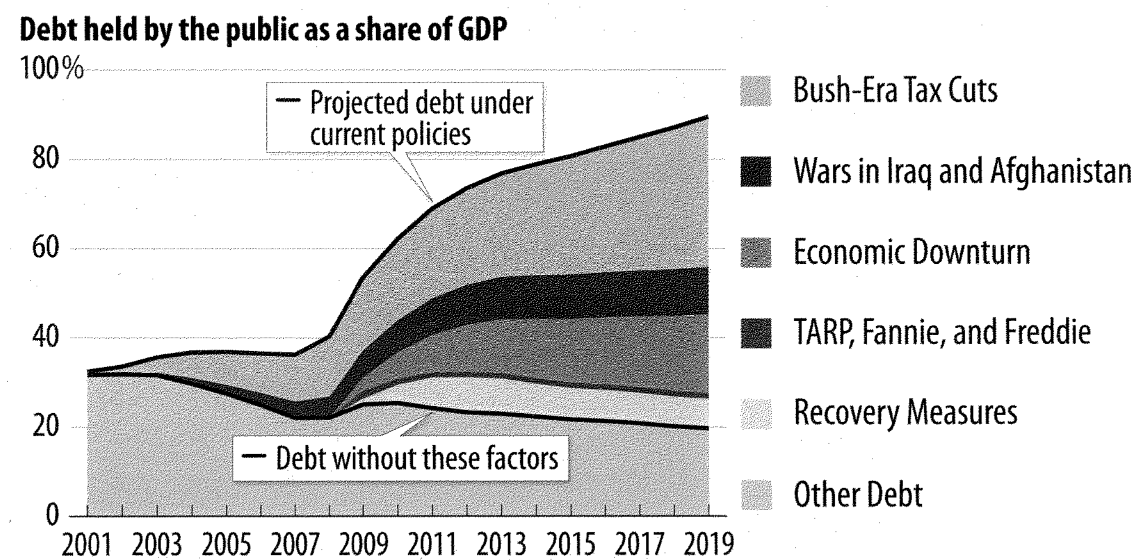
Center on Budget and Policy Priorities

Factors Driving Budget Deficits, 2009-2019

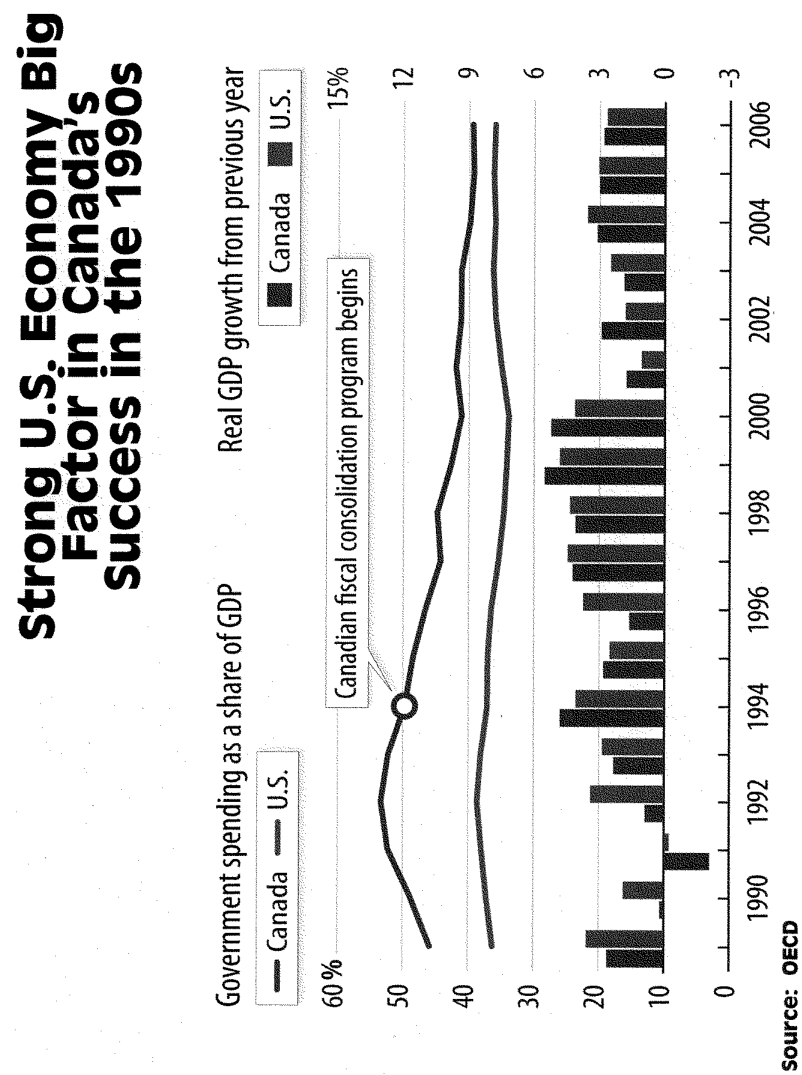


Source: CBPP analysis based on Congressional Budget Office estimates

Factors Driving Debt, 2001-2019



Source: CBPP analysis based on Congressional Budget Office estimates



Strong U.S. Economy Big Factor in Canada's Success in the 1990s
Government spending as a share of GDP
Canada
U.S.
Real GDP growth from previous year
Canada
U.S.
Canadian fiscal consolidation program begins
60%
50
40
30
20
10
0
15%
12
9
6
3
0
-3
1990
1992
1994
1996
1998
2000
2002
2004
2006
Source: OECD