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MAXIMIZING AMERICA'S PROSPERITY: HOW FISCAL RULES CAN RESTRAIN FEDERAL OVERSPENDING

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BEFORE THE

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MAXIMIZING AMERICA'S PROSPERITY: HOW FISCAL RULES CAN RESTRAIN FEDERAL OVERSPENDING

WEDNESDAY, JULY 27, 2011

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

The committee met, pursuant to call, at 10:15 a.m. in Room 216, the Hart Senate Office Building, the Honorable Kevin Brady, Vice Chairman, presiding.

Senators present: Casey, Klobuchar, DeMint, and Lee.

Representatives present: Brady, Burgess, Campbell, and Maloney.

Staff present: Gail Cohen, Will Hansen, Colleen Healy, Jesse Hervitz, Matt Solomon, Connie Foster, Robert O'Quinn, and Michael Connolly.

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

Vice Chairman Brady. Well good morning, everyone. Thank you for being here. Between debt limit discussions and broken subways, we are running a little late today. Thank you for your patience.

I am pleased to join with Senator Casey and Senator DeMint and other members of the JEC in hosting this hearing today to talk about how we can fundamentally restrain future spending in Congress; what tools work at the state level; what are the right measurements.

The United States is on the precipice of a financial crisis because Washington really spends too much relative to the size of our economy. Under this President, Federal spending has grown far beyond the ability of our tax system to generate revenues from American families and businesses sufficient to pay for Washington's overspending. The resulting large budget deficits are causing an unsustainable accumulation of Federal debt.

Business investment in new buildings, equipment, and software drive job creation—not Federal spending. Today, both large corporations and entrepreneurs are not investing because of uncertainty. They fear higher taxes and new burdensome regulations. Consequently, job creation is anemic, the unemployment rate remains stubbornly high, and American families are suffering.

As one major businessman recently—a Democrat, it turns out—recently commented about the Administration, he described it as the greatest wet blanket to business and progress and job creation in my lifetime. The business community in this country is frightened to death.

Overspending cannot be cured by a so-called "balanced approach." A recent study, "Spend Less, Owe Less, Grow the Economy," published by the Joint Economic Committee Republican staff this past March found that successful fiscal consolidations by our global competitors were composed of at least 85 percent spending reductions with additional revenues largely from non-tax sources such as asset sales. Balanced approaches that included both spending reductions and tax increases failed in other countries.

[The study titled "Spend Less, Owe Less, Grow the Economy" appears in the Submissions for the Record on page 30.]

Instinctively, Americans know that Federal spending must be reduced. Nevertheless, Washington has demonstrated that it cannot maintain a spending diet. Public choice economists have identified many biases in our political system against fiscal restraint and for higher Federal spending.

When I became Vice Chairman, I asked the Joint Economic Committee Republican staff to examine what Constitutional and statutory tools our global competitors and our states use to control their government spending. The results were published in the study, "Maximizing America's Prosperity," this June. This study found that our global competitors capped the spending of their national government relative to the size of their economy to put their financial house in order. We must do the same.

[The study titled "Maximizing America's Prosperity" appears in the Submissions for the Record on page 48.]

Washington should also consider using a number of tools that our states employ to control their spending, including the item-reduction veto and sunset laws. The item-reduction veto allows state governments to reduce specific items in appropriations bills without vetoing an entire bill. Sunset laws require the periodic review of all state agencies and programs. State agencies and programs expire if the legislature does not review them before their sunset date.

Interestingly, the study found that the effectiveness of state tax and expenditure limitations has varied greatly based on their design. In particular, expenditure limits tied to measures of a state's actual GDP have been breached during recessions when mandated spending cuts proved to be politically unsustainable.

Today's hearing will examine how these lessons can be applied to the Federal Government. Like our global competitors, Congress must establish spending caps. Yet, from our own states we have learned that the durability of spending caps through business cycles depends in large part on how they're designed, their metrics.

In my opinion, caps should be placed on Federal non-interest spending. Congress can control discretionary and entitlement spending through legislation. However, interest spending is a function of past fiscal decisions, the Federal Reserve's monetary policy, and financial market conditions largely beyond the control of Congress.

Clearly, any spending caps should be related to the size of the economy over time. However, actual GDP poses a problem because it fluctuates with the business cycle. Therefore, spending caps based on actual GDP allow rapid spending growth during boom times only to force large, politically unsustainable spending cuts during recessions.

A better choice is potential GDP. Potential GDP is a measure of what GDP would be at full employment without inflation. It is a well understood and a widely used economic concept. For example, Stanford University economist John Taylor uses potential GDP in the "Taylor Rule" to estimate what the Federal Reserve's target rate for Federal funds ought to be. The Congressional Budget Office already calculates potential GDP for its 10-year budget window.

Potential GDP is the GDP family's smarter brother. Using potential GDP provides a more stable path for controllable spending through time, eliminating the spending blowouts on the upswing and preventing draconian spending cuts on the downswing that have not proven to be achievable.

Given the differences between Republicans and Democrats on the size and scope of the Federal Government, it is unlikely that we will agree on the level of spending caps. However, I hope that we could agree on the metrics used to design them.

I look forward to hearing the testimony of today's witnesses. And with that, I would like to yield to the Chairman of the Joint Economic Committee, Senator Casey.

[The prepared statement of Representative Kevin Brady appears in the Submissions for the Record on page 63.]

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

Chairman Casey. Vice Chairman Brady, thanks very much. I don't know if Senator DeMint—did you want to jump ahead?

Senator DeMint. [Nods in the negative.]

Chairman Casey. I will be brief. I will submit a statement for the record, but I want to thank our Vice Chairman for calling this hearing. I know we will have a chance to examine some very difficult issues, and especially in light of where we are today with a resolution to this debt ceiling debate that we have been having.

I think the key thing here is that I think there is broad agreement that we not only have to get a resolution of this, but we have got to do so by way of reducing spending.

One of the reasons that I favor the approach taken by the Major Leader, Senator Reid, is that there is a substantial reduction in discretionary spending. And that would be the second time, if it were enacted, the second time this year where those numbers have been reduced. And I think that indicates the willingness that folks have here in the Congress to reduce spending.

But there is more to do, and there is also an awareness I think that no matter what happens between now and the deadline, that we are going to have a lot of work to do after that—a lot of work to do in terms of cutting spending, a lot of work to do to putting us on a much firmer fiscal, or a much firmer foundation for fiscal responsibility.

So we have got a lot of work to do. The key thing I think for the American people to see is that we are trying to do this in a bipartisan way. This is not just about getting the policy right; how we do it, and the manner and approach we take is going to be very important.

So I want to thank the Vice Chairman for calling the hearing, and I will have to leave early after the testimony of Dr. Miller, Dr. Mitchell, and Dr. Reischauer. But I will be here for the testimony and then I have to go, but I know the hearing is in good hands with our Vice Chairman.

Thank you.

[The prepared statement of Senator Robert P. Casey, Jr. appears in the Submissions for the Record on page 64.]

Vice Chairman Brady. Mr. Chairman, thank you very much for your participation and for working together on a series of hearings about our economy and jobs and the path forward, and the right size of government as we strengthen our economy.

I would ask—normally we do not ask for opening statements, but I know Senator DeMint has a very busy schedule today, and certainly would offer that opportunity.

Senator DeMint. No, thank you.

Vice Chairman Brady. Thank you very much for being here. And Representative Campbell, as well. Thank you.

I would like to take a moment to introduce our distinguished panel of three witnesses, two of whom happen to be Georgia Bulldogs: Dr. James C. Miller III is the Senior Advisor to the International Commercial Law Firm of Husch Blackwell, LLP, and a member of the Board of Directors of Americans for Prosperity. Dr. Miller is one of the country's leading public choice economists. His experience in government includes serving as Chairman of the Federal Trade Commission and Director of the Office of Management and Budget during the Reagan Administration; and Chairman of the Board of Directors of the U.S. Postal Service during the second Bush Administration. Dr. Miller's private-sector experience includes serving on the Board of Directors of several organizations, and as Chairman of the Capital Analysis Group of Howery LLP. He is a frequent contributor to many national media outlets. Dr. Miller holds a B.B.A., Economics, from the University of Georgia; and a PhD in Economics from the University of Virginia. We are pleased to have you here today as a witness, Dr. Miller.

Dr. Daniel J. Mitchell, our second Bulldog, is a Senior Fellow and tax expert at the Cato Institute. Prior to his time at Cato, Dr. Mitchell was a Senior Fellow with the Heritage Foundation. He knows the Hill well, having worked as an economist for Senator Bob Packwood and the Senate Finance Committee. Dr. Mitchell also contributes to several national newspapers and is a frequent guest on radio and television shows. He holds Bachelor's and Master's Degrees in Economics from the University of Georgia, and a PhD in Economics from George Mason University. Thank you for joining us today, Dr. Mitchell.

Dr. Robert D. Reischauer is President of the Urban Institute and is a nationally known expert on the Federal budget, Medicare, and Social Security. Dr. Reischauer served as the Director of the nonpartisan Congressional Budget Office from 1989 to 1995, and currently serves on the boards of several educational nonprofit organizations. He is one of the two Public Trustees of the Social Security and Medicare Trust Fund. Much like our other two witnesses, Dr. Reischauer is a frequent contributor to the public policy debate in newspapers, on the radio, and television. Dr. Reischauer holds an A.B. in Political Science from Harvard University; and a M.I. and PhD in Economics from Columbia University. Thank you, Dr. Reischauer for sharing your experience today.

With that, I would invite Dr. Miller to begin the testimony. And again, welcome, all.

STATEMENT OF HON. JAMES C. MILLER III, SENIOR ADVISOR, HUSCH BLACKWELL, L.L.P AND FORMER DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, DC

Dr. Miller. Thank you, Mr. Vice Chairman. I appreciate the opportunity of being with you today and to testify about this proposed Maximizing America's Prosperity Act. It addresses a very important question, perhaps a little bit abstract compared to all the nitty gritty of the negotiations going on today, but nevertheless I think a very important one. And that is: How do you maximize economic activity and thereby maximize income per capita, incomes per capita?

This Act relates this to the proportion of government—the expenditures of government as a proportion of GDP. And why is that important? The reason is that there is—while the economists are debating over precise numbers—there is general consensus that there is a relationship between the size of government and our economy and the ability of our economy to produce goods and services.

Obviously at root state of society, there is very little output, where people do not have property rights and so forth. But as you apply property rights, you enforce contracts, and this sort of thing, output rises. But if you get too large—that is, you get the government too large—this output begins to fall. It can no longer maintain this rise.

And so a challenge, it seems to me, for the Members of our Congress is to look and see—to understand this relationship better, and to consciously try to choose the size of government, relative size of government, that maximizes prosperity. And if not doing that, recognize what the tradeoffs are.

This bill, like I said, does address the question of output. I have a little graph in my testimony that depicts the relationship that I just described. The MAP Act places a ceiling on spending, or actually noninterest spending as a proportion of potential GDP. And it provides for mechanisms to keep that spending under control.

It provides, for example, sequestration of budget resources. I have experience with that because Gramm-Rudman-Hollings was passed and implemented while I was Budget Director. It provides for an item-reduction veto for the President. It requires the President's budget submissions to comply with the restraints of the MAP Act.

It establishes a commission to recommend the sunsetting of agencies—and goodness knows, while there are a lot of criticisms of agencies that are not justified, there is a lot of criticism that is justified. And some agencies simply should be sunsetted, and this commission would supply, or would come up with those kinds of answers. And there would be an expedited procedure for Congress to consider those recommendations.

Let me just mention three additional points:

First of all, there are things that you could do in addition to the MAP Act. It's not that you should exclude all these things. For example, the Cut, Cap, and Balance legislation passed by the House includes a requirement to put before the states a balanced budget amendment. I think that would be a good idea, in addition to the passage of the MAP Act.

Second, the cost of government includes—I think we would all agree here—the cost of government includes not only spending but the cost of regulation. And I have urged for some years that Congress impose a regulatory budget and have the budget, or a regulatory budgeting process just like the fiscal budget process, and that you would want to add that cost in the cap, or you might want to change the numbers for that reason. Also, tax expenditures are basically an alternative way of accomplishing the same thing you can accomplish with direct outlays.

And relatedly, there will be attempts to get around the strictures of the MAP Act by going for more regulation, or for tax expenditures. So you want to close off those loopholes and keep those opportunities from abusing the purposes of the MAP Act.

Mr. Chairman, and Mr. Vice Chairman, that concludes my remarks. Thank you.

[The prepared statement of Hon. James C. Miller III appears in the Submissions for the Record on page 65.]

Vice Chairman Brady. Thank you, Dr. Miller.

Dr. Mitchell.

STATEMENT OF DR. DANIEL J. MITCHELL, SENIOR FELLOW, CATO INSTITUTE, WASHINGTON, DC

Dr. Mitchell. Thank you to the Chairman, and Members of the Committee, for this opportunity to testify.

In the past 10 years under Presidents of both Parties, the burden of Federal spending has jumped from 18.2 percent of GDP to close to 25 percent of GDP—but that is just the tip of the iceberg. Thanks to demographic changes and poorly designed entitlement programs, the burden of Federal spending as a share of GDP could double over the next several decades according to CBO's long-term forecast.

The question is: What are we trying to fix when we are looking at budget process reforms? This is a critical question. Most people think that deficits and debt are the problems with fiscal policy. Excessive red ink surely is a problem, as places such as Greece and Portugal demonstrate, but deficits and debt should be viewed as symptoms. The real problem is that governments are too big and they are spending too much.

The true fiscal tax is the amount of money that government diverts from the productive sector of the economy. And whether it finances that spending by borrowing, or whether it finances that spending by taxes, it still results in a transfer of resources from the private sector to the public sector. And so I think the important thing, when you are looking at budget process reforms, is trying to address that issue.

But it is also important to have very realistic goals. No budget process reform is going to be perfect. The appropriate analogy is that fiscal rules are sort of like anti-crime mechanisms. If you put locks on your door, that does not mean you will not ever be burglarized. Even if you have bars on your window, an alarm system, and gun ownership, you are not guaranteed that you will never be victimized by crime. But the perfect should not be the enemy of the good, particularly when the alternative is to let the country slowly but surely sink into some sort of a European-style fiscal crisis.

I touch on several things in my written testimony, including a balanced budget amendment, line-item veto, current-services' budgeting, but in my brief time for oral testimony I want to focus on the idea of spending caps and what should they try to achieve.

A spending cap is, of course, the notion that there should be some upper limit on how much government can spend in any given year. Those spending caps can be very narrow—say, just applying to discretionary spending; or they can be very broad.

When you are talking about defining a spending cap, there are two ways of doing it. You can just say: government can only spend so much of GDP—however GDP is defined; or you can say: government can only spend this nominal amount every single year.

In theory they could wind up being exactly the same thing. I like the idea of focusing on GDP, and I especially like the idea of looking at potential GDP, because, as was discussed in the opening statement by Vice Chairman Brady, when you focus on actual GDP and you have booms and busts in a business cycle, you wind up allowing politicians to spend too much money perhaps when the economy is booming. And we certainly see this in states.

One of the reasons why states get in fiscal trouble is that when the economy is doing very well, their revenues are rising 8, 9, 10 percent a year, and they wind up letting spending increase by that much. Then, when the economy goes into a downturn, all of a sudden, the revenue disappears and they wind up in very, very serious trouble, as we have seen with States such as California and Illinois.

Whereas, if you focus on potential GDP, you not only solve that problem, you smooth out the spending patterns of the government, and you create something that is more stable.

One of the problems with Gramm-Rudman was not a problem with the legislation itself, but a problem with the political durability of the legislation. As we moved into an economic downturn, the Gramm-Rudman spending caps—which were very indirect because they were actually deficit caps, which basically meant government could spend the amount of revenue coming in plus the deficit cap—those indirect spending caps under Gramm-Rudman simply could not be sustained when the potential sequester became too large, or Congress was being asked to do too much. And so potential GDP largely solves that problem.

Another advantage of potential GDP, if you are using some forecast of future GDP, is that there is a risk that lawmakers might pressure CBO or OMB.

And then, real quickly, I want to talk about what spending to cap. Obviously we know from looking at the CBO and OMB forecast that entitlements are the main long-term problems. So while discretionary caps are good, some cap that applies to all spending is better. But if you take out interest, you actually focus on just the spending that Congress truly can control through legislation.

So I think the idea of focusing on primary spending—in other words, total expenditures minus debt interest—is a very reasonable way of doing it. It also has certain advantages in not complicating tax policy debates.

But I see I am out of time, so I will stop there. Thank you very much.

[The prepared statement of Daniel J. Mitchell appears in the Submissions for the Record on page 66.]

Vice Chairman Brady. Thank you, Dr. Mitchell. Appreciate it. Dr. Reischauer.

STATEMENT OF HON. ROBERT D. REISCHAUER, PRESIDENT, URBAN INSTITUTE, WASHINGTON, DC

Dr. Reischauer. Vice Chairman Brady, Chairman Casey, Members of the Committee:

I appreciate the opportunity to discuss the contribution that fiscal rules might play to restrain Federal spending. As my prepared statement makes clear, I think fiscal rules can play a rather limited role in getting the Nation's fiscal house in order.

Let me elaborate on this by offering a few observations about some of the fiscal rules mentioned in the letter of invitation.

What would happen if the existing Concurrent Budget Resolution were replaced with a Joint Resolution requiring the President's signature?

Well first, the Congress would give up some of the budgetary independence that it gained when it went to the Congressional Budget Process in 1974.

Second, it is likely that it would be even more difficult to formulate a budget resolution with three cooks in the kitchen representing two Branches of Government versus the current situation where we have the two Chambers of Congress representing one Branch of Government. And that has not proven very successful in the last few years.

Third, a Joint Resolution would fog responsibility for failure as few would be able to judge which of the three participants was responsible for budgetary failure.

Overall, I do not see why one would expect this reform to have an appreciable impact on spending or deficits, although it could make post-budget resolution decisions and processes less contentious and speedier.

What about discretionary spending caps enforced through sequestration?

This tool is clearly going to play a major role in whatever resolution we have to the debt ceiling crisis, and that seems appropriate considering that the discretionary spending caps of the 1990s appear to have been quite successful. But before you place too much emphasis on this mechanism, you should examine the record carefully.

Between 1990 and 2000, total discretionary spending measured in inflation-adjusted dollars fell by almost 6 percent, or an even more dramatic 27 percent drop as a percentage of GDP. But this successful record was largely a story about the defense budget and the rapid economic growth of the last half of the 1990s.

The Berlin Wall came down in the Fall of 1989. The Soviet Empire collapsed, bringing the Cold War to an end. The combination of this new international environment and the spending caps resulted in a reduction in defense outlays of over 20 percent during that decade measured in real or constant dollars, a reduction as a fraction of GDP of 42 percent.

The story was quite different if one looks at the nondefense side of the budget where the constant dollar spending actually increased by 17 percent over this period. And as a percent of GDP, it just decreased marginally, but that was due to the rapid growth in the economy in the last half of the 1990s, some of which proved to be illusory.

The take-away lesson from the 1990 experience with spending caps is that this tool can be effective if there exists a broad bipartisan consensus that certain areas of the budget should be scaled back in a significant way. But spending caps are relatively easy to agree to because no one knows which specific programs will be reduced disproportionately to achieve these caps.

This creates a real risk that more will be promised than can be delivered, and the caps will prove to be unsustainable as they did after 1997.

What about enhanced recision authority?

The Budget Control and Impoundment Act gives the President the authority to propose recisions, but Congress has no obligation to take them up. And so the President's requests are frequently ignored. Enhanced recision authority would stop this benign neglect by requiring Congress to vote on the President's recision requests unamended, up or down, within a fixed time period.

Enhanced recision would give the President a strengthened ability to weed out narrow, special interest allocations that do not have widespread Congressional support. It is doubtful, however, that large amounts of budget authority would be rescinded under this tool, and furthermore one has to make sure that whatever budget authority was rescinded did not get reallocated back into the pot but rather was offset by reductions in the budget resolution's allocation of authority.

Balanced budget amendments to the Constitution could dampen the growth of spending, but this would come, in my opinion, at a very high price. The automatic stabilizing role that the Federal Government now plays for the economy would be seriously compromised. Economic downturns would be both deepened and prolonged, and vulnerable populations would suffer.

Under a balanced budget amendment, the Federal Government will lose some of the budgetary flexibility it has now and its ability to respond quickly to unexpected events, be they natural or manmade catastrophes.

Some proposed versions of a balanced budget amendment would make it difficult for Social Security or the government's pension plans to draw down reserves that they have built up over the years to pay benefits.

Similar constraints would face the FDIC, the PBGC, and many of the government's insurance and loan guarantee programs, effectively eliminating the reasons for their existence.

While the wording of the balanced budget amendments being considered by the Congress seems simple and clear, all of these proposals raise thorny questions involving definitions, implementation challenges, and enforcement.

For example, answers would have to be found to such questions as: What is the budget? What constitutes the budget? Is Congress or the President responsible for achieving balance? And through what processes?

What remedies would be imposed if balance were not achieved? And on whom? To assure the balanced budget amendment could achieve its objectives, Congress would probably have to cede some of its short-run authority over the budget to the President.

Let me conclude by noting the fiscal rules can help frame and organize budget decisions. They can influence expectations, and they can provide a bit of political cover to those who must make difficult votes. But they cannot create or substitute for political will.

History has shown us that if fiscal rules are found to be too stringent, they are going to be ignored, waived, circumvented, or repealed. Recent experience suggests that there exists a bottomless well of budget gimmicks that lawmakers can draw on to avoid the discipline implied by fiscal rules they have endorsed but cannot find the will to impose——

Vice Chairman Brady. Doctor, at this point we have exceeded the time by about two-and-a-half minutes.

Dr. Reischauer. Excuse me.

Vice Chairman Brady. We will make sure your full—no, no. We will make sure your full statement is included in the record.

[The prepared statement of Hon. Robert D. Reischauer appears in the Submissions for the Record on page 69.]

Vice Chairman Brady. We will begin questioning. We appreciate being joined by Senator Lee and by Congressman Burgess, as well as Senator Klobuchar. Thank you.

The size of a country's debt relative to its economy is a major indicator of its financial health. The amount of deficit related to its economy is the same. The size of government related to its economy and to its revenues are critical.

Republican or Democrat, everyone agrees that a nearly 25 percent—a government that is nearly 25 percent the size of the economy is unsustainable. So how we shrink the size of this government over time is critical. And those spending caps matter.

In the MAP Act—and both Dr. Miller and Dr. Mitchell referenced this—we use different metrics. Rather than total spending that includes interest, which is not controllable—it is like a credit card; you cannot control necessarily the interest rate on your card, but you can control the monthly principal and continue to focus to shrink that over time.

The same with GDP. Not only are there wide bands, it was revised several times over the years. You are always looking back at it, and it can be gamed. People try to get around it by making continual rollover estimations, or estimates of it. Potential GDP tracks actual GDP but in a much tighter band, so in the future you constrain spending during good economic times and the cuts are not quite so steep during the tough times.

My question is: For lawmakers who are so accustomed to measuring all spending rather than controllable spending, and actual GDP versus the more stable potential GDP, as economists how do you translate this into a real-world example that lawmakers can better understand? Because it is a shift from the way we have thought about spending caps in the past.

Dr. Miller. Dr. Mitchell.

Dr. Miller. Well nothing comes to my mind as an easily grasped analogy or metaphor on this. I think I have no criticism of your choice of potential GDP. In fact, I think potential GDP, as Dr. Mitchell was mentioning, may have a stabilizing effect along the same lines that Dr. Reischauer was suggesting that the Federal spending does play with our national economy.

If I might, Mr. Chairman, Mr. Vice Chairman, I would like to mention—I am not sure if it is—maybe it is a clarification of what Bob was saying. I think that these kinds of institutional restraints do work. They absolutely do work.

If you look at the Gramm-Rudman-Hollings, it really worked. It brought the deficit way down. And it would have brought it all the way down to zero had Congress not panicked and changed the rules, or changed the targets when they did.

Secondly, I did some work with one of my colleagues, Mark Crane, who, Mr. Chairman, Mr. Casey, is the William Simon Professor of Economics at Lafayette College, and we looked at state restraints. It may have been material that you covered in that report you were talking about. But states that had balanced budget requirements tended to control spending better.

States that had a line-item veto for the governor tended to control things better. And all those institutional arrangements, they do work. But I think Bob's point is correct to the extent that he is saying that they may not work—they would not work if Congress undermines them.

So you are making a big statement if you pass this kind of legislation because you are basically going—you need to commit that you are going to live under those constraints in the future.

Vice Chairman Brady. Thank you, Dr. Miller.

Dr. Mitchell.

Dr. Mitchell. Your question is a challenge because I suspect that the average person, or for that matter the average lawmaker, when told that we are going to have some budget rule focused on potential GDP, they are going to say, wait, that sounds fishy. They are going to be suspicious. And for that matter, primary spending. Wait, wait. What's that?

So there really is an educational mission here. This hearing obviously is part of it. As I am sure you know, Senator Corker has some legislation in the Senate, and so there is a lot of discussion about this, and everyone seems to be talking about discretionary caps.

I just think it is a question of almost Member to Member education, staff to staff education, so they understand that this is not just some strange idea pulled out of nowhere that allows for some slipperiness. It is something that actually makes the legislation much more durable over time.

And I gave my little example that putting locks on your doors does not mean you will never get victimized by crime. Maybe another way of thinking about it, when trying to put together budget process reform is: If I go on a diet and I want to lose 20 pounds and I only lose 10 pounds, it is still good that I went on a diet even if I did not achieve all of what I wanted. It is better not to have those extra 10 pounds.

And so, yes, I fully expect that any budget process reform, no matter how well designed, is going to face challenges in enforcing and implementing it in the future just because it is the nature of the political system for people to try to get around it. But by all means, it is better than not doing something.

Vice Chairman Brady. It is the biggest challenge when we set these guardrails, to put them in place in a way where, when things get a little tough, as Dr. Miller pointed out, both parties do not hold hands and jump the guardrails. That has been the challenge in the past. Appreciate the commitment.

Senator Casey.

Chairman Casey. Thanks very much, Mr. Vice Chairman.

Dr. Reischauer, I wanted to ask you two basic questions, but then also if we have time refer back to part of your testimony.

Am I right that you were at the Congressional Budget Office from 1977 to 1981, and then Director from 1989 to 1995?

Dr. Reischauer. Yes.

Chairman Casey. That is a long——

Dr. Reischauer. I mean, not—I actually was the first employee of CBO. Alice Rivlin and I got in the cab. In 1975 I was sort of a kid at the Brookings Institution, and we came down to the Capitol. She was sworn in. There was a reception. The lights went out, and she said to me: Help set it up.

[Laughter.]

And I had to find a home, and I had to figure out how to get franking privileges, all of the complexities of starting something here. So it was really 1975 through the beginning of 1981, and then 1989 to 1995.

Chairman Casey. So present at the creation.

Dr. Reischauer. But don't blame me.

[Laughter.]

Chairman Casey. They are in the news again. But in light of that experience, and you have been through a lot of these budget debates and what economic conditions were like in the 1980s and the 1990s versus today. Anything you can tell us about how you compare the conditions then as to what they are now? And use that as a basis to analyze how we approach these budget issues. Or is that significant, or relevant?

Dr. Reischauer. It is both significant and relevant.

There is a huge difference between where we were in the 1970s when we were worried about growth and budgets, and the 1980 deficit problems. And that was, that we looked forward and we said: We've got to do something because the Baby Boom generation is going to retire in a couple of decades.

Well, it is a couple of decades later and they are retiring. The demographic tsunami is on us. And we have not, in a sense, prepared ourselves for that.

If you go back to the first years I was at CBO, there was one very huge difference when we were projecting the budget situation. And that was, we did not have an indexed-tax system. And so it was almost always true that no matter how deep the deficit was in the budget year, when you looked forward things corrected themselves. And they corrected themselves because the tax burden rose as people's effective tax rates rose as their incomes rose, and they got into higher and higher brackets.

I am all for the indexation of the tax system, but we had in that, you know, an automatic fix for the deficit problems that we faced.

I just want to add one thing, because it will probably be one of the few opportunities I have to show that there is some common agreement on this panel.

That is, the use of potential GDP is really a good idea. And also if one were going to go down the route that Dr. Mitchell talked about, talking about spending, ex-interest is the right way to go about it.

So I am on board with that. But I would add one caution. That is, that potential GDP is not a concept that everyone agrees how it should be calculated. When we are talking about actual GDP, when we are talking about outlays, when we are talking about revenues, there is no debate about what those involve. It is complicated to figure out what potential GDP is, and therefore it is difficult to explain to the average person I think.

Thank you.

Chairman Casey. Well, Doctor, if you guys can stay a couple of hours maybe we can get agreement on the debt ceiling, too. That would be great.

[Laughter.]

One final question. I know I am down to about 30 or so seconds. When you assess the last decade or so, how did we get to where we are now? What is your sense? We had not just surpluses in the late 1990s, but the projection was I guess trillions in surplus.

Dr. Reischauer. Yes, it was sort of amusing. Eleven years ago we were having an argument on how the Federal Reserve would manage monetary policy when there was no Federal debt to buy and sell?

And the answer to that question of course was: Well, they could begin buying and selling GMAC paper, Fannie and Freddie paper, et cetera.

Well, half of it came true. They are.

[Laughter.]

But the other half, the elimination of Federal debt, seems to have fallen a bit short.

Chairman Casey. I have a couple more but if I do not get them to you I will have to submit them in writing. Thank you.

Vice Chairman Brady. Thank you, Mr. Chairman.

Representative Campbell.

Representative Campbell. Thank you, Mr. Vice Chairman.

You know I think the reason we are talking about spending caps and so forth is, in the 12 years since I lost my mind and left the private sector and came into this line of work, it is politically really easy to spend money and give people money or services and not ask them to pay for all of it. And that is just a really easy political thing to do.

So I think the natural thing that happens in any legislative body is to create deficits, because it is politically easy. There are some of my colleagues who never vote for a tax increase, but never vote for a spending cut either, because neither one is particularly popular.

So, you know, there are a lot of things we have in life as individuals that we know are the right thing to do but we do not like to do. So what we generally do is create some external discipline that makes us do what we know we ought to do but will not do without that discipline—whether that is the trainer at the gym, or the money that comes out of your 401K, comes out of your paycheck so that you save for your retirement.

That is what drives my interest in spending caps, or balanced budgets, or whatever.

Dr. Reischauer, the first question is for you. I certainly get the impression from your testimony you are not a fan of balanced budget amendments.

Is there a form of a spending limit or spending cap that you like, or that you think is better than the status quo that I just described?

Dr. Reischauer. Well——

Representative Campbell. Or let me phrase it more broadly. Is there an external discipline that you believe could help the situation to keep us from being driven toward these increasing and unsustainable deficits?

Dr. Reischauer [continuing]. Well I think that the various measures that I talked about, excluding the balanced budget amendment, can make small contributions. But they are not going to solve the problem.

The question here I think has much more to do with the structure of our political system and the fact that you are elected every two years, Senators every six years; you can communicate to the public all of the good things you do directly on television; there is very little in the way of Party discipline, and you want to continue to be elected. And that is not changed by a set of rules that, when faced with tough decisions that might mean that you face a primary opponent, or lose in a general election, it is very difficult to in a sense do the “right” thing for the long-run fiscal health of the Nation.

If you do, no one will thank you 20 years from now. It will be sort of unclear the contribution that you did make. I do not think that is any different from many of us in our current jobs where we do not make decisions that could lead to us being asked to leave. You know, it is just that you bear a much greater responsibility for the future of this country than I do.

Representative Campbell. Okay, I want to just, before my time runs out——

Dr. Reischauer. Oh, sorry.

Representative Campbell. Dr. Mitchell, what are your thoughts on the disciplines? And also, we are talking about a spending cap. I am curious about your view of a balanced budget amendment versus a spending cap, or any external discipline that we have not discussed.

Dr. Mitchell. I am obviously a big fan of spending caps. I focused on that in my oral testimony just because I think there is actually some nontrivial chance that something like that could emerge from the political process this year.

I am also a fan of a balanced budget amendment, specifically the kind of amendment that has super-majority requirements for tax increases, and limit spending as a share of GDP. And I view those two as complementary because the spending caps get you to a point in the process where you actually are finally balanced. And then some sort of Constitutional reform can keep you there.

The challenge of course is how do you get a two-thirds vote in both Houses of Congress and ratification by three-fourths of the States? I hope that happens in my lifetime. I am not sure I would bet a lot of money on it, and therefore I was focusing more on spending caps just for purposes of my oral testimony.

Representative Campbell. Okay, let me—Dr. Miller, the same question as Dr. Mitchell's.

Dr. Miller. Well let me say, if your goal is to maximize prosperity I think it would be better—if you had to choose one or the other—would be to go with the MAP Act, with appropriate restraints on the abuse of regulation and tax expenditures as a way of getting around the constraints.

But the balanced budget amendment would be very helpful inasmuch as, because of fiscal illusion the public generally, and their elected representatives, tend to underestimate the cost of government that is financed by debt. And if you had a balanced budget amendment, then you could not do that.

Representative Campbell. Thank you. Thank you, Mr. Chairman.

Vice Chairman Brady. Thank you. Former Chairwoman Maloney.

Representative Maloney. First of all, thank you for calling this hearing. And it is good to see you again, Dr. Reischauer. Welcome back. It is very nice to see all of you. I regret I was in another hearing earlier.

Chairman Bernanke testified last week before the Financial Services Committee that cutting too deeply too strongly would impede economic recovery and would increase unemployment in our country. That is then another challenge for us.

So I would like to ask Dr. Reischauer to respond to his comments. We face many challenges, one of which is a fragile economy that we need to make sure continues to recover.

Dr. Reischauer.

Dr. Reischauer. I agree with that completely. We are not in a situation right now where it would be good for the economy if sharp fiscal contraction were enacted by Congress. At the same time, I think it is imperative that decisions be made now that are credible and specific that will begin tightening our fiscal stance by 2013.

I think that it would be a huge tragedy if that did not occur. But as we have seen from the impact that the cutbacks by state and local governments are having on our overall employment and our overall economy, contraction at this point would be damaging and could even threaten another recession.

Representative Maloney. Well that is very sobering. I have been told that right now our revenues are 15 percent of the GDP and 25 percent expenditures. So it is very out of line. And I would like your comments if that is a correct number. I read that in the paper. I do not know if it is correct or not, but having only 15 percent revenues with 25 percent expenditures, that is not sustainable.

And your comments on what we could do to address that, and certainly putting it more in balance would help with economic growth, I would think, again Dr. Reischauer.

Dr. Reischauer. Those are roughly the right numbers. And you are absolutely correct that that is an unsustainable situation. And as I suggested in the answer to my previous question, we should move forward with legislation that will guarantee that that gap narrows.

I, as opposed to my colleagues here, would narrow the gap in different ways. I would rely partially on revenue increases associated with tax reform. But I think it is essential that we not focus solely on discretionary spending when we are ratcheting down the spending side of the budget. That has not been a major cause of the deficits that we are experiencing now, nor is it projected to be a cause of future deficits.

What we have to do is reform the entitlement programs that are projected to grow rather substantially, but do that within a framework that preserves their fundamental objectives to help elderly, disabled, and low-income groups share in the American dream.

Representative Maloney. And some of these proposals, one thing that I find very disturbing about this economic downturn is that the gap between the haves and the have-nots is growing, and in fact it is larger than it ever has been in the history of our country.

Some of us are concerned that the cuts directed to the seniors and the needy will only broaden that gap and cause more turmoil in trying to get back to a balanced economy that works for everyone.

On the balanced budget amendment, one of the things that helps our families grow is the ability to borrow money to buy a car so you can get to work, to invest in a company so that you can be an entrepreneur and grow it and make it prosper. And I would like to ask Dr. Reischauer and Dr. Miller, on the balanced budget amendment, if one should be ratified and passed in our country, what would the impact be on our ability not only to respond to catastrophes such as a 9/11 where we had to reorganize the whole spending of our country to respond to homeland security and more efforts to protect the Homeland, or our ability to invest in innovation and areas to grow our economy.

What would the impact of a balanced budget amendment be on the ability of our country to do, like a family does, take out a loan to buy a car to get to work; to take out a loan to invest in new technologies; to create the new ideas that not only employ our people but move our country forward?

Dr. Miller, if you could comment on it—and Dr. Mitchell, too, if you would like. I know my time is up, I believe. Thank you. Thank you, Mr. Chairman.

Dr. Miller. Congresswoman, as I said in my statement, in an ideal world the Federal Government would borrow sometimes, run surpluses at times, et cetera. But the world is not ideal. It is not perfect. And so this rough-and-ready rule of a balanced budget would lead, in my judgment, to a much better situation than we have today.

Secondly, the proposals for a balanced budget requirement that I have seen—and I will not comment on cap and balance, the legislation that recently passed the House—but most of them I have seen incorporate a supermajority option. That is, that you could violate this balanced budget requirement upon a supermajority passed by both Houses of Congress and signed by the President. And that would meet your concern for some kind of an emergency.

Let me say also with respect to Dr. Reischauer's point about—and to the issue that you raise, Congresswoman, about the possible damage to the economy of immediately having a balanced budget, given the difference between spending as a portion of GDP and revenue as a portion of GDP.

First of all, under the MAP Act those limits would not apply immediately.

And secondly, as I believe passage of that Act and the affirmation and guarantee that outlays by the Federal Government would be a declining portion of GDP, would lead to economic growth to increase—given that our tax rates would not be going down much—you would have an increase in the total amount of revenue generated by the economy.

And so that would itself narrow the deficit. So I think there is—I agree that we are in a very unusual situation, as I think you were pointing to, and we need to be careful how we get out of this box. But I think that it is doable to get out of the box without having substantial adverse effect on the economy.

Vice Chairman Brady. All right. Thank you all very much.

Senator Lee.

Senator Lee. Thank you. And thank you, Chairman Brady, for calling this meeting and assembling this great panel of experts.

As we approach the August 2nd debt limit deadline, I like most of my colleagues am very concerned about the double-pronged threat that we face. I want to emphasize the double-pronged nature of the threat because there is only one side of it I feel has gotten adequate attention.

On the one hand we face a very real threat that has gotten a lot of attention, that if we do not raise the debt limit by August 2nd bad things will happen. Bad things do happen when you are traveling at 120 miles an hour and you immediately decelerate to 50 or 60 miles an hour. If you do it a little bit more gradually, things can be a little bit less painful and injurious.

On the other hand, we also face a different risk, one that has gotten far too little attention. That is, that if we raise the debt limit reflexively, if we raise the debt limit the same way we have always raised it in the past, if we raise it especially to an unprecedented $2.4 trillion amount all in one fell swoop without putting in permanent binding structural spending reform mechanisms that will fundamentally change the way that we spend money in Washington and put us on a trajectory toward a balanced budget, we will face a credit downgrade.

And that threat could well be as severe, if not more severe, than the threat associated with not raising it, at least in the short-term period.

It is at that point that I think our most vulnerable populations in America face perhaps the greatest threat. If we look at what happened in Greece when Greece went into its economic tailspin after its debt-to-GDP ratio went well above 100 percent, let's just say it is a very bad time to be a poor person, or an elderly person, or a person who for whatever reason is dependent on government assistance or government programs of one sort or another in Greece.

Because when that happens, when your sovereign credit rating goes down that badly that quickly, it is the poor and the otherwise vulnerable that suffer the most.

So, Dr. Reischauer, I have a question in response to your testimony, both your initial testimony and your answers to some of these questions. You referred to America's vulnerable populations and the fact that if we had a balanced budget amendment in place that might limit or impair our ability to provide them the services that they need to support them.

But is it not also true, Doctor, that if we do raise the debt limit again, and if we do not put in place a permanent structural binding spending reform mechanism, that could also bring about revenue shortfalls that are equally if not more harsh, draconian, and abrupt?

Dr. Reischauer. My responses to that are, the reference in my answers to the previous questions and in my prepared statement. It was about the cyclical nature of the economy. If you had a balanced budget amendment you would have a hard time paying unemployment benefits, SNAP benefits, various things that people depend on. That is sort of a short-term issue.

On the long-term issue, I agree with you completely that if we let this fiscal situation continue to run out of control until there is a response from international markets and we are forced to make changes not on our own timetable, not maybe in our own priorities, but being dictated to by our creditors or international lending agencies, the fate of low-income vulnerable elderly populations will be severely tested, I think.

One reason I have long been an advocate of putting our fiscal house in order is precisely that: I think it is in the long run best interests of those who are less fortunate to get this done, and get it done quickly.

Whether one needs a balanced budget amendment or some extraordinary set of rules to do this, I am a bit skeptical because I have watched this process over a 30-year period and many times we have said, well, you know, this is the silver bullet, this is the process reform that will make it happen. And it has not happened.

Senator Lee. But does the fact that it has not passed and we still have not solved the problem prove your point? Or does it prove the opposite point? I mean, one could argue, could one not, that because it has not passed, and because we have still not solved the problem, perhaps we ought to do that which we have failed to do in the past, which is to Constitutionally obligate ourselves to do it?

Dr. Reischauer. That is an argument we could have, but I don't want to take the risk.

Senator Lee. Understood. And I see my time has expired. Thank you.

Vice Chairman Brady. Thank you, Senator. Congressman Burgess.

Representative Burgess. Thank you, Chairman.

Let me ask a question. I apologize that I wasn't here at the beginning, but as you know we are debating and redebating the issues related to the debt ceiling. I just have to say for the record, I am grateful this country has a statutory debt limit. I do not think we would be doing this hard work right now if we were not required to do it.

So for those who argue against a debt limit, I would just say that if we did not have the debt limit, as Senator Lee points out, we could be Greece. So I am grateful we are having the discussions. They are not easy to have. They are sometimes painful internally and externally, but I am grateful we are doing it.

We woke up this morning to the news that General Electric was moving some of its imaging jobs over to China. And there have been various theories put forward as to why that might be happening, but I think when we get beyond the discussion of the debt limit and what happens with our spending, the bigger problem that we have of course is the joblessness that has been pervasive for the last two-and-a-half years and shows no sign of abating.

And, you know, I am from Texas and we are not doing as badly as other parts of the country, but I would like us to do a lot better. And I certainly want my country to do a lot better. When you look at the joblessness of the 20-year-olds, that is startling that we have a whole generation that may never know the value and reward of work.

When you look at particularly the young people who are minorities, the joblessness rate is absolutely staggering. So now we are seeing jobs from a large, revered American company going over to China. And one of the reasons postulated is that it may be the Tax Code that is creating this impetus for this company to move those jobs.

I was just wondering, Dr. Mitchell, do you have an opinion about that?

Dr. Mitchell. There is no question that the U.S. corporate tax rate is among the highest in the world, sort of neck-and-neck with Japan for the dubious honor of the highest corporate tax rate among industrialized nations.

I remember that President Bush had a tax reform panel—I forget what the formal title of the tax reform panel was—but one of the testimonies to that panel, I think, was from the tax vice president at Intel who said that the biggest difference in the cost of locating a plant in the U.S. versus—I think Malaysia was their other choice, but I assume China would be similar—was not labor costs; it was taxation. That would be the number one advantage for them to build a plant overseas.

Now obviously maybe it would be different in a labor-intensive plant versus a high-tech plant, but I do think that our tax system is extraordinarily punitive to savings and investment in general, our corporate tax rate is very, very high, and is the statutory tax rate that acts as the marginal tax rate on new investment and new profits for companies. So I do think it is important to look at that statutory corporate tax rate. It is just punitive and self-destructive.

Representative Burgess. So raising that rate, elevating that rate to add revenues to the Federal Treasury would be counterproductive?

Dr. Mitchell. Well Kevin Hassett at the American Enterprise Institute—I think along with Alex Breaux, estimated that the revenue-maximizing corporate tax rate was closer to 25 percent over the long run. So not only would it be self-destructive to competitiveness and job creation in the U.S., but it very likely might have negative impact on the amount of revenue government collects.

The greater danger is most likely not so much a higher corporate tax rate—I have not heard too many people talk about that; the greater danger is in increased double taxation of saving and investment through increased double taxation of dividends and capital gain. And those of course have an impact on the decisions of people to defer consumption and to save and invest. I think that is probably a greater danger. Although it is indirect, it could be just as injurious to our competitiveness.

Representative Burgess. Representative Maloney talked about the fact that the tax rate, effectively 15 percent of GDP, and that needs to be corrected. Wouldn't normally that correct over time?

Dr. Mitchell. If you look at the CBO 10-year forecast, they assume a baseline of current law, which means the Bush tax cuts would expire, and revenues would climb to over 19 percent of GDP by the end of the decade. If you assume that the 2001 and 2003 tax cuts are extended or made permanent, you would still have revenues climbing up to about 18 percent of GDP, which is the long-run average.

So if you look at our long-run fiscal imbalance, it is not because revenues, at least in the medium- and long-term will be below their historical levels; it is because spending has risen above its long-run levels. Historically we had 20 percent spending, 18 percent revenue. Well revenues are going to climb back up to 18 percent, and that is without any rosy scenarios. CBO's estimates do not show any great growth. It is the spending that has skyrocketed.

Representative Burgess. Let me just quickly ask Dr. Reischauer a question, if I can, in my remaining time.

Dr. Reischauer, we hear a lot of talk, and you spoke about the social safety net to some degree. Representative Maloney talked about the stress being put on Medicare. Now proposals have been put forward. There has been a lot of discussion about them.

Can you tell us, is there a substantial difference between a voucher and a program of premium support?

Dr. Reischauer. This has become a semantic issue of some importance to people. I was under the impression that premium support, and I have some responsibility for coining the term in an article Henry Aaron and I wrote back in 1995, associates the payment to the underlying cost of the service being delivered. Whereas in a voucher that not necessarily was the case.

As Chairman Ryan's proposal suggests, that would be associated with price increases, general price increases, not medical price increases. So that is the distinction that some people make.

Representative Burgess. And do you feel that it is a worthy distinction?

Dr. Reischauer. Oh, I think it is a very important one. You know, especially when we are dealing with health care which has tended to rise in our measured inflation much faster than other goods and services.

I for one think that we have a bit of confusion in this because, whereas as inflation is usually measured as the increase in the price of a good or service adjusted for qualitative change, more often when we talk about medical care there are huge improvements in quality or in the nature of the service. We can do things now that we could not do 10 years ago, and those are not factored in appropriately.

But our expectations as a Nation are that everyone should benefit from whatever improvement and new technology comes on the market.

Vice Chairman Brady. Thank you very much.

Representative Burgess. I thank the Chairman for his indulgence.

Vice Chairman Brady. No, no, that's called "deficit questioning" when you go beyond the five minutes.

[Laughter.]

Can I ask, what lessons have we learned from past fiscal rules Congress has put in place to restrain spending? There is a mixed record. What has worked? When has it not worked? And what would we do differently to create the guardrails to create discipline around future spending? What should we keep in mind as we do that?

Dr. Mitchell. I would echo what Dr. Miller said, that I think Gramm-Rudman worked. It was grossly unsuccessful compared to the ideal, but compared to what might have happened without Gramm-Rudman, I think it was one of the few things I can look back on and think, okay, that made a difference in terms of how Congress behaved.

We did of course have discretionary spending caps in the 1990s. That to me was a little bit like having a 50-mile-an-hour speed limit in a school zone. Yes, they were by and large adhered to, but I thought they were too high. But that is just a matter of judgment, of course. But for the most part, we just have not really done much budget process. We have had budget deals. We have had budget summits. We have had budget agreements. But those are just sort of just packages of legislation that tend to have a very short half-life anyhow.

Budget process reform? There is really not much real-world evidence to look at—unless you are going to other countries, or looking at the states as Jim was mentioning.

Vice Chairman Brady. Dr. Miller.

Dr. Miller. I think what we have learned is that if you put these in place, or these restraints in place, and follow them, they work. If you violate them, they do not work.

The legislation that established, among other things, the budget resolution that is supposed to be done by April and has a whole set of time limits, works when it is followed by Congress. But of course it has not been followed by Congress in decades.

And the Gramm-Rudman-Hollings, as Dr. Mitchell was mentioning, did work and it brought the deficit down dramatically, but then it was violated by Congress. So you have got to stick with them.

And these other—the other evidence from the states is that they work, so long as they are not violated. And keep in mind there are these avenues even under the MAP Act as written, there would be these avenues for getting around the restraints by increasing the amount of government regulation, or Federal regulation, but also the use or abuse of tax expenditures.

Vice Chairman Brady. Thank you.

Dr. Reischauer.

Dr. Reischauer. There is more agreement on this panel than I expected. I believe that the Gramm-Rudman-Hollings procedures modestly held down the growth of spending, kept this as a front-burner issue so the Congress and the President were fighting it every year, but it was a terribly designed process.

I think the discretionary spending caps allowed us to reduce defense spending very significantly, and that probably would not have occurred to the degree that it did had we not had those caps.

I think the PAYGO procedures that we had during the 1990s were very important at stopping proposals that members had for expanded mandatory programs or tax cuts. I was running CBO during that era, and the number of times things came to us to look at, and when we gave our score to them they never appeared—they died—was quite impressive.

The volume of "good ideas" that came rushing forth, attractive things, you know, was hugely reduced. So I think all of these things can make a small amount of difference, but the real question goes back to Dr. Miller's point.

He said, if you adhere to these they will work. So what can you enact that will help you adhere to them when the going gets tough? When the American people do not want the cuts? They want the tax cuts. They want the spending increases. And this is very unpopular. And that is really a question I think for you to try and answer.

Vice Chairman Brady. Thank you, Doctor.

Dr. Miller. Could I give you just a quick set of metrics here?

Vice Chairman Brady. Yes.

Dr. Miller. In fiscal year 1987 the forecast for the deficit was something like $221 billion. That was the deficit. And this was on total spending of almost $1 trillion.

The next year it came down to $108 billion, cut in half. So I mean that was Gramm-Rudman-Hollings. So it does work. But then of course the following year is when the Congress passed and the President had to sign—it's a long story—basically a redefining of those targets.

Vice Chairman Brady. Thank you, Doctor.

Representative Campbell.

Representative Campbell. Thank you. I will just ask you all just one simple question, since it is something that is kind of boiling out there right now, the debt limit is. A balanced budget amendment that is so-called "clean" or "straight up" or however you want to do it, no supermajority for taxes, no spending limit attached, a supermajority to override clearly but otherwise just a straight balanced budget amendment, in each of your opinions is that a worthy thing to have? Does it help the situation, or not? I will start with you, Dr. Miller.

Dr. Miller. Yes.

Representative Campbell. Well that was quick. Dr. Mitchell.

Dr. Mitchell. I will be a little more loquacious. It is a double-edged sword. One of the reasons I like Senator Lee's balanced budget amendment is because it, in reality, is more of a spending limit amendment. It is just called a balanced budget amendment because that is one of the features it has.

I do worry because we have 49 out of 50 states with balanced budget requirements of some kind, and that obviously has not stopped some states from taxing and spending themselves into a fiscal ditch.

Representative Campbell. That would include my home State of California.

Dr. Mitchell. I was not going to point that out, but if you are willing to say so——

[Laughter.]

Representative Campbell. I point it out all the time.

Dr. Mitchell. The Mostra Criteria in Europe, where these rules were 3 percent of GDP deficits and 60 percent of GDP debt, has not stopped the Europeans from taxing and spending themselves into fiscal crisis.

So in my gloomier pessimistic moments, I worry that just a plain vanilla watered down balanced budget amendment would be seen as a Constitutional obligation to raise taxes, which I think would simply be like a dog chasing its tail. So I am leery about that.

But I can certainly see that, well, if we did nothing else, we may have no choice but a plain balanced budget amendment. But it is not my preference.

Representative Campbell. Okay, Dr. Reischauer.

Dr. Reischauer. It will not surprise you that my answer to the question is: No. And one reason why I would say that—it is certainly better than the alternatives, but still not acceptable in my view—a balanced budget amendment to get through the Congress, to define all of the issues that I talked about, and to be ratified by the states, probably would take until around 2020, which I think is long after we have to settle this set of issues. And were we to—and pass through the Congress, a balanced budget amendment, the tendency of legislators I think would be to say, well, we have done that. Let's relax. And international markets are not going to let us relax.

We have to face up to this issue in the next year or two.

Representative Campbell. And I could not agree with you more on that point. However, I would love to think that this would be the last fiscal crisis the country will ever have; but I think that is not likely to be the case.

So just for what it is worth, I mean, you are right. It would not have any impact. We are going to, in my view, we are dealing with a statutory debt limit. I talk about the real debt limit, which is the point out there at which markets no longer will buy our debt except at a severely higher interest rate.

And unless we make progress on the real debt limit soon, the statutory debt limit is not going to matter very much over time. But you are right, we have to solve this problem much quicker than that. But it would at least maybe help future crises—future Congresses from getting to this point in decades ahead from now.

I will yield back, Mr. Chairman.

Vice Chairman Brady. Thank you, Congressman. Representative Maloney.

Representative Maloney. I would like to ask all the panelists, I am really concerned, and we seem to be more challenged than I thought we would be at this point in passing something.

What would happen if we did not raise the debt ceiling? What would happen if we defaulted? And would we not be self-inflicting a wound, increasing our required payments to service our debt, and making our debt problem worse? And are these immediate problems that we face, is it worth this to get a budget deal done by August 2nd?

I would just like to ask the same question to all of you. This is really the question of the day. This is what is before Congress and what is being debated. We have all read the press reports, and we are in serious challenges right now.

So what would happen? Do you want to start, Dr. Miller, and go down?

Dr. Miller. Thank you, Congresswoman.

First, as I laid out in an op ed piece in The Hill recently, the debt ceiling is much more forgiving than I think people have talked about.

Also, it is not a "cliff" as the kind of debt ceiling we had in the Reagan Administration where the ceiling is here (indicating) and then it falls automatically unless extended. It just continues. The current one just continues. In the case of the cliff, it is rather catastrophic because you cannot roll over any of the debt as it comes due.

What you have to do would be to make the kinds of decisions any family would make if their credit card company called them up and says: You have hit the limit and you cannot have any more. That means that you have to make choices.

So I mean the President will of course realize that the money coming in, the revenues coming in, are far more than what is required to pay the interest on the debt, far more than is required to pay Social Security, and pay Medicare, and most of the other entitlement programs, to pay our Armed Forces, and probably to pay most of the Federal employees.

But you would have to make some hard decisions on the programs. And it would be relatively easy for awhile. You could also sell some assets. I'll just tell you a secret here: When I was Budget Director I wrote a memo to the President when we were facing one of these things and said: Well, Mr. President, if it comes down to the worst, you could sell the gold in Fort Knox. I got a note back from him that says: We're not selling the gold in Fort Knox.

But there are a lot of ways that you can do something to ameliorate the problems. But it will not last very long. So it will be increasingly costly for the Congress and the President to have gridlock.

Dr. Mitchell. The only thing I would add to what Professor Miller said is that spending is projected to be, $3.7 trillion or so; revenues $2.2 trillion. So obviously if we can no longer borrow, it would require overnight, a 35, to 40 percent reduction in government spending compared to what we have projected and promised for the year.

As was just mentioned, there is obviously more than enough money to pay interest on the debt. So I do not think default is a real possibility.

But there is no question that a 35 to 40 percent reduction overnight means real disruption. It means hospitals not getting their Medicare reimbursements. It means grants not going out to state and local government. It would mean all sorts of things like we have seen in the State of Illinois where vendors were going six months, nine months without payment.

So as much as I want a much smaller government, that is probably not the best way to do it.

Dr. Reischauer. I think my colleagues have made this sound a lot more "doable" than in fact it is. All of Dr. Mitchell's reactions would occur, but there are economic consequences.

And if this lasts let's say more than a week or two, you are going to see economic activity begin to shrink. You are going to see spreading hardship among those who are getting a partial check when they expected a total—a large check, or applied for unemployment benefits and were denied them because there was no money.

You know, besides that, once it occurred and was remedied, the tail would exist for a long time. Contractors in the Federal Government would say "there's a risk I'm not going to get paid in a timely way, I'm going to charge a little more for this."

Lenders to the United States will say: You know this is not the safest bet in the world. I want a little higher interest rate. And we will be paying large amounts of money, tribute in a sense, for our failure to act in a responsible way when the time came.

Representative Maloney. Thank you. My time has expired.

Vice Chairman Brady. Thank you. Congressman Burgess, for the final question.

Representative Burgess. Thank you. Dr. Reischauer, you were talking about the effect of the balanced budget amendment on some of the social safety nets, and you specifically referenced Social Security.

Now I am sitting here addressing three high-powered economists, and I'm just a simple country doctor, but as I understand the Social Security Trust Fund and the way it was designed—now true enough, the Federal Government would have great difficulty in having to monetize the debt that we owe to the Trust Fund—but Social Security payments would continue because they are taken out of the Trust Fund, not out of the General Treasury. Is that correct?

Dr. Reischauer. What I was talking about is some of the balanced budget amendments that say you cannot spend more in any single year than the revenues coming into the Federal Government. Then, to draw down the Trust Fund you are going to have to reduce other spending of the government. I mean, you could. I said it would make it more difficult, especially if you were sort of up at the limit, meaning you had passed appropriation bills and mandatory spending and all that that equaled, you thought, what the revenue stream would be during the year.

Representative Burgess. But there are still dollars owed to the Trust Fund that would be available to pay the beneficiaries' Social Security?

Dr. Reischauer. Yes, but every dollar you drew you would have to reduce some other spending. It is not that it is impossible; it is just that it is more difficult.

Representative Burgess. There are certainly some that would argue that we should have never been spending the money collected for Social Security as general revenue in the first place; that that was a mistake to allow the commingling of assets. And were we a private law firm, we might all go to jail for having done that.

But at the end of—if the Trust Fund at some point in the future becomes exhausted, what then happens to the benefits paid to people who are receiving Social Security at that point? Are the benefits not limited to the amount of money that is collected with the Social Security Tax?

Dr. Reischauer. Yes, they are. And I believe under current law, rather than have a ratable reduction in benefits of something around 25 percent, as would occur, you would delay payments to individuals. I think that is the way the legal structure works.

Representative Burgess. But there will be consequences.

Dr. Reischauer. There certainly will.

Representative Burgess. And, you know, I have not been here a long period of time, but long enough to have lived through the previous Administration's discussion of let's do something to improve the long-term solvency of Social Security. It has come up from time to time. It becomes a political football. But in truth, we are not being honest with people by simply saying the status quo will allow these benefits to be paid in perpetuity with no negative consequence to the benefits paid. Is that correct?

Dr. Reischauer. That is correct, but I think the Trustees Reports, which I have some responsibility for, state that very clearly and have for many years.

Representative Burgess. As you know——

Dr. Reischauer. Few people read it.

[Laughter.]

It is not bedtime reading, to pick up the Trustees Report.

Representative Burgess. But the truth—there's the old saying: A lie can get around the world twice before the truth gets a chance to put his pants on. And that is a problem.

And yet, despite the political downside, I think this is something which we need to be honestly discussing. And unfortunately a lot of the rhetoric that surrounds the Ryan budget, and Medicare, and a lot of the rhetoric that surrounded when President Bush was talking about trying to save Social Security, it becomes a huge distraction and Congress has not done its work.

And as a consequence, at some point in the future there is going to be a very, very serious price to be paid. And I will just never forget the day 20 years ago when, as a young 40-year-old physician I am in an audience listening to Paul Tsongas the day after President Clinton gave his health care speech to a Joint Session of Congress, not a dry eye in the house as reported by Senator Tsongas, because President Clinton described five new entitlement programs and we cannot pay for the ones that we have now.

And if we did not do something, in 20 years' time, if we did not do something to address the crisis coming in entitlements, in 20 years' time there likely could be an intergenerational conflict the likes of which this country has never seen. That was 20 years ago when I was 40. That seemed so far off and so theoretical, why worry about it? The problem is, it is 20 years later and that time now is at hand. And it is important that this Congress face those facts and deal with those hard problems because they are not going to be easier 10 years from now.

Thank you, Mr. Chairman, for your indulgence. I will yield back, unless, Doctor, you wanted to make a comment on that?

Dr. Reischauer. Your call for action is one I agree with completely.

Vice Chairman Brady. There is no substitute for political will in getting our financial house in order. Fiscal rules done right can matter, can help. And I so appreciate, we all do, the experience of this panel in dealing with real-world experiences in trying to get a handle on this.

Dr. Miller, Dr. Mitchell, Dr. Reischauer, thank you for taking the time from your very busy schedules to share your insight with us today. We have got a lot of work to do, as you know, going forward. So do not be surprised if we are calling on your insights and advice and counsel as we move forward as well.

So thank you, very much.

Dr. Mitchell. Thank you.

Dr. Miller. Thank you.

Dr. Reischauer. Thank you, Mr. Chairman.

Vice Chairman Brady. The meeting is adjourned.

[Whereupon, at 11:43 a.m., Wednesday, July 27, 2011, the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

Joint Economic Committee
Republicans Representative Kevin Brady Vice Chairman Designate

REPUBLICAN STAFF COMMENTARY

Spend Less, Owe Less, Grow the Economy

March 15, 2011

I. INTRODUCTION

The global financial crisis and the subsequent recession increased government outlays for transfer payments to households and reduced tax receipts in the United States and other developed countries. In addition, the U.S. and some other governments recapitalized failing banks, insurers, and other firms and initiated Keynesian "stimulus" programs containing one-time rebates, even higher transfer payments to households, and additional government spending on infrastructure. Consequently, government budget deficits and government debt as a percentage of GDP rose sharply. According to the International Monetary Fund (IMF):

> *[B]ased on current likely policies... advanced economies will continue to run sizable primary deficits* [i.e., government non-interest outlays less government receipts] *over the medium term, leading the average general government gross debt ratio—which has already ballooned by close to 20 percentage points of GDP since the onset of the crisis—to rise by a further 20 percentage points by 2015, reaching about 110 percent of GDP.*[1]

Soaring federal spending. The current and prospective levels of U.S. government spending are extremely troubling. Federal outlays averaged 19.4% of GDP during most of the post World War II period (fiscal years 1947-2007). During the last three fiscal years, federal outlays have soared 26.6%—from $2.73 trillion, equal to 19.6% of GDP, in fiscal year 2007 to $3.46 trillion, equal to 23.8% of GDP, in 2010. In its January 2011 baseline for fiscal years 2012 to 2021, the Congressional Budget Office (CBO) projected that federal outlays will be 24.7% of GDP in the current fiscal year and 24.0% of GDP in fiscal year 2021 [fig.1]. In June 2010, the most recent long-term projection, the CBO projected that federal outlays would climb to 35.2% of GDP in 2035 in the alternative fiscal scenario under current policies [fig. 2].

Ballooning federal debt. This explosion in federal spending has caused an unprecedented deterioration of the fiscal condition of the federal government. At the end of fiscal year 2007, gross federal debt was $9.00 trillion, equal to 64.4% of GDP, while publicly held

Highlights

- Fiscal consolidations are programs to reduce government budget deficits and stabilize debt as a percentage of GDP.
- Fiscal consolidation programs that rely predominately or entirely on spending reductions are more likely to achieve their goals of government budget deficit reduction and debt stabilization as a percentage of GDP than programs that rely primarily on tax increases.
- In the long term, fiscal consolidation programs that reduce government spending as a percentage of GDP accelerate economic growth.
- In the short term, fiscal consolidation programs that rely predominately or entirely on spending reductions have expansionary "non-Keynesian" effects that may offset the contractionary Keynesian reduction in aggregate demand.
- In some cases, "non-Keynesian" effects may be strong enough to make fiscal consolidation programs expansionary in the short term.
- Eliminating agencies and programs; cutting the number and compensation of government workers; and reducing transfer payments to households and firms have strong "non-Keynesian" effects.
- Reforming government pension and health insurance programs for the elderly to make them sustainably solvent may also have strong "non-Keynesian" effects even if reforms are phased in slowly, do not affect current beneficiaries, and do not significantly reduce government outlays in the short term.

federal debt was $5.05 trillion, equal to 36.2% of GDP. During fiscal year 2010, the federal government ran a $1.29 trillion budget deficit (8.9% of GDP). At the end of fiscal year 2010, gross federal debt reached $13.53 trillion (93.2% of GDP), while publicly held federal debt was $9.02 trillion (62.1% of GDP) [fig. 3]. In its January 2011 baseline, the CBO projected that publicly held federal debt will grow to 76.7% of GDP in 2021. In June 2010, the CBO projected that publicly held federal debt would climb to 185% of GDP in 2035 in the alternative fiscal scenario under current policies [fig. 4].

High government debt slows growth. A high level of federal debt as a percentage of GDP will slow U.S. economic growth. In "Growth in a Time of Debt," economists Carmen Reinhart and Kenneth Rogoff (2010) observed, "The sharp run-up in public sector debt will likely prove one of the most enduring legacies of the 2007-2009 financial crisis in the United States and elsewhere."[2] Analyzing 20 developed countries between 1946 and 2009, Reinhart and Rogoff found a distinct threshold for gross government debt equal to 90 percent of GDP. For developed countries above this threshold, the median real GDP growth rate is 1 percentage point lower than developed countries below this threshold, and the mean average real GDP growth rate is almost 4 percentage points lower. Reinhart and Rogoff warned, "Seldom do countries simply 'grow' their way out of deep debt burdens."[3] Rather, Reinhart and Rogoff found that countries that have accumulated large gross government debts as a percentage of GDP must take comprehensive action to reduce their debt levels.

Unsustainable fiscal course. On February 24, 2010 in a hearing of the Committee on Financial Services, then Ranking Member Representative Spencer Bachus asked Federal Reserve Chairman Ben Bernanke whether the U.S. government was on an "unsustainable" fiscal course. "[G]iven the numbers that the CBO and the OMB have projected, that is right," Bernanke replied. "I do think that it is very important that we begin to look at the path, the trajectory of the deficit as it goes forward." Bernanke continued, "[I]t would be very helpful even to the current recovery to markets' confidence if there were a sustainable credible plan for a fiscal exit."[4]

Risk for a credit rating downgrade. On January 13, 2011, *The Wall Street Journal* reported

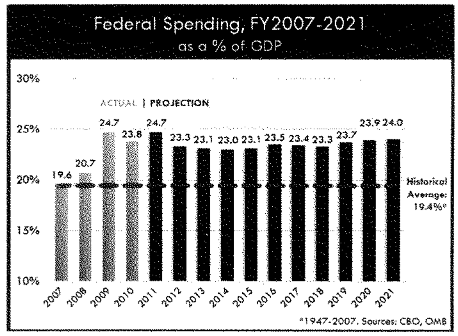

Figure 1

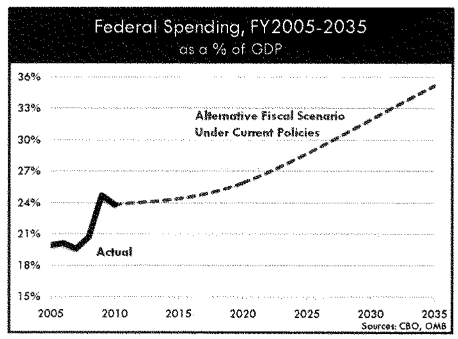

Figure 2

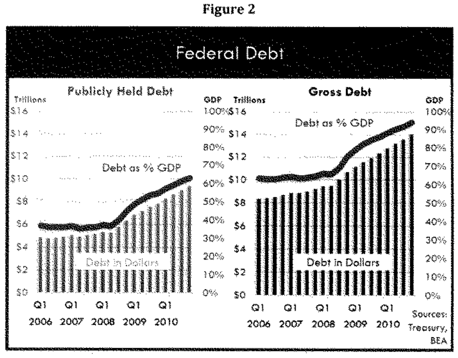

Figure 3

that Standard and Poor's and Moody's Investors Services cautioned the United States on its credit rating, expressing concern over a deteriorating fiscal situation.[5] The next day, *The Wall Street Journal* reported that the European debt crisis had thinned the ranks of triple-A sovereigns, with Spain and Ireland falling by the wayside. The article warned that the government debt crisis is moving toward the core of the global financial system, leading to speculation that France, Germany, the United Kingdom, and the United States could lose their triple-A ratings.[6]

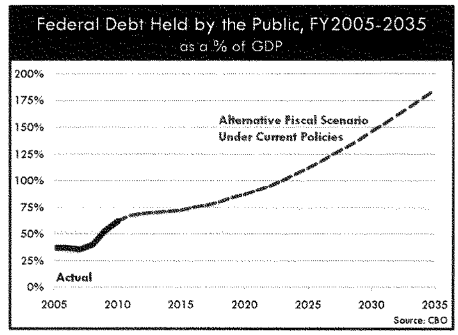

Figure 4

Fiscal consolidation. To create a "credible plan for a fiscal exit" and avoid a government debt crisis, U.S. policymakers should initiate a fiscal consolidation program that would reduce government budget deficits and stabilize government debt as a percentage of GDP. Theoretically, a fiscal consolidation program may accomplish its goals by either reducing government spending or increasing government receipts (including tax increases, higher user fees, and asset sales). A growing body of empirical studies proves that fiscal consolidation programs based predominately or entirely on government spending reductions are far more likely to be successful in achieving their goals of government budget deficit reduction and government debt stabilization than fiscal consolidation programs in which tax increases play a significant role. In fact, empirical studies have found that fiscal consolidation programs that reduce government spending as a percentage of GDP will boost the real GDP growth rate in the long term. These studies also suggest that fiscal consolidations based predominately or entirely on government spending reductions may even boost the real GDP growth rate in the short term under certain circumstances.

II. COMPETING THEORIES: FISCAL CONSOLIDATION AND ECONOMIC GROWTH

A. KEYNESIAN VIEW

Keynesian theory. Keynesian economists hold that fiscal consolidation programs are contractionary in the short term, but may be expansionary in the long term. According to Keynesians, either deceasing government outlays or increasing government receipts reduces the real GDP growth rate in the short term.

As for spending reductions, Keynesians say:

1. Decreasing the number of government workers or their compensation lowers government consumption;
2. Decreasing government outlays for infrastructure lessens government investment; and
3. Decreasing transfer payments to households shrinks personal consumption expenditures as most of these transfer payments go to households with a high marginal propensity to consume.

As for tax increases, Keynesians say:

1. Higher taxes on households (including higher individual income, payroll, and consumption taxes) decrease personal consumption expenditures; and
2. Higher taxes on firms (including higher individual and corporate taxes) decrease non-residential fixed investment (i.e., business investment in productive assets such as equipment, software, and structures).

Keynesians agree with the conventional view that fiscal consolidation programs may boost economic growth in the long term. Fiscal consolidation programs decrease the government's demand for funds in the credit market by reducing government budget deficits and slowing the accumulation of government debt. All other things being equal, a smaller demand for credit reduces its price. Therefore, real interest rates fall.[7] Over time, lower real interest rates will spur business investment in productive assets, accelerating the real GDP growth rate.

Keynesians are generally indifferent about whether fiscal consolidation occurs through government spending reductions or tax increases. According to Keynesian theory, the size of government budget deficits or surpluses, not the level of government spending or taxes, affects real interest rates and business investment. The composition of fiscal consolidation programs is therefore irrelevant.

How government budget deficits and debts affect real interest rates. While Keynesian theory may sound plausible, it is not well supported. First, the relationship between government budget deficits or surpluses (or government debt) and real interest rates is more complex and smaller than Keynesians contend. Increases in federal budget deficits due to temporary factors—e.g., recession or war—which financial market participants expect to be transitory and reversed do not affect real interest rates. However, a permanent increase in federal budget deficits does elicit a small, but statistically significant increase in real interest rates.

For example, Engen and Hubbard (2004) found that "an increase in government debt equivalent to one percentage point of GDP" would increase real interest rates by 2 to 3 basis points.[8] Moreover, Laubach (2009) found that a projected increase in the federal budget deficit equal to 1% of GDP raises the five-year-ahead 10-year forward Treasury rate by 20 to 29 basis points. Alternatively, Laubach found that a projected increase in the federal debt held by the public equal to 1% of GDP increased the five-year-ahead 10-year forward Treasury rate by 3 to 4 basis points.[9]

"Higher government debt as a percentage of GDP, in the long term, reduces business investment."

Relationship among government budget deficits and debt, real interest rates, and business investment. Second, recent empirical studies have found that government debt, the real interest rate, and business investment are not as statistically related as Keynesians contend. In a study examining whether additional government debt "crowds out" private investment through a higher real interest rate, Traum and Yang (2010) found "no systematic relationship among [government] debt, the real interest rate, and [business] investment."[10]

- **Short term**. Additional government debt, in the short term, may either "crowd in" or "crowd out" business depending on what caused government debt as a percentage of GDP to increase. If higher government debt as a percentage of GDP is due to a reduction in "distortionary taxes"—e.g., high marginal tax rates on capital income – that increase the after-tax rate of return on business investment, then higher government debt is associated with a short-term increase in business investment. On the other hand, if higher government debt as a percentage of GDP is due to an increase in government spending as a percentage of GDP—particularly for higher government consumption and transfer payments to households and firms—then higher government debt is associated with a short-term decrease in business investment.
- **Long term**. Higher government debt as a percentage of GDP, in the long term, reduces business investment. Imposing higher taxes in order to service the increase in government debt as a percentage of GDP drives this negative long-term relationship with business investment.

Traum and Yang analyzed the effects of the *Omnibus Budget Reconciliation Act of 1993* (OBRA 1993) and the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA 2001) on business investment.

- **OBRA 1993**. President Bill Clinton signed OBRA 1993 into law on August 10, 1993. Among other things, OBRA 1993 (1) increased the top federal individual income tax rate to 39.6%, (2) increased the top federal corporate income tax rate to 35%, (3) removed the earnings cap on the Medicare payroll tax, (4) increased the taxable portion of Social Security benefits, and (5) increased the federal motor vehicle fuel tax by 4.3 cents. The capital and labor tax increases in OBRA 1993 reduced the real stock of federal debt by 11% below what it would have otherwise been in the second quarter of 1997, while the reductions in federal spending as a percentage of GDP between 1993 and 1996 reduced the real stock of federal debt by another 6% below what it would have otherwise been in the second quarter of 1997. Despite a reduction in federal debt held by the public from 49.3% of GDP at the end of fiscal year 1993 to 45.9% of GDP at the end of fiscal year 1997, business investment was about 7% lower than it would have otherwise been without the OBRA

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1993 tax increases. When government spending reductions, which have a positive effect on business investment, are also included with the OBRA 1993 tax increases, business investment was still about 0.5% lower than it would have otherwise been.

- **EGTRRA 2001**. President George W. Bush signed EGTRRA 2001 into law on June 7, 2001. Among other things, EGTRRA 2001 (1) reduced federal marginal individual income tax rates from a range of 15% to 39.6% to 10% to 35% in phases through 2006, (2) made major changes to qualified retirements plans, and (3) phased-out the estate tax by 2010. The EGTRRA 2001 tax reductions increased the real value of federal debt by 7% over what it would have otherwise been at the end of the fourth quarter of 2002. Nevertheless, the EGTRAA 2001 tax reductions increased output and business investment by 0.8% and 2.2%, respectively, above what they would have otherwise been at the end of the fourth quarter of 2002.[11]

B. NEOCLASSICAL VIEW

Neoclassical economists have a different view of fiscal consolidations. According to neoclassical economists, the composition of fiscal consolidation programs largely determines:

1. Whether programs succeed in achieving their objectives for government budget deficit reduction and government debt stabilization; and
2. How programs affect the real GDP growth rate in both the short term and the long term.

Optimal size of government. Unlike Keynesians, neoclassical economists focus on government spending as a percentage of GDP rather than government budget deficits or government debt as a percentage of GDP to assess the burden that government imposes on the private sector. Determining the appropriate level of government spending necessarily requires an analysis of the appropriate size of government. On the one extreme, anarchy discourages individuals from working, saving, and establishing firms to invest in productive assets. On the other extreme, an extremely large government makes large transfer payments and levies very high taxes that discourage work, saving, and investment. At both extremes, very little economic growth occurs. Between these extremes, the optimal size of government, as measured by government spending as a percentage of GDP, maximizes the real GDP growth rate over time.

"Increasing government spending slows economic growth."

The optimal size of the U.S. government varies through time based on many factors, some of which include (1) external threats, (2) the assignment of governmental functions among the federal government, states, and localities, and (3) demographics. Vedder and Galloway (1998) found that the optimal level of federal spending was 17.5% of GDP for 1947 through 1996 and 11.1% of GDP for 1796 through 1996.[12] While the precise government spending-to-GDP ratio for the optimal size of the federal government is debatable, most neoclassical economists agree that the current level of federal spending—a projected 24.7% of GDP in fiscal year 2011—is far above the optimal level.

- Landau (1983, 1986), Grier and Tullock (1989), and Barro (1991) found a consistently negative relationship between government spending as a percentage of GDP and the real GDP growth rate, meaning that increasing government spending slows economic growth.[13]
- Examining the effects of government size and fiscal volatility on growth for OECD member-countries and EU member-states from 1970 to 2004, Afonso and Furceri (2007) found that both larger government and fiscal volatility reduced the real growth rate per capita of GDP for both sets of countries.[14] In particular, they conclude that "a percentage point increase in the share of total revenue (total expenditure) would decrease output by 0.12 and 0.13 percentage points respectively for the OECD and for the EU countries."[15]
- Based on an analysis of 107 countries between 1970 and 1985, Engen and Skinner (1992) found that increasing tax revenue by 10 percentage points of GDP reduces the medium-term (15 years) real GDP growth rate by 3.2 percentage points annually. Moreover, Engen and Skinner also found that a 10 percentage point increase in government spending as a percent of GDP that is fully paid for through higher taxes would reduce the medium-term real GDP growth rate by 1.4 percentage points. The findings of

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Engen and Skinner refute the Keynesian contention that it is the government budget deficit, not the level of government spending that is the drag on economic growth.[16]

Economic efficiency. To neoclassical economists, reducing government spending as a percentage of GDP increases economic efficiency by shifting financial, physical, and labor resources from the government to the private sector. In turn, greater economic efficiency boosts long-term economic growth. The private sector is generally more efficient than government because (1) private firms and government pursue different goals, and (2) private firms face competitive discipline, while governments have monopoly power.

- **Different goals**. Private firms pursue the goal of wealth maximization and align the interests of firm managers and workers with those of the owners through incentive-based compensation (e.g., stock options). In contrast, governments pursue multiple and often conflicting goals because of the inherently divergent interests of elected officials, government employees, and citizens cannot be as easily aligned. For example, some elected officials may seek re-election or election to higher office by promising unsustainable transfer payments to households knowing the bills will come due years later. Some agency officials may seek to enlarge unnecessarily their agency's budget to increase their own compensation and prestige. Some individuals and private firms may capture the government, hoping to use its regulatory, spending, or taxing power to gain some advantage.[17]
- **Competitive discipline**. Competition forces private firms to respond to price signals, increase the quantity and quality of their output, and reduce waste. In contrast, most governmental functions are legal monopolies (e.g., armed forces and police) or near monopolies (e.g., K-12 public schools). Because of the lack of competition, government is insensitive to price signals, indifferent to increasing the quantity or quality of its output, and prone to waste.[18]

III. EMPIRICAL EVIDENCE: FISCAL CONSOLIDATION AND ECONOMIC GROWTH

"Non-Keynesian" effects. For decades, Keynesians asserted that reducing government spending as a percentage of GDP had opposing short-term and long-term effects on economic growth (i.e., reducing government spending would be contractionary in the short term, but expansionary in the long term). In recent years, however, Alberto Alesina, Francesco Giavazzi, and other neoclassical economists have revived the traditional view that fiscal consolidation programs based predominately or entirely on government spending reductions have expansionary "non-Keynesian" effects that may offset some or all of the contractionary "Keynesian" reduction in aggregate demand in the short term.

"...changes in business investment explain a large part of the change in GDP growth around these large fiscal stabilizations."
--Alesina et al.

"Non-Keynesian" effects on major household purchases. First, Giavazzi and Pagano (1990), Perotti (1999), and Giavazzi et al. (2000) argued that fiscal consolidation programs based predominately or entirely on government spending reductions provide a short-term boost to personal consumption expenditures and residential fixed investment. When government budget deficits are persistently high and the level of government debt is rising rapidly as a percentage of GDP, households expect the government to levy large tax increases on them, either imminently or sometime in the future, in order to service the government's debt burden. Fiscal consolidation programs that reduce government spending as a percentage of GDP decrease short-term uncertainty about taxes and diminish the specter of large tax increases in the future. In turn, higher expectations for permanent disposable income create a positive wealth effect among households. Consequently, households will purchase more homes and durable consumer goods such as motor vehicles in the short term.[19]

"Non-Keynesian" effects on business investment. Second, Alesina et al. (2002) found that "[f]iscal adjustments which rely mostly on spending cuts, particularly in transfers and government wages, are associated with a surge in growth during and immediately after the adjustment . . . changes in business investment explain a large part of the change in GDP growth around these large fiscal stabilizations."[20]

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Like households, firms expect large tax increases, either imminently or sometime in the future, when they observe increased government spending causing large government budget deficits and a rapidly rising level of government debt as a percentage of GDP. Fiscal consolidation programs that reduce government spending as a percentage of GDP reduce short-term uncertainty about taxes rising to pay for the spending and allay fears about large tax increases in the future. Moreover, fiscal consolidation programs that decrease the number and compensation of government workers increase the availability and reduce the cost of skilled labor to private firms. The combination of improved expectations about taxes and lower labor costs increases the expected after-tax rate of return on new business investment. Consequently, private firms will boost their investment in non-residential fixed assets in the short term.[21]

Examining data for 18 OECD member-countries from 1960–1986, Alesina et al. (2002) estimated how an increase in primary government spending and its major components—government employee compensation, transfer payments, and government consumption—would affect private investment as a percent of GDP. The authors found that an increase in primary government spending equal to one percentage point of GDP would decrease private investment by 0.15 percent of GDP in the same period and by 0.74 percent of GDP cumulatively over five years. Alesina et al. (2002) also found that an increase in government employee compensation equal to one percentage point of GDP would decrease private investment by 0.48 percent of GDP in the same period and by 2.56 percent of GDP cumulatively over five years. Similarly, an increase in government transfer payments equal to one percentage point of GDP would decrease private investment by 0.21 percent of GDP in the same period and by 1.05 percent of GDP cumulatively over five years.[22]

"Certain government spending reductions generate significantly larger pro-growth effects than others."

Cutting government spending. For these expansionary "non-Keynesian" factors to offset significantly or even overwhelm the contractionary Keynesian reduction in aggregate demand in the short term, fiscal consolidation programs must be based predominately or entirely on government spending reductions. Increasing the marginal income tax rate on labor income through higher individual income or payroll tax rates reduces both the quantity and quality of work that households provide, reducing real GDP. Likewise, increasing the marginal income tax rate on capital income through higher individual or corporate income tax rates, higher taxes on capital gains and dividends, or lengthening tax depreciation schedules reduces individual saving and business investment, also reducing real GDP.

Certain government spending reductions generate significantly larger pro-growth effects than others. For "non-Keynesian" factors to be significant, government spending reductions must be viewed as large, credible, and politically difficult to reverse once made. Some examples of such reductions are:

1. **Decreasing the number and compensation of government workers**. Generally, government workers are well-educated and have significant skills. A smaller government workforce increases the available supply of educated, skilled workers for private firms, thus lowering labor costs.
2. **Eliminating agencies and programs.**
3. **Eliminating transfer payments to firms**. Generally, government provides transfer payments to firms to entice them to engage in otherwise unprofitable and unproductive activities. If eliminating transfer payments causes firms to cease these activities, there are immediate gains in efficiency. For example, the United States could increase efficiency by eliminating subsidies for Amtrak or ethanol.
4. **Reforming and reducing transfer payments to households**. Reforming major programs of transfer payments to households, such as government pension and health insurance benefits for the elderly, to make them sustainably solvent in the long term increases the credibility of fiscal consolidation plans. Even if current beneficiaries are exempt from any change, the reforms are phased in slowly, and any short-term spending reductions are very small, the credibility of fiscal consolidation plans will be enhanced. Moreover, reforming government pension and health insurance benefits for the elderly in the future will induce younger workers to increase their current saving, to work more, and retire later, thus boosting real GDP growth.

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Asset sales and privatization. While tax increases are contractionary, increases in other types of government receipts may be expansionary. In particular, government asset sales and the privatization of government-owned enterprises and commercial functions both generate government receipts and increase economic efficiency. Since government asset sales and privatizations are politically difficult to reverse, they may also have an expansionary "non-Keynesian" effect in the short term.

IV. EVALUATING FISCAL CONSOLIDATION PROGRAMS

There are two empirical criteria for evaluating a fiscal consolidation program:

1. **Success criterion.** Did a fiscal consolidation program actually achieve the goals of reducing government budget deficits and stabilize government debt as a percentage of GDP?
2. **Growth criterion.** Did a fiscal consolidation program accelerate the real GDP growth rate?

Government budget deficit reduction and government debt stabilization. Many empirical studies have found that successful fiscal consolidation programs focused on cutting government spending as a percentage of GDP. Many successful fiscal consolidations also reformed tax systems to lower marginal income tax rates and reduce the after-tax cost for business investment in productive assets while eliminating "special interest" tax preferences for specific firms, industries, and locations. Lilico, Holmes, and Sameen (2009) found that successful fiscal consolidation programs were comprised of at least 80% government spending reductions and no more than 20% tax increases.[23]

Alesina and Ardagna (2009) examined 107 large fiscal adjustments (defined as a cyclically adjusted improvement in the primary balance of at least 1.5% of GDP in one year) in 21 OECD member-countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States) from 1970 to 2007. Alesina and Ardagna defined a successful fiscal adjustment as a cumulative reduction in the government debt-to-GDP ratio of at least 4.5 percentage points three years after the beginning of a fiscal adjustment. Alesina and Ardagna identified 21 successful large fiscal adjustments in 10 OECD member-countries: Austria (2005), Denmark (2005), Finland (1998), Ireland (2000), Italy (1982), the Netherlands (1972, 1973, 1993, 1996), New Zealand (1993, 1994), Norway (1979, 1980, 1989, 1996), Sweden (1986, 1987, 2004), and the United Kingdom (1977, 1988, 2000). After examining these episodes, Alesina and Ardagna concluded that successful fiscal consolidations were based predominately or entirely on government spending reductions.[24]

Biggs, Hassett, and Jensen (2010) found strong evidence that government spending reductions outweigh revenue increases in successful consolidations regardless of the methodology used to identify consolidations.[25] They found that across both methods for identifying consolidations—Alesina's cyclically adjusted primary balance method (excludes interest payments and business cycle effects) and the IMF's action-based method (spending cuts and tax increases explicitly for deficit or debt reduction)—successful fiscal consolidations averaged 85% spending cuts and 15% revenue increases, while unsuccessful fiscal consolidations averaged 47% spending cuts and 53% revenue increases [fig. 5]. Further, they show that the degree of success correlates to a larger share of spending cuts [fig. 6].

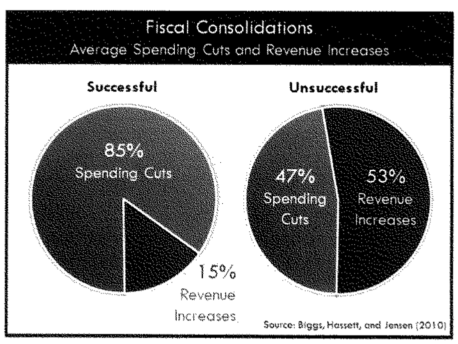

Figure 5

Economic growth effects. Examining Denmark and Ireland in the 1980s, Giavazzi and Pagano (1990) found that large fiscal consolidation programs based predominately or entirely on government spending reductions were expansionary.[26]

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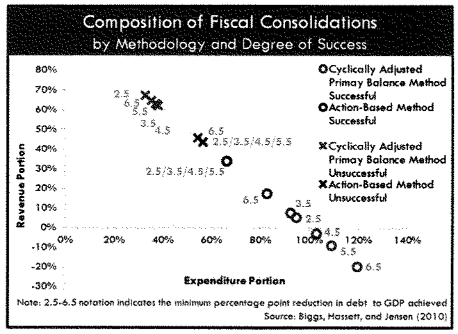

Figure 6

Alesina and Ardagna (1998) examined fiscal adjustments in 15 countries (Australia, Belgium, Canada, Denmark, Finland, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, the United Kingdom, and the United States) during the 1980s. After eliminating Spain (1986-7) and the United Kingdom (1988) because their improvement in the government budget balance was due exclusively to high growth rates, five fiscal adjustments involved both government spending reductions and tax increases. Fiscal adjustments in Ireland (1987-9), Australia (1987), Belgium (1984-5), and Italy (1993, 1994-5) were based on government spending reductions. Alesina and Ardagna concluded that "regardless of the initial level of debt, a large fiscal adjustment that is expenditure-based and is accompanied by wage moderation and devaluation is expansionary. However, no large tax-based fiscal adjustment can be expansionary even if accompanied by devaluation."[27]

Giudice, Turrini and Veld (2003) studied the fiscal policy conducted by 14 EU member-states over a period of 33 years. There have been 49 (based on size) and 74 (based on duration) episodes of fiscal consolidation. About half of them (24 and 43, respectively) have been connected with higher economic growth. Of that half, 11 and 19, respectively, are considered to be "pure" growth episodes in which growth cannot be attributed to a concomitant monetary policy or devaluation of the exchange rate. Giudice, Turrini and Veld found that the size of the adjustment and the size of the initial debt (in percent of GDP) do not seem to play a significant role. By contrast, Giudice, Turrini and Veld found the composition of fiscal adjustment is of high importance. Fiscal consolidation programs based predominately or exclusively on government spending reductions are more likely to enhance growth than programs that involve significant tax increases.[28]

Ahrend et al. (2006) found that both policy interest rates (e.g., the target federal funds rate in the United States) and long-term interest rates are more likely to decline when fiscal consolidations rely on government spending reductions rather than tax increases.[29] Using a dynamic general equilibrium model, Cournède and Gonand (2006) found that tax increases are a much more costly way, in terms of real GDP growth, to achieve fiscal sustainability than government spending reductions.[30]

"Fiscal consolidation programs based predominately or entirely on government spending reductions may be expansionary even in the short term."

Alesina and Ardagna (2009) stressed that fiscal consolidation programs based predominately or entirely on government spending reductions may be expansionary even in the short term. Alesina and Ardagna defined expansionary fiscal adjustments as episodes in which the difference between (a) the average GDP growth rate in the first year of an episode and the following two years, and (b) the weighted average GDP growth rate for the G-7 countries is in the 75th percentile of all such differences. Using this definition, Alesina and Ardagna found 26 episodes of expansionary large fiscal adjustments in nine OECD member-countries: Finland (1973, 1996, 1998, 2000), Greece (1976, 2005, 2006), Ireland (1976, 1987, 1988, 1989, 2000), the Netherlands (1996), New Zealand (1993, 1994, 2000), Norway (1979, 1980, 1983, 1996), Portugal (1986, 1988, 1995), Spain (1986, 1987), and Sweden (2004).[31]

The IMF (2010), however, claimed that Alesina and Ardagna (2009) suffered from methodological issues that may have caused them to overstate the expansionary effects of fiscal consolidations in the short term.[32] Instead, the IMF used an "action-based" method to identify fiscal consolidations that relies on an examination of ex-ante official plans with the goals of government budget deficit reduction and/or government debt stabilization. The IMF found that fiscal consolidations were contractionary overall, but that government spending reductions have much smaller contractionary effects. According to the IMF, a fiscal consolidation equal to 1% of GDP based on tax increases caused a 1.3% decrease in GDP and a 0.6 percentage point increase in the unemployment rate after two years, while a fiscal consolidation equal to 1% of GDP based on government spending reductions caused a 0.3% decrease in GDP and 0.2 percentage point increase in the unemployment rate after two years.[33]

Among different kinds of government spending reductions, the IMF found that a reliance on reductions in transfer payments caused GDP to increase by 0.2% after two years, while reductions in government consumption and investment caused to GDP to decline by 0.4% and 0.6%, respectively, after two years. However, these results were within the margin of error.

"'Cold shower' fiscal consolidations send convincing signals to financial markets about the political will of governments to achieve fiscal retrenchment."

While the IMF strikes a more cautionary note than Alesina and Ardagna (2009) or Giudice, Turrini, and Veld (2003) about the ability of expansionary "non-Keynesian" factors to offset contractionary Keynesian reductions in aggregate demand in the short term, the IMF and these other studies agree that fiscal consolidation programs based predominately or entirely on government spending reductions—especially in transfer payments to households and firms—are better for the economy in the short term than fiscal consolidation programs in which tax increases play a significant role.

Keys for success. Barrios, Langedijk, and Pench (2010) found that quick, decisive government spending reductions (called "cold showers") are effective in achieving successful fiscal consolidations because they send a signal about "political will."[34] This study examined financial crises in EU member-states and OECD member-countries from 1970 to 2008. Barrios, Langedijk, and Pench found that countries facing high levels of government debt or those at risk of slow GDP growth would be better off with sharp and sustained reductions in government spending because "cold shower" fiscal consolidations send convincing signals to financial markets about the political will of governments to achieve fiscal retrenchments. This approach is viewed as more effective than cuts phased-in or scheduled for the distant future.

Von Hagen, Hughes-Hallet, and Strauch (2002) found that the likelihood of sustaining a fiscal consolidation program increases when governments simultaneously address all politically sensitive budget reductions (e.g., transfer payments to households and firms, subsidies, and the number and compensation of government workers).[35] Additional empirical studies found that government spending reductions (especially in government employment and transfer payments) are also more likely to generate lasting fiscal consolidation and better economic performance—e.g., Ardagna (2004);[36] Hughes and McAdam (1999);[37] McDermott and Wescott (1996);[38] Von Hagen and Strauch (2001);[39] Alesina and Perotti (1996);[40] and Alesina and Bayoumi (1996).[41] The OECD (2007) explains the prevalence of cuts to transfer programs in successful consolidations as due to several reasons:

"'[A] greater weight on cuts in social spending tended to increase the chances of success." --OECD

> *[A] greater weight on cuts in social spending tended to increase the chances of success. A reason for this could be that governments more committed to achieving fiscal sustainability may also be more likely to reform politically sensitive areas. As a by-product of doing so, they may at the same time bolster the credibility of the consolidation strategy, thereby improving its chances of success.*[42]

Political consequences of fiscal consolidation. In general, Alesina and Ardagna (1998) found that successful fiscal consolidations were not politically fatal to the governments that enacted them. "[I]t is not the case that governments which engage in large fiscal adjustments are systematically kicked out of office. Just the opposite: in the vast majority of cases, the government that implemented the adjustment was reappointed. This result is consistent with the statistical results of Alesina, Perotti, and Tavares (1998)."[43]

This appears to be true even when governments address transfer payments to households. In their fiscal consolidation programs, both Canada and Sweden reformed their government old-age pension systems to make them financially sustainable over the long term. Yet the Canadian and Swedish governments that enacted these sweeping reforms were subsequently re-elected.

V. SUCCESS STORIES

Over the last four decades, a number of developed countries have successfully reduced government spending and government budget deficits, and stabilized the level of government debt through fiscal consolidation programs. The OECD and many economists have studied fiscal consolidation programs in developed countries. Below is a discussion of three large fiscal consolidations—in Canada, Sweden, and New Zealand—that both achieved their goals for government deficit reduction and government debt stabilization and boosted their real GDP growth rates by reducing government spending.[44]

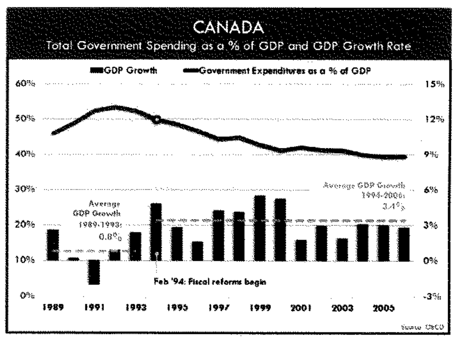

Figure 7

- **Canada: 1993-2006** [fig.7].[45] On October 25, 1993, the Liberal Party led by Jean Chrétien won a majority government, ousting the Progressive Conservative government. Upon taking office, Prime Minister Chrétien and his Finance Minister Paul Martin faced a deteriorating fiscal outlook. In eight years under the Progressive Conservative governments of Prime Ministers Brian Mulroney and Kim Campbell, general government spending had increased from 47.5% of GDP to 52.2% of GDP in 1993. General government spending refers to combined federal, provincial, and local government spending after eliminating the double counting of intergovernmental transfers. Federal spending rose nominally from C$109.2 billion in the Canadian fiscal year (CFY) April 1, 1984 to March 31, 1985 to C$162.4 billion CFY 1993–4, while declining slightly as a percentage of GDP from 24.3% in CFY 1984–5 to 22.3% in CFY 1993–4.

  In February 1994, Prime Minister Chrétien and Minister of Finance Martin embarked on a fiscal consolidation program. They thought that significant tax increases would slow Canada's economic growth and weaken its international competitiveness. They were convinced that Canadian voters would accept tough, previously unacceptable federal spending cuts to avoid higher federal income and value-added taxes. Acting on these beliefs, Martin issued a specific fiscal consolidation program for federal spending reductions and guidelines on how the Liberal government would make other federal spending reductions in the future. The fiscal consolidation program created deadlines and objective benchmarks to judge the Liberal government's performance.

  The federal spending reductions and program reforms included:

  1. **Reforming Canada's Employment Insurance (EI) benefit program** by reducing the duration of benefits, increasing the amount of time people needed to be employed to qualify for the benefits, and reducing the maximum benefit from 60% to 55% of previous pay. As a result of these changes, EI benefit payments fell from C$17.1 billion in CFY 1993–4, to C$11.4 billion in CFY 1997–8;
  2. **Reforming the Canadian Pension Plan (CPP) for the elderly** by moving from a "pay-as-you-go" system to a hybrid between a "pay-as-you-go" system and a fully funded plan. After extensive negotiations with the provinces, the combined employer-employee contribution rate was increased from 5.85% in 1997 to 9.9% in 2003. Under the management of an independent board, the CPP used the additional revenues to accumulate a diverse portfolio of financial assets—including stock—to make the CPP sustainably solvent over the next 75 years;

3. **Cancelling the EH-101 helicopter program**. Defense expenditures fell from C$11.1 billion, equal to 1.5% of GDP, in CFY 1993-4 to $9.0 billion, equal to 1.1% of GDP, in CFY 1997-8;
4. **Reducing transfer payments to Canadian provinces and private firms**. Transfers to the provinces fell from C$26.9 billion, equal to 3.7% of GDP, in CFY 1993-4 to C$20.5 billion, equal to 2.6 percent of GDP, in CFY 1997-8; and
5. **Substantially reducing the operating budgets of federal departments**.

In four years, Martin reduced nominal federal outlays from C$164.2 billion, equal to 22.3% of GDP, in Canadian fiscal year 1993-4 to C$157.9 billion, equal to 17.9% of GDP, in CFY 1997-8. Consequently, general government spending fell from 52.2% of GDP in 1993 to 44.3% of GDP in 1997. Martin's federal spending reductions transformed a federal budget deficit of C$38.5 billion in CFY 1993-4, equal to 5.3% of GDP, into a federal budget surplus of C$3.0 billion, equal to 0.3% of GDP in CFY 1997-8.

Over the next nine Canadian fiscal years, nominal federal outlays grew at an average annual rate of 5.8% to C$222.2 billion, equal to 15.3% of GDP, in CFY 2006-7. Because of strong economic growth, however, general government spending continued to decline from 44.3% of GDP in 1997 to 39.4% of GDP in 2006. And, Canada continued to enjoy federal budget surpluses throughout this period.

Federal spending reductions followed by years of restrained growth in federal spending helped to reduce Canada's federal debt. Canada's net federal debt (gross federal debt less federal financial assets) rose steadily both nominally and as a percent of GDP during the 1970s and 1980s. By end of calendar year 1993, net federal debt was C$471 billion, equal to 64.8% of GDP. Net federal debt peaked nominally at C$588 billion at the end of 1997 and at 69.1% of GDP at the end of 1996. By the end of 2006, net federal debt had fallen to $508 billion, equal to 35.5% of GDP.

Canada's fiscal consolidation program had a positive effect on economic growth. Canada's real GDP growth rate, which had averaged a mere 0.8% in the five years (1989-1993) before fiscal consolidation began, rose to an average of 3.4% between 1994 and 2006.

This fiscal consolidation program proved popular with Canadian voters. The Chrétien-led Liberals won reelection with majority governments on June 2, 1997 and on November 27, 2000. After Martin became leader of the Liberal Party, he won a minority government in the June 28, 2004 election.

- **Sweden: 1994-2000** [fig. 8].[46] Sweden's economy deteriorated severely in the early 1990s as a result of a bursting housing bubble and banking crisis reminiscent of the one the United States recently experienced. The unemployment rate skyrocketed from 2% in the first quarter of 1990 to over 11% in less than three years. The average GDP growth rate during the three years from 1991 to 1993 was -1.5%.

Sweden's fiscal condition also deteriorated during the same period. General government expenditures rose from 58% of GDP in 1988 to 71% of GDP in 1993, and central government debt rose to approximately 76% of GDP. The Swedish government also made large transfer payments to recapitalize failing banks.

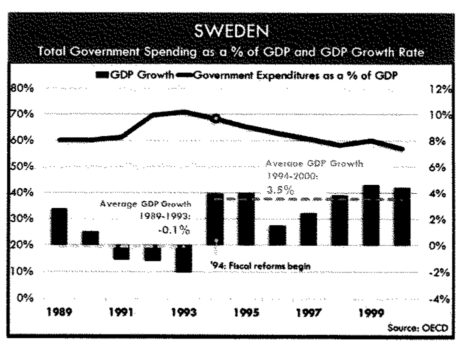

Figure 8

However, the fiscal deterioration was not solely a result of the bursting housing bubble and banking crisis. Similar to the U.S. experience, the Swedish central government had been on an unsustainable long-term fiscal trajectory for many years—the crisis exacerbated the problem.

From 1975 to 1994, Sweden's debt-to-GDP ratio grew at an average rate of 5.2%. In the early 1980s and the early 1990s, the country experienced rising deficits stemming from a rapidly increasing ratio of government spending to GDP. Revenues to GDP lagged during the same period, falling from an average of 61% during the period 1986–1990 to 57% in 1993. And, on top of that, Swedish demographics were placing the sustainability of the public pension system into grave doubt.

On October 7th, 1994, Ingvar Carlsson became Prime Minster of Sweden, backed by the Swedish Social Democratic Party. Over the next six years, his administration and that of his successor, Göran Persson, also of the Social Democratic Party, instituted a fiscal consolidation program focused on reforming the budget process, tightening transfer payments to businesses and households, and increasing certain taxes.

One particularly hard fought reform was an overhaul of the Swedish pension system, which was initially agreed to in 1994 and implemented beginning in 1998. Prior to the reform, Sweden's pension was much like the U.S. Social Security program—tax-financed, pay-as-you-go and facing sustainability issues due to an aging population. Swedish policymakers faced two choices: partially privatize the system or cut benefits and increase taxes. They chose a partially privatized reform package including four major features:

1. Workers were allowed to invest 2.5% of the total 18.5% mandatory set-aside of income;
2. Payroll taxes funded notional accounts with the remaining 16%, with beneficiaries receiving benefits based on the taxes paid during their working life rather than a defined benefit;
3. A minimum pension benefit was guaranteed to the poor, to be paid out of general revenues; and
4. Current and near-retirement workers remained under the old system.

As a result of these various reform efforts, Sweden's fiscal health shifted from a government budget deficit of over 11% of GDP in 1993 to a surplus of 3.6% of GDP in 2000 and the central government debt-to-GDP ratio was reduced from 71% in 1993 to 57% in 2000.

Once Sweden's fiscal condition improved after the adoption of a fiscal consolidation program, the government announced a medium-term target (a surplus of 2% of GDP over the cycle) in order to avoid repeating the same fiscal mistakes. Fiscal rules with embedded expenditure limits have proven to be associated with larger and longer adjustments, and with higher success rates.

Sweden's fiscal consolidation program boosted the Swedish economy. In the five years prior to the program's launch, real GDP contracted by an average of 0.1% per year. Between 1994 and 2000, Sweden enjoyed an average real GDP growth rate of 3.5% per year.

- **New Zealand: 1986–1996** [fig. 9].[47] For several decades before David Lange led the Labour Party to win a majority government in the July 16, 1984 election, successive National Party and Labour Party governments had steadily expanded the crown's (i.e., central government's) role in New Zealand's economy. The period was characterized by persistent and heavy intervention into the economy, including (1) the institution of protectionist policies (e.g., import tariffs and licensing fees, foreign exchange controls, and foreign direct investment restrictions); (2) strict internal regulations; and (3) major agricultural subsidy programs. New Zealand's government controlled a vast web of crown departments and crown-owned enterprises operating in the communications, energy, manufacturing, and transportation industries. By 1984, crown spending was 36.1% of GDP.

  As a result, productivity and income growth rates in New Zealand fell relative to other developed countries. For example, from 1960 to 1984, real GDP per capita increased by an annual average of only 1.4% in New Zealand, approximately half that of other OECD member-countries. Inflation, as measured by the annual CPI rate, rose to 17 percent in June 1982. New Zealand ran persistent government budget deficits that escalated to NZ$2.3 billion, equal to 6.3% of GDP, in the New Zealand fiscal year ending on March 31, 1984. Consequently, New Zealand accumulated an unsustainable level of crown debt of $21.9 billion, equal to 60.7% of GDP in NZ FY1984.

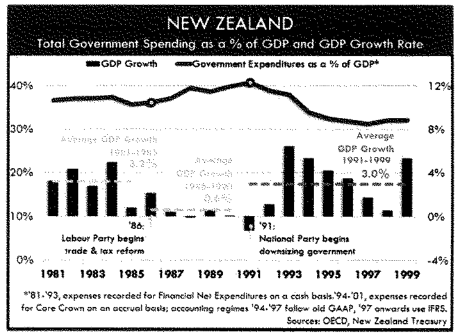

Figure 9

In 1984, Prime Minister David Lange and Minister of Finance Roger Douglas launched a comprehensive reform program focused on reducing government intervention in the economy. Among the program's features were steep reductions in personal income tax rates (the top rate was reduced from 66% to 33% in October 1986) and the corporate tax rate (reduced from 48% to a flat 33% in October 1986), the removal of the great majority of agriculture subsidies, and substantial deregulation of virtually all industries.

The Labour government was re-elected on August 15, 1987. By the New Zealand fiscal year ending on June 30, 1991, crown spending had slightly risen to NZ$30.3 billion, equal to 40.7% of GDP.[48] Although the crown budget deficit was NZ$2.6 billion, equal to 3.4% of GDP, the crown debt had been stabilized at NZ$43.9 billion, equal to 59.1% of GDP.

After the National Party won the October 22, 1990 election, Prime Minister Jim Bolger and Minister of Finance Ruth Richardson slashed crown spending and expanded upon Labour's reforms to liberalize the labor market. Over the next three New Zealand fiscal years, crown spending fell to NZ$28.5 billion, equal to 33.8% of GDP. For the first time since 1978, the crown recorded a budget surplus of NZ$679 million, equal to 0.8% of GDP, in NZ FY 1994. The National government was re-elected on November 6, 1993. By NZ FY 1996, crown spending had been slashed to NZ$30.5 billion, equal to 31.8% of GDP, while budget surpluses reduced crown debt to NZ$41.9 billion, equal to 43.7% of GDP.

Both Labour and National governments made fundamental reforms in crown operations. Whole ministries were eliminated or consolidated, and the overall structure of the government was simplified. Using a corporatize-then-privatize model, major state-owned monopoly enterprises were introduced to market forces. Senior employees were given efficiency-based incentives. Several fiscal accountability and transparency initiatives were enacted during the period. The number of government employees was cut from approximately 88,000 in 1984 to approximately 36,000 in 1996—a nearly 60% reduction.

Fiscal consolidation took much longer in New Zealand than in Canada and Sweden to accelerate economic growth because most of the spending cuts did not occur until 1991. The real GDP growth rate accelerated to 4.7% in 1993 after a decade of sluggish growth.

VI. IS THIS THE WRONG TIME TO DO THE RIGHT THING?

According to the Business Cycle Dating Committee of the National Bureau of Economic Research, the latest U.S. recession ended in June 2009. Although the economy has been recovering for 20 months, payroll job growth remains exceedingly weak by historical standards. Against this backdrop, the fiscal policy debate in Washington rages on. Keynesian economists who backed President Obama's more than $800 billion stimulus plan in February 2009 now oppose significant federal spending reductions. Now is no time for austerity, they say.[49] However, economist John Taylor of Stanford University and of the Hoover Institute rebutted these Keynesian claims in recent testimony before the House Committee on Financial Services:

> *"...the surest way to reduce unemployment is to increase private investment as a share of GDP."*
>
> *--John Taylor*

> *Some say we need to wait to start reducing government purchases because of the high unemployment and the fragile recovery. Some even say we need to increase spending before we start reducing it. But there is no convincing evidence that a gradual and credible reduction in government purchases as a share of GDP will increase unemployment. Indeed, the history of the past two decades shows that lower levels of government purchases as a share of GDP are associated with lower unemployment rates. The same history suggests that the surest way to reduce unemployment is to increase private investment as a share of GDP: Over the past two decades, when investment increased as a share of GDP, unemployment fell. In other words, unemployment is inversely correlated with private investment. . . . So reducing the share of government spending and focusing on increasing the share of private spending . . . is a proven way to create jobs and reduce unemployment.*[50]

VII. CONCLUSION

The current fiscal condition of the U.S. government is perilous. During fiscal year 2011, the CBO projects that federal spending will be 24.7% of GDP, well above the average of 19.4% of GDP for fiscal years 1947–2007, and will remain far above its post World War II average for the next decade. Moreover, the CBO projects that federal spending will increase to 35.2% of GDP by 2035 in the alternative fiscal scenario under current policies. The United States cannot maintain this level of federal spending—let alone allow it to escalate—without seriously damaging its economy.

The abundant empirical evidence is clear and irrefutable; increasing federal spending as a percentage of GDP will slow economic growth in the long term. Therefore, U.S. policymakers should embark on a fiscal consolidation program based on reducing federal spending as a percentage of GDP.

Keynesians warn that significant federal spending reductions now would weaken the current economic recovery. During the last two decades, however, numerous studies have identified expansionary "non-Keynesian" effects from government spending reductions that offset at least some and possibly all of the contractionary "Keynesian" effects on aggregate demand. In some cases, these "non-Keynesian" effects may be strong enough to make fiscal consolidation programs expansionary in the short term as well the long term.

According to empirical studies, fiscal consolidation programs that (1) eliminate government agencies and programs; (2) cut the number and compensation of government workers; and (3) reduce transfer payments to households and firms have strong expansionary "non-Keynesian" effects. Fiscal consolidation programs that reform government pension and health insurance programs for the elderly to make them sustainably solvent in the long term may also have strong positive "non-Keynesian" factors even if reforms are phased in slowly, do not affect current beneficiaries, and do not significantly reduce outlays in the short term.

Obama Administration officials have emphasized the risk of starting a fiscal consolidation program now while ignoring the risk of delay. There are significant external risk factors to the U.S. economy in both the short run and the long run that cannot be foreseen, such as: (1) resurging price inflation, (2) loss of confidence in the U.S. dollar as the world's reserve currency, (3) euro-zone sovereign debt defaults, and (4) war in the Middle East. But, the many examples cited in this commentary show that the United States will be in a better position to respond to any of these challenges by reducing federal spending sooner rather than later.

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[1] "Navigating the Fiscal Challenges Ahead," International Monetary Fund, Fiscal Monitor, May 14, 2010, p. 5, *available at* http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf.

[2] Reinhart, C. M. and Rogoff, K.S., "Growth in a Time of Debt," *American Economic Review*, V. 100(2), p. 577, May 2010.

[3] *Ibid.*

[4] Testimony of Federal Reserve Chairman Ben Bernanke, Committee on Financial Services, Hearing Transcript, Feb. 24. 2010, pp. 15–6, *available at* http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-102.pdf.

[5] "News Hub: S&P & Moody's Warn on U.S. Credit Rating," *Wall Street Journal*, Jan. 13, 2011, *available at* http://online.wsj.com/video/news-hub-sp--moodys-warn-on-us-credit-rating/85C0D4F1-4786-44ED-8C62-E9DF52108C2A.html?KEYWORDS=moody%27.

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[6] Barley, R., "The Triple-A Debt Threat," *Wall Street Journal*, Jan. 14, 2011, *available at* http://online.wsj.com/article/SB10001424052748703583404576079862342374014.html?KEYWORDS=moody%27s.

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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.

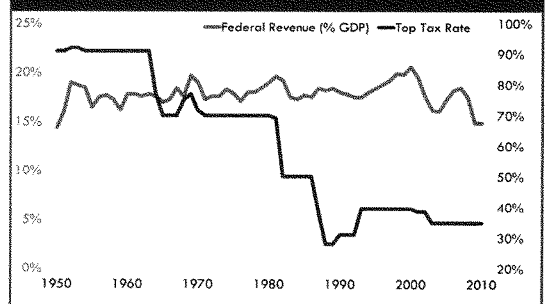
Since the income tax had not yet been invented and government transfer payments were rare, these public choice biases toward higher spending were not readily apparent to many of our founding fathers when they drafted the U.S. Constitution and established the federal government during the late 18th century. 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

Fig. 1

Federal Income Tax Revenue and Top Income Tax Rate



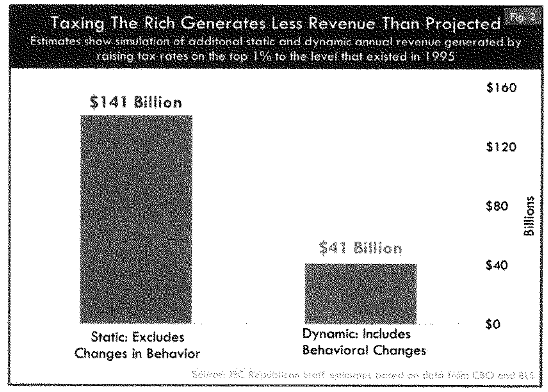
Sources: Office of Management and Budget and Internal Revenue Service

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.

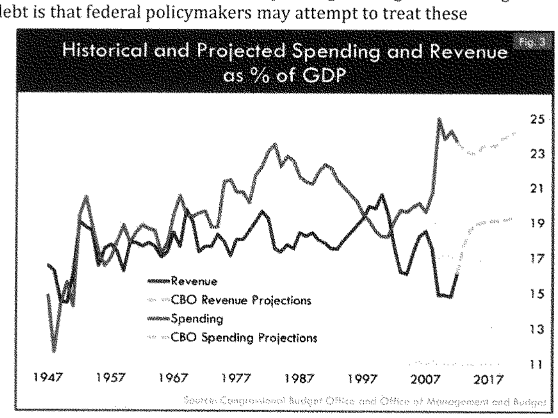
Analysis by the JEC Republican staff based on historical data confirms the negative effects of higher marginal tax rates.[3] If the effective tax rate on only the top one percent of earners were increased to the highest rate that existed under President Clinton, a static analysis (such as that done by 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 not 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



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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 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]

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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]

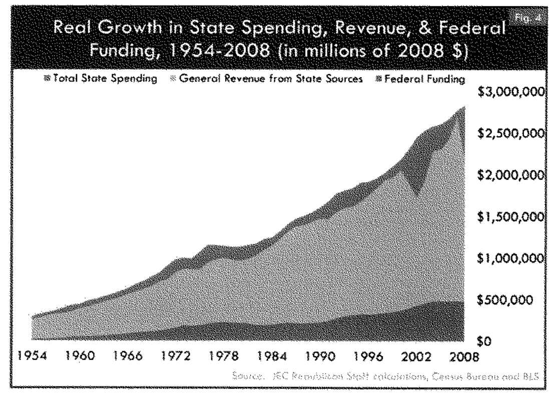
Tax and Expenditure Limitations

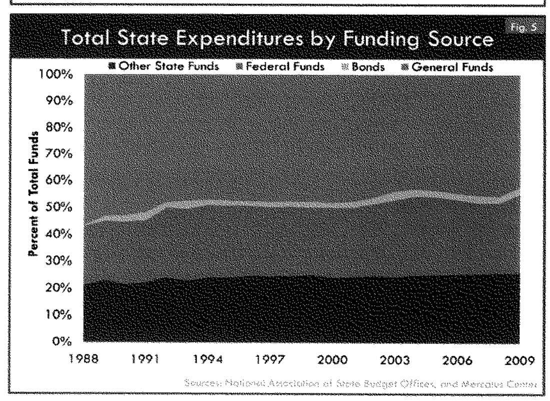
The implementation of a tax and expenditure limitation (TEL) can improve the effectiveness of fiscal rules by limiting growth in government spending and increasing overall budget stability. TELs offer an effective mechanism for overcoming the concentrated benefits – dispersed costs bias toward higher 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]

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]





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.

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- **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.

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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PREPARED STATEMENT OF REPRESENTATIVE KEVIN BRADY, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

The United States is on the precipice of a financial crisis because Washington spends too much relative to the size of our economy. Under President Obama, federal spending has grown far beyond the ability of our tax system to generate revenues from American families and businesses sufficient to pay for Washington's overspending. The resulting large budget deficits are causing an unsustainable accumulation of federal debt.

Business investment in new buildings, equipment, and software drives job creation, not federal spending. Today, both large corporations and entrepreneurs are not investing because of uncertainty. They fear higher taxes and new burdensome regulations. Consequently, job creation is anemic, the unemployment rate remains stubbornly high, and American families are suffering.

As entrepreneur Steve Wynn, a self-identified Democrat, observed, "[T]his administration is the greatest wet blanket to business and progress and job creation in my lifetime. ... Everybody complains about how much money is on the side in America. You bet. ... [T]he business community in this country is frightened to death ... "

Overspending cannot be cured by a so-called "balanced approach." A study, Spend Less, Owe Less, Grow the Economy, published by JEC Republican staff on March 15, 2011, found that successful fiscal consolidations by our global competitors were composed of at least 85 percent spending reductions with additional revenues largely from non-tax sources such as asset sales. Balanced approaches that included both spending reductions and tax increases failed in other countries.

Instinctively, Americans know that federal spending must be reduced. Nevertheless, Washington has demonstrated that it cannot maintain a spending diet. Public choice economists have identified many biases in our political system against fiscal restraint and for higher federal spending.

When I became Vice Chairman, I asked the JEC Republican staff to examine what constitutional and statutory tools our global competitors and our states use to control their government spending. The results were published in the study, Maximizing America's Prosperity, on June 21, 2011.

This study found that our global competitors capped the spending of their national government relative to the size of their economy to put their fiscal house in order. Washington must do the same.

Washington should also consider using a number of tools that our states employ to control their spending, including the item-reduction veto and sunset laws. The item-reduction veto allows state governors to reduce specific items in appropriations bills without vetoing an entire bill. Sunset laws require the periodic review of all state agencies and programs. State agencies and programs expire if the legislature does not renew them before their sunset date.

Interestingly, the study found that effectiveness of state tax and expenditure limitations have varied greatly based on their design. In particular, expenditure limits tied to measures of a state's actual GDP have been breached during recessions when mandated spending cuts proved to be politically unsustainable.

Today's hearing will examine how these lessons can be applied to the federal government. Like our global competitors, Congress must establish spending caps. Yet, from our states, we have learned that the durability of spending caps through business cycles depends in large part on their metrics.

In my opinion, caps should be placed on federal non-interest spending. Congress can control discretionary and entitlement spending through legislation. However, interest spending is a function of past fiscal decisions, the Federal Reserve's monetary policy, and financial market conditions largely beyond the control of Congress.

Clearly, any spending caps should be related to the size of the economy over time. However, actual GDP poses a problem because it fluctuates with the business cycle. Therefore, spending caps based on actual GDP allow rapid spending growth during booms only to force large, politically unsustainable spending cuts during recessions.

A better choice is potential GDP. Potential GDP is a measure of what GDP would be at full employment without inflation. It is a well understood and a widely used economic concept. For example, Stanford University economist John Taylor uses potential GDP in the "Taylor rule" to estimate what the Federal Reserve's target rate for federal funds should be. The Congressional Budget Office already calculates potential GDP for its 10-year budget window.

Potential GDP is the GDP family's smarter brother. Using potential GDP provides a more stable path for non-interest spending through time, eliminating the spending blowouts on the upswing and preventing draconian spending cuts or the downswing that have not proven to be politically sustainable.

Given the differences between Republicans and Democrats on the size and scope of the federal government, it is unlikely that we will agree on the level of spending caps. However, I hope that we could agree on the metrics used to design spending caps.

I look forward to hearing the testimony of today's witnesses.

PREPARED STATEMENT OF SENATOR BOB CASEY, CHAIRMAN, JOINT ECONOMIC COMMITTEE

Thank you Vice Chairman Brady for holding today's hearing on how fiscal rules can help the federal government control spending and get our finances in order. The absence of steady, responsible fiscal stewardship over the past decade has gotten us into a deep financial hole.

Our federal debt has skyrocketed. Publically held federal debt increased from 33 percent of GDP in 2001 to 62 percent of GDP in 2010. The Congressional Budget Office projects that our publically held federal debt will reach 70 percent of GDP by the end of this year and exceed 100 percent of GDP in ten years. That's no way for the United States to operate.

In the past weeks, as the leaders of both parties have worked to put together a deficit reduction package and extend the debt ceiling, the challenges of forging agreement on spending cuts and revenue increases have been clear for all to see.

As we approach the August 2nd debt ceiling deadline, the first order of business must be to avoid default that can hurt the economy and job creation. The United States defaulting on its commitments would have catastrophic global consequences. It is not an option.

Majority Leader Reid's proposal will allow us to raise the debt ceiling through 2012, providing certainty to world markets and businesses and consumers. It is a smart plan that balances the need to sustain the recovery in the immediate term with significant deficit reduction in the longer term.

The Congressional Budget Office scored Senator Reid's proposal and concludes it will reduce the deficit by $2.2 trillion over the next ten years. CBO estimates that nearly $1.8 trillion of that deficit reduction comes from savings in discretionary spending. The deficit reduction achieved by the Reid plan is more than twice as great as the deficit reduction included in Speaker Boehner's proposal, according to CBO.

Additionally, the Reid plan includes no changes to revenue and all of the spending cuts have been previously agreed to by Democrats and Republicans. It protects Medicare, Medicaid and Social Security. In my view, it is the most viable plan under consideration.

By contrast, Speaker Boehner's short-term plan would require Congress to revisit and vote again on the debt ceiling issue next year. We've also learned that the Boehner plan could trigger a downgrade of the United States' AAA credit rating. Such a downgrade would lead to higher borrowing costs for businesses and consumers and slow the pace of economic growth. For example, consumers will face higher costs of financing on everything from refrigerators to houses—and Retirement Accounts could take a drastic hit if the financial markets slip.

While there is a shared commitment in Washington to reducing our deficit and stabilizing the debt, we have not yet been able to reach a consensus on how best to do it. In the next few days, Washington must put partisan politics aside and come to agreement on a plan that will enable the United States to avoid default and make a significant down payment on reducing our deficit. How we forge this bipartisan agreement is also important, as it can provide a model for future cooperation and reassurance to so many who have grown understandably tired of partisan posturing.

I believe strongly that the federal government should balance its books. But, Washington must be careful not to impede the economic recovery. How we reconcile the need to get our fiscal house in order while preserving the federal government's ability to step in during times of economic emergency is a central question for today's hearing and for this Congress.

I look forward to the discussion this morning. I'm interested to learn more about how individual states' experiences and fiscal rules can apply at the federal level.

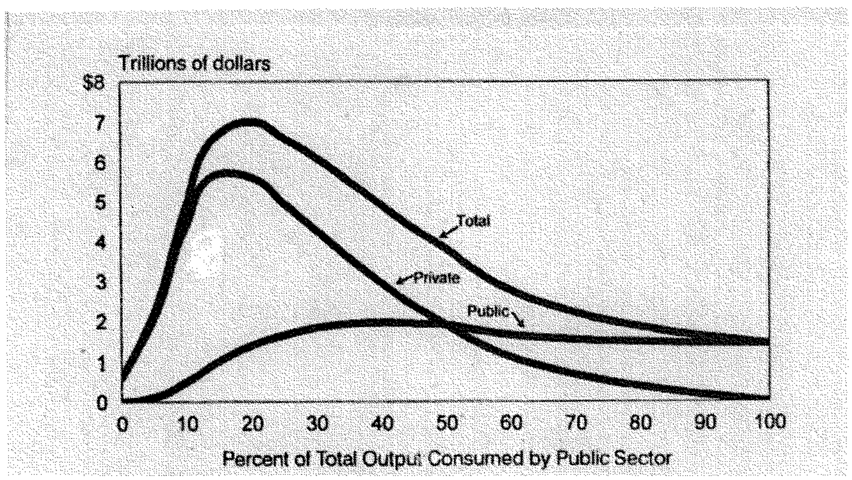
We have terrific witnesses who have dedicated their careers to thinking about the federal budget and fiscal rules and I'm sure you all have great insights into how to get our federal government back onto a sustainable fiscal course.

PREPARED STATEMENT OF JAMES C. MILLER III [1]

Mr. Chairman and Members of the Committee: thank you for inviting me here today, and thank you for addressing this important legislative proposal. The Maximizing America's Prosperity (MAP) Act sets forth an important goal, and goes about accomplishing it in an efficient manner. I welcome the opportunity to discuss this with you and with my distinguished fellow panelists, Bob Reischauer and Dan Mitchell.

The goal of the MAP Act is prosperity, and the focus is on government spending. Why is that? The reason is that there is an acknowledged relationship between size of government and prosperity, and spending is the most common measure of size of government.

Only the most naive conservative among us would argue that prosperity is enabled by having no government (spending) at all, and only the most naive liberal among us would argue that prosperity is enabled by having government account for all spending. Thus, as shown in the graph,[2] prosperity is maximized somewhere in between these two extremes. Initially, as the public sector grows, total output does as well, as property rights are established, as contracts are enforced, as important infrastructure is put in place, and so forth. But past some point, the public sector adds less and less value, and in a sense crowds out the private sector, and total output and income per capita actually fall, even though government's share of the economy continues to rise.



As you know, at just what point between the two extremes prosperity is maximized is the subject of debate among economists. The prevailing opinion is that prosperity is maximized at a smaller size of government than we have today. That's a basic rationale for trying to control spending and to bring down the ratio of spending to GDP.

We ought to ask as well why government spending tends to exceed levels that maximize prosperity. The answer is that inherent in the political budgeting process is a propensity to spend far beyond what is justified—and to be wasteful with spending as well. Like everyone else, elected officials respond to incentives, and when the incentive structure is biased toward ever-larger-government, that's what you get. Moreover, I conjecture, the larger government grows, the larger are the incentives to grow government even further.

[1] The author served as Director of the U.S. Office of Management and Budget (1985–1988) and is currently a Senior Advisor to Husch Blackwell, LLP, Chairman of the Executive Committee of the International Tax and Investment Center, Senior Fellow at both the Hoover Institution (Stanford University), and Distinguished Fellow at the Center for Study of Public Choice (George Mason University).

[2] The rough approximation of the relationship shown on the next page is taken from the author's Monopoly Politics (Stanford: Hoover Institution Press, 1999), p. 9. Obviously, the economy is larger today than it was then. For further discussion of the nature of the curves depicted, see ibid., pp. 9–11.

For this reason, it is imperative that any solution to the problem of overspending address the issue of incentives, either by changing the incentives directly or by limiting the excesses produced by the system—which, of course, is another way of changing incentives. The MAP Act does some of both. It places limits on non-interest spending as a proportion of potential GDP, and it provides for institutional changes that will make it easier to meet spending limits in an efficient manner. Specifically, it requires the President's budget submission to comply with the overall spending limits, it gives the President an item reduction veto, it provides for sequestration of budget resources in case spending is likely to exceed limits, and it establishes a commission to recommend sunsetting of agency functions and an expedited procedure for consideration of these recommendations by Congress.

This is an excellent proposal. It incorporates spending limits that are in accord with what would be most beneficial to the economy as a whole and thus to prosperity in general. It adopts measures to assure meeting those targets with institutional reforms that would be effective and efficient in the sense of assuring that priorities are addressed.

That said, let me make three additional points for your consideration.

First, alternative and/or supplementary approaches to meeting spending limits do exist. For example, the recent House-passed "cut, cap, and balance" bill puts before the state legislatures for approval or disapproval a requirement that the federal budget be balanced. Although in a perfect world the federal government would incur deficits at times and surpluses at times, the world is not perfect, and a balanced budget requirement would lead to more prosperity. A major reason is that the failure of citizens and their elected representatives to fully "capitalize" the cost of borrowing reduces the perceived cost of government and leads to harmful increases in spending.

Second, the cost of government includes not only spending but the cost of regulation as well. At some point you may wish to consider incorporating the cost of federal regulation in a revised cap. Probably the best way of doing this would be to establish a "regulatory budget," with a legislative process that parallels the fiscal budget process.

Third, the cost of government is disguised, to some extent, by "tax expenditures." As you know, these are dispensations in the tax code that accomplish government goals through the revenue side of the fiscal equation instead of the spending side. Without question, these "expenditures" are just like direct spending, and you may want to include them in a revised cap.

Fourth, without meaning to cast aspersions on anyone, let me emphasize that even under the current MAP Act's restraints on spending, strong incentives will lead to efforts to circumvent it's provisions. As implied by my last two points, you may well experience a rise in regulatory activity as a substitute for spending and also an increase in tax expenditures as another way of growing the size of government. Thus, you may wish to address these possible "loopholes" by including regulatory and tax-expenditure costs within the cap or to limit them by some other means.

Mr. Chairman, that completes my statement. I shall be happy to address any questions you and your colleagues may have.

Prepared Statement of Dr. Daniel J. Mitchell, Senior Fellow, Cato Institute

PROCESS REFORMS TO RESTRAIN LEVIATHAN

In the past 10 years, the burden of federal spending has jumped from 18.2 percent of GDP to about 25 percent of GDP. But that's just the tip of the iceberg. Over the next several decades, the combination of demographic changes and poorly designed entitlement programs could cause the burden of federal spending to double as a share of economic output.

This fiscal tsunami already has resulted in record deficits. Left unchecked, it suggests even more debt, along with rising tax burdens, in the future. And since the academic evidence is very clear that there is a negative relationship between the size of government and economic performance, this does not bode well for American prosperity and competitiveness.

The only solution is to restrain the growth of spending, and today's hearing is very well designed, asking us to consider "How fiscal rules can restrain federal overspending."

WHAT ARE WE TRYING TO FIX?

This is a critical question. Many people think deficits and debt are the problem. Excessive red ink surely is not a good thing, as places such as Greece and Portugal demonstrate, but deficits and debt generally should be seen as symptoms, while the real problem is that governments are too big and spending too much.

The true fiscal tax is the amount of money that government diverts from the productive sector of the economy. In other words, government spending—at least beyond a certain level—undermines economic vitality, and that is true if the spending is financed by taxes and that is true if the spending is financed by borrowing.

This doesn't mean that "deficits don't matter." It just means that "taxes also matter," and that the real issue is the overall burden of government spending.

REALISTIC GOALS

Perhaps the most important caveat in my presentation is that no process reform will be perfect. The appropriate analogy is that fiscal rules are like anti-crime mechanisms. Locks on your doors are a good idea, but they don't guarantee that you won't be victimized. Bars on your window, an alarm system, and gun ownership also would help deter crime, but even those steps are not a guarantee.

But the perfect should not be the enemy of the good—particularly when the alternative is to let the nation slowly sink into Greek-style fiscal chaos.

In addition, my testimony will focus only on policies that might make a difference in restraining spending. There are many proposed reforms, such as biennial budgeting, that would be akin (with a full-time legislature) to rearranging the deck chairs on the Titanic.

BALANCED BUDGET AMENDMENT

The ultimate budget process reform would be some form of balanced budget amendment. But the devil is in the details. How would such an amendment be written? How would it be enforced? And, most important, is it realistic?

These are not simple questions. A balanced budget amendment can be a watered-down requirement that says nothing more than deficits (in peacetime) require a supermajority vote. Or a balanced budget amendment can be a comprehensive package that requires supermajorities for both taxes and borrowing, and thus is really a spending limit amendment. Senator Lee's proposal is a good example of such a proposal.

Enforcing a balanced budget is another challenge. Is it self-enforcing, meaning that the supermajority requirements are all that's needed? Is it necessary to have something in place for the period of time between an amendment being approved by Congress and its ratification?

Last but not least, there is a special challenge with reforms that require changes to the U.S. Constitution. Simply stated, it is extremely difficult—and deliberately difficult—to amend the Constitution. A proposal has to achieve ⅔rds support in both the House and Senate, and then it must be ratified by ¾ths of the states.

LINE-ITEM VETO

Over the years, there have been many proposals to give presidents some sort of line-item veto or enhanced-rescission authority. Interest in these proposals often is stimulated by stories of corrupt earmarks and specific wasteful spending items. And there is some evidence that governors have effectively used such authority to trim spending.

But, just as is the case with a balanced budget amendment, the details are important since not all proposals are created equal. It also appears that such an initiative might require a constitutional amendment, which imposes a very high bar to its enactment.

CURRENT SERVICES BUDGETING

There is a form of funny math in Washington. Lawmakers can increase spending, but then tell voters that they cut spending because outlays didn't rise even faster. Let's take the Ryan budget as an example. Legislators and journalists routinely talk about that proposal imposing trillions of dollars of cuts, yet CBO numbers show that spending would rise by an average of 2.6 percent each year if it was implemented.

This is because Congress starts with an assumption that all spending should automatically increase for reasons such as inflation, built-in program expansions, and changes in beneficiary populations.

All of that information is very useful in the budgeting process, but it is dishonest to tell the American people that spending is being cut when it is being increased—

particularly when that process is used to frighten people into thinking that proposals to slow the growth of spending are actually plans filled with "savage" and "draconian" cuts.

Some form of zero-based budgeting would address this problem. If spending is rising by, say, 3 percent next year, that's the information that should be presented. And by giving the American people accurate data, that will alleviate the current system's bias for bigger government.

SPENDING CAPS

I would like to spend most of my time on the issue of spending caps. This is the notion that there will be an upper limit on spending for some—or all—parts of the federal budget. The spending cap(s), whether broad or narrow, would be enforced by a process known as sequestration, which is an automatic spending cut if outlays rise above the cap.

As with the BBA and line-item veto, it's very important to specify how a spending cap would operate. There are two important decision points—how is the upper limit defined and what spending will be covered by the cap.

DEFINING A SPENDING LIMIT

There are two ways of defining the upper limit of spending. The first option is to select a nominal spending target and the second is to require that spending not exceed a certain percentage of GDP. In theory, both options generate similar results, but lawmakers generally have gravitated to proposals that specify that spending should not exceed a certain share of economic output.

But once that decision is made, there's another important choice: How to define GDP. The obvious answer is to use GDP, but which GDP? If you select estimates of future GDP, you create an opening for gimmickry since lawmakers might pressure CBO or OMB for an exaggerated estimate to facilitate more spending.

Another option would be to use an average of the past couple of years of GDP. That would give a firm number, but it might create complications if the economy is coming out of boom or recovering from a downturn. This is why "potential GDP" might be the best option. Potential GDP is a technical concept based on what GDP would be at full employment without price inflation. It is a widely used number that CBO calculates for 10 fiscal years into the future.

Why use "potential GDP"? A spending cap based on traditional GDP allows spending to rise rapidly under booms only to force large spending cuts during recessions. That tends to be politically unsustainable, as we saw under Gramm-Rudman. Moreover, state spending caps tied to some measure of state GDP have largely failed because of this reason. Potential GDP eliminates this problem by smoothing out the fluctuations of the business cycle and thus curbing excessive spending growth during booms and not attempting to force politically difficult spending restraint during recessions.

DEFINING WHAT SPENDING TO CAP

The other key decision is what parts of the budget should be subject to cap. Some lawmakers focus only on so-called discretionary spending—i.e., annual appropriations. Considering the massive increase in spending in this category over the past 10 years, there certainly is a strong argument for discretionary caps.

But America's real fiscal problem is entitlements. So-called mandatory spending already is the lion's share of the federal budget and entitlement programs will consumer ever-larger shares of our economic output as the baby boom generation retires and outlays skyrocket for Social Security, Medicare, and Medicaid. A cap that only applies to discretionary spending would be akin to visiting a doctor after an auto accident and getting treated for a sprained wrist while ignoring a ruptured spleen.

So does that mean a spending cap should apply to all spending? That certainly would be a better option than a discretionary cap, but that means net interest—payments to service the publicly-held debt—would be included. Notwithstanding recent threats by the Treasury Secretary to deliberately and unnecessarily default on those obligations, interest on the debt is the one part of the budget that is truly uncontrollable.

It is more reasonable, therefore, to target "primary spending," which is everything other than net interest. One big advantage of this approach is that a cap on all spending creates a "tax trap" that may prevent the extension of current tax policy or future tax cuts. This is because a tax cut will be scored as a spending increase thanks to higher interest outlays. In other words, including interest in the spending cap hinders good tax policy. A non-interest cap on primary spending not only focuses lawmakers on the spending they can control, but it also avoids creating an inadvertent obstacle to good tax policy.

Moreover, it's also worth noting that, with a total spending cap, Congress and the President may press the Federal Reserve to have an overly loose monetary policy that keeps interest rates artificially low in order to lower interest payments on the debt and allow for increased spending on discretionary and entitlement programs. A noninterest spending cap eliminates this perverse incentive for inflationary monetary policy.

CONCLUSION

Thank you for the opportunity to testify. I would be happy to answer any questions.

PREPARED STATEMENT OF ROBERT D. REISCHAUER, PRESIDENT, URBAN INSTITUTE *

Chairman Casey, Vice-Chairman Brady, and members of the committee, I appreciate this opportunity to discuss with you the efficacy of fiscal rules that many believe can help to restrain federal spending.

Over the past few years it has become abundantly clear that the nation is careening down an unsustainable fiscal path and that we will have to restrain the growth of spending significantly to put the federal budget on a more viable trajectory. Notwithstanding the growing realization that long-run spending restraint is imperative, elected policymakers find it difficult to curb both outlays and tax expenditures.

There is no mystery behind why this is the case. While it is easy to give speeches embracing unspecified spending cuts, the termination of low-priority, wasteful or duplicative programs, the elimination of fraud, and the streamlining of the bureaucracy, it is another matter to vote to cut something that has an appropriation account number be it NIH research, veterans' health, or NASA. It is even harder to vote to change authorizations that guarantee Social Security recipients a certain sized benefit, reimburse states for Medicaid expenditures they have already made, or pay hospitals-only partially at that-for the costs they have incurred treating Medicare beneficiaries. Such votes engender opposition from affected constituents and interest groups who, no matter how broadly the sacrifice is shared, argue that some different distribution of the cuts would be more in the nation's interests, fairer, and better for the economy.

Despite the rhetoric, there is no significant constituency for deep spending cuts that are specific. The pain from such cuts is immediate, significant and measurable and those affected are identifiable. The benefits of the fiscal restraint such cuts would generate are distant, uncertain in magnitude, and diffuse. When they materialize they will be difficult to identify and no one will reward those who made the tough decisions. If history is any guide, many of those lawmakers will have "moved on" involuntarily to other careers.

Given this situation it is reasonable to ask whether there are some fiscal rules that might create a more hospitable environment for those who must make unpopular but unavoidable decisions involving fiscal restraint. Among the measures that have been put forward to do this are proposals that would:

- Transform the concurrent budget resolution into a joint resolution,
- Impose statutory spending caps,
- Reinstitute strong PAYGO rules,
- Give the President expedited or enhanced rescission authority, and
- Amend the Constitution to require a balanced budget.

JOINT BUDGET RESOLUTION

The Congressional Budget Process was established to allow the legislative branch to set its own budget priorities, look at the budget comprehensively and with a multiyear perspective, set fiscal policy by considering the interdependence of the budget and the economy, provide structure and discipline to congressional budget decisions, and reduce Congress's dependence on the executive branch for fiscal information. The concurrent budget resolution establishes the framework for accomplishing these objectives. If the concurrent budget resolution were replaced with a joint resolution requiring the President's signature, Congress would be giving up its independence on these matters. In years when the House, Senate and White House

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* The views expressed in this statement should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

are in hands of a single party, this might make little difference; at other times implications would be profound. For example, Congress would almost certainly have to rely on OMB scoring of its actions.

For many years, formulating and passing a budget resolution in the timeframe called for by the Congressional Budget Act has been a challenge. More recently, the two chambers have not even been able to agree on a common resolution. Adding the President to the mix would undoubtedly slow down the process and would make it even more likely that a consensus budget resolution could not be fashioned. A joint resolution would also fog the responsibility for failure as few would be able to judge whether the House, Senate or White House was most intransigent.

DISCRETIONARY SPENDING CAPS

Statutory caps can be imposed on discretionary spending and enforced through sequestration. They are not an effective way of controlling mandatory spending because such spending is affected by many factors over which lawmakers have little or no control such as the strength of the economy, weather, college attendance rates, new developments in medical technology, and interest rates.

Many have argued that spending caps are a tool that has been proven to work and, therefore, a heavy emphasis on such caps should be part of any deficit reduction plan enacted to resolve the debt ceiling crisis. First imposed by the Budget Enforcement Act of 1990, discretionary spending caps, in one form or another, existed through the early years of the 21st century. However, after budget surpluses appeared in 1998, adherence to them waned and they were frequently waived or circumvented.

Before placing too much emphasis on this mechanism for our future salvation, the record of the past should be examined carefully. On the surface, the discretionary spending caps of the 1990s look very successful. Between 1990 and 2000, total discretionary spending in constant 2005 dollars fell from $784 billion to $737 billion—or almost 6 percent. As a fraction of GDP, the fall was even more dramatic, from 8.7 percent to 6.3 percent of GDP, which is a drop of over one-quarter (27.5%). But this successful record was largely a story about the defense budget and rapid and sustained economic growth during the last half of the decade.

The Berlin Wall came down in the fall of 1989 and the Soviet empire collapsed soon after. Our military budget, which had been justified by the Cold War, had to be rethought and there was widespread support for cashing in on the peace dividend. Because of the changed environment and spurred on by the spending caps, defense outlays in 2005 dollars declined from $463 billion to $362 billion—or by over one-fifth-between 1990 and 2000. Relative to GDP, the fall was 42 percent (from 5.2 percent of GDP to 3.0 percent).

The story was different on the non-defense side of the discretionary budget. In constant 2005 dollars, non-defense discretionary spending increased by 17 percent over the 1990-2000 period (from $321 billion to $375 billion). While non-defense discretionary spending as a percent of GDP declined slightly-from 3.5 percent to 3.3 percent of GDP-this was largely a reflection of rapid GDP growth during the last half of the 1990s, a portion of which the collapse of the Dot-com bubble revealed to be illusory.

The lesson to be taken away from the 1990-2000 experience with spending caps is that this tool can be effective if there exists a broad and bipartisan consensus that a certain budget function or a specific large program should be scaled back. While today there is widespread support for reducing spending on the military conflicts in Afghanistan and Iraq, more uncertainty surrounds the pace and the extent of the possible drawdown than was the situation when the Soviet Union collapsed in 1990. As was the case in the 1990s, there is little consensus concerning deep cuts in the non-security portion of the discretionary budget.

Spending caps are relatively easy to agree to because no one knows how they will play out over time, that is, which specific programs will be reduced disproportionately. Therefore, there is a real risk that more will be promised than can be delivered and that the caps will prove to be unsustainable. Some will try, as they did at the end of the 1990s, to evade the caps by attempting to designate certain spending as an emergency. Advocates of programs that will be cut deeply in regular appropriations will try to stymie the process knowing that their accounts would be better off under an across-the-board sequestration of a continuing resolution. In short, spending caps represent general promises that are easier to make than to fulfill.

PAYGO

Like discretionary spending caps, PAYGO rules were first introduced by the Budget Enforcement Act of 1990. In the original formulation, PAYGO required that the impact on the deficit of all direct spending legislation and all changes to the tax code enacted during a legislative session not increase the deficit. In the aggregate, increases in direct spending or decreases in revenue had to be offset by other spending decreases or revenue increases or a sequester would be imposed on a select set of mandatory programs to make up the difference.

Unlike spending caps, which can be used to lower future deficits, PAYGO procedures can only ensure that new mandatory or revenue legislation does not make the deficit situation worse. In that role PAYGO was effective at restraining mandatory spending initiatives and new tax cuts during the decade of the 1990s. In the current situation, PAYGO, with a more balanced sequestration process that included selected tax expenditures and protected low-income mandatory programs, would be an essential component of any deficit reduction plan.

ENHANCED RESCISSION AUTHORITY

The Budget Control and Impoundment Act gives the President the authority to propose rescissions of all or parts of items within appropriation bills and to delay obligating the relevant budget authority for up to 45 days while Congress considers the request. The Congress has no obligation to take up the President's requests and usually they are ignored.

Enhanced rescission authority would require the Congress to vote up or down the President's rescission requests, without amendment, within a fixed number of continuous legislative days. Some proposals would limit the President to one package of rescissions per spending bill and require that the request be made within a fixed number of days following enactment of the spending bill.

Spending bills are amalgamations of many items, some large and others quite small, some directed at national concerns and priorities, others quite narrow and parochial in nature. Enhanced rescission would give the President a strengthened ability to weed out narrow, special interest allocations that do not have widespread congressional support. It is doubtful, however, that large amounts of budget authority would be rescinded under this tool. Furthermore, to ensure that the rescinded amounts reduced overall spending rather than were redirected to other accounts through subsequent appropriation bills, mechanisms to reduce the budget resolution's budget authority allocations by the rescinded amounts would have to be adopted.

Enhanced rescission would shift budget power marginally in the direction of the executive branch. It would improve transparency and accountability. Extending the reach of the process to mandatory spending legislation and to bills that provide targeted tax benefits would increase the deficit reduction potential of this tool.

BALANCED BUDGET AMENDMENT TO THE CONSTITUTION

A balanced budget amendment to the Constitution may well dampen the growth of spending but this would come at an extremely high price. The automatic stabilization role that the federal government now plays for the economy would be seriously undermined. When economic weakness caused federal revenues to fall and expenditures on unemployment insurance, SNAP benefits, Medicaid and Social Security to rise, other programs would have to be cut precipitously or the spending on these essential safety net programs would have to be curtailed significantly. Economic downturns would be both deepened and prolonged.

Under a balanced budget amendment, the federal government would lose much of its flexibility and ability to respond quickly to unexpected events. It would become more difficult to respond to natural disasters such as hurricanes and Tsunamis be they at home or abroad and to mitigate the consequences of events like terrorist attacks.

Balanced budget amendments that require revenues to equal or exceed spending on an annual basis would not allow Social Security or the government's military and civilian worker pension systems to draw down the reserves they have built up over the years to pay benefits unless the remainder of the budget was running an equal-sized surplus. A similar constraint would face the FDIC, the PBGC and the many government insurance and loan guarantee programs, effectively eliminating the reason for their existence.

While the wording of the many proposals being considered by the Congress seems simple, clear and straight forward, all of these balanced budget amendments would raise many questions involving definitions, implementation and enforcement, which the courts would be reluctant to resolve. For example, answers would have to be found for such questions as, "What is the budget? Is Congress or the President responsible for achieving balance and through what processes? What remedies would be imposed if balance were not achieved and on whom?"

To have any chance of achieving a balanced budget amendment's objectives, Congress would probably have to cede much of its short-run authority over the budget to the President and OMB. Those who do business with the government and those who receive government benefits would have to expect some uncertainty with respect to when they would receive expected payments or benefit checks.

In the short run, the volume of federal spending cannot be controlled with any precision. Millions of actors-individuals, states, federal contractors, hospitals and so on-make decisions that result in outlays. Unless the budget included a significant surplus for contingencies, the President would probably have to be given authority to vary taxes somewhat during the year.

CONCLUSION

Fiscal rules and procedural innovations can help to frame and organize budgetary decisions, influence expectations and provide a bit of political cover for those who must take difficult votes, but they can't force lawmakers to support policies they strongly oppose or ones they believe will end their political careers. In short, fiscal rules cannot create political will.

Fiscal rules that are found to be too stringent will be ignored, waived, evaded, circumvented or repealed. Activities can also be moved "off-budget" to escape the discipline of a fiscal rule. Recent experience suggests that there exists a bottomless well of budget gimmicks that lawmakers can draw from to avoid the discipline implied by the fiscal rules they have endorsed but cannot find the will to impose.

In conclusion, it is worth noting that spending is not the only route lawmakers can take to achieve their objectives. Denied the ability to respond to the nation's needs through spending programs, Congress and the President will turn to the other tools they have available to achieve their objectives such as regulations imposed on businesses, unfunded mandates placed on individuals, states and localities, and tax expenditures. In most cases these approaches are less effective, less transparent and more difficult to control than is spending.

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