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MID-SESSION HEARINGS ON THE BUDGET

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

June 27, 2001--REASSESSING THE ECONOMIC OUTLOOK

June 28, 2001--HOW BIG IS THE REMAINING SURPLUS?

July 12, 2001--ECONOMIC AND BUDGET UPDATE

July 18, 2001--DEFENSE SPENDING AND THE BUDGET OUTLOOK

August 2, 2001--SOCIAL SECURITY: BUDGETARY TRADEOFFS AND TRANSITION COST

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September 6, 2001--OMB'S MID-SESSION REVIEW AND THE BUDGET AND ECONOMIC

October 2, 2001--THE ECONOMIC OUTLOOK

October 25, 2001--ECONOMIC STIMULUS

Printed for the use of the Committee on the Budget

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REASSESSING THE ECONOMIC OUTLOOK

WEDNESDAY, JUNE 27, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Sarbanes, Wyden, Nelson, Stabenow, Clinton, and Domenici.

Staff present: Mary Ann Naylor, Majority Staff Director; and G. William Hoagland, Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Why do we not bring this hearing to order. First of all, I want to welcome our witnesses. Thank you. I think we have a very distinguished panel this morning. We appreciate very much your taking time to be with us on an important subject. This is the first of two hearings this week to assess the current state of the budget.

Today, we will look at how the economic outlook has changed since CBO made its baseline projections in January, with an emphasis on how uncertain that outlook remains, particularly with respect to the long-term trend in productivity.

Tomorrow, we will focus on the available surplus. We have now, in looking back at CBO's January baseline, we see that there were some signs that the economy might be slowing after a period of very rapid economic growth. Nevertheless, most economists at the time believed that the longest economic expansion on record still had plenty of room to run. The CBO baseline budget projected $5.6 trillion of surpluses between 2002 and 2011, based on a relatively favorable short-term and long-term economic outlook.

In the short-run, CBO assumed the economy would experience a mild slowdown in 2001 and a recovery in 2002. Growth in real GDP, they indicated, would fall from an estimate 5.1 percent in 2000 to 2.4 percent in 2001, with a bounce back to 3.4 percent in 2002.

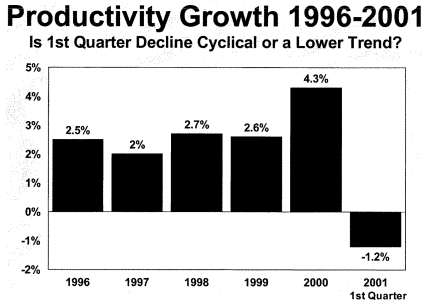
CBO's long-term growth projection reflected an upward revision in the estimated rate of potential productivity growth to about 2.7 percent a year over the 2002 to 2011 period. Taking into account the moderation of growth in 2001, actual productivity growth was estimated to be somewhat less, but a still robust 2.5 percent per year. This projected rate of productivity growth was well above the 1.5 percent achieved in the 1974 to 1995 period, but a little less

than the very strong growth we saw from 1996 to 2000. In large measure, CBO accepted the view of many economists that trend productivity had increased after 1995.

Subsequent developments: We will hear testimony today that the economic situation, in the short run, is certainly looking somewhat worse than CBO was projecting in January. Dr. Baily, you have an interesting chart in your testimony that shows how the blue chip forecast for 2001 has deteriorated over the course of the year. In January, the blue chip—and do we have a chart that shows that? In January, the blue chip consensus was 2.6 percent, when CBO was estimating 2.4 percent, but the June blue chip forecast is now down to 1.8 percent, as we can see on the chart.[1]

A short-term slowdown obviously hurts the surplus for a few years, but if the economy bounces back quickly, the long-term impact does not have to be that significant. What matters for the long term is the economy's sustainable growth rate. That is really one of the things we want to focus on today, which is based on productivity and labor force growth, with productivity being the key unknown and what we really want to focus on today.

Back in January, economists seem to be coming around to the view that trend productivity had rebounded from two decades of rather sluggish growth. Federal Reserve Chairman Greenspan testified before this committee that productivity was holding up remarkably well, even as the economy showed signs of slowing, and he was confident of the longer term outlook. I wonder what he would have said if he knew that productivity growth was falling as he was speaking and that productivity would fall in the first quarter by 1.2 percent at an annual rate. We have a chart that shows that as well.



We saw very handsome gains in productivity in the late 1990's, but in the first quarter of 2001, that reversed, and we saw productivity actually fall 1.2 percent. All of us, I think, need to be warned that quarter-by-quarter numbers are not all that critical, but this may be an indicator that we are seeing a slowing in productivity growth.

The implications for the budget. I think one of the most important things that can come out of this hearing is a renewed respect for the uncertainty—I want to put the frame on that—the uncertainty of long-term economic and budget forecasts. This, after all,

[1]CHART NOT AVAILABLE AT PRESS TIME.

is a 10-year forecast. The famous CBO fan chart that showed estimates of uncertainty based on CBO's past forecasting records should have warned us that there was nothing certain about a projection of $5.6 trillion of surpluses over the next 10 years. Now, of course, the baseline is smaller because we have enacted a tax cut, and we have, as a result, updated the CBO fan chart——

Welcome.

Senator DOMENICI. Thank you. Oh, I am on the wrong side. [Laughter.]

Chairman CONRAD. Welcome, Senator Domenici. We are glad you are here.

Senator DOMENICI. Thank you very much, Mr. Chairman. I am glad to be here.

Chairman CONRAD. We have put up the new fan chart that just shows the uncertainty of the CBO forecast. And in the year 2006, shows a variance of anywhere from a negative $250 billion to a positive $1 trillion in that sixth year alone. The uncertainty in the fan chart is based on CBO's past forecasting record. This is their own analysis of what has happened over this period.[2]

Now, today, we are going to have a chance to hear from a distinguished panel of witnesses, and we really do have I think an outstanding group. We are going to limit opening statements to the chairman, our former chairman, and myself, then we are going to go to the witnesses. We are going to limit them to 7 minutes each, ask them to include their full statements as part of the record. Then we will go to a questioning round with each Senator having 7 minutes for a statement and questions, however they choose to divide up the time.

With that, I just want to, again, acknowledge our witnesses, and I will introduce them after our ranking member has a chance to make whatever opening statement he would like to.

We will turn to Senator Domenici, my very able colleague, who has served this committee, and the Senate, and the country in a very distinguished way over a long period of time.

Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

Senator Clinton, it is good to be with you. I was sorry I was late. I had to be at two places at once and, frankly, you know what? I should not have tried because the other event I could not stick around long enough to do it, so I just spent my time walking back and forth in order to not be too late here. So that is not a very typical senatorial set of events, but I might as well confess it.

I am glad to have these three distinguished witnesses. The way I see it, they are going to make an effort to give us some short-term evaluations on where things are. I want to, since I hear you commented about Alan Greenspan's thoughts regarding productivity, he just recently spoke last week, and he said when the 2.5 productivity growth estimate came out, a lot of people thought it was overly conservative. What one may readily argue at this stage is that it is less conservative than it was at the time that it was done, but I do not see anything in the data, per se, at this par-

[2] CHART NOT AVAILABLE AT PRESS TIME.

ticular point, which should lead one to make any major revisions of the current surpluses.

So you said you would like to know what he said, and my staff remembered that he just said it. So we thought we would—we even knew you were going to ask that question. [Laughter.]

Senator DOMENICI. Anyhow——

Chairman CONRAD. I am glad you did.

Senator DOMENICI. I would just like to say to the chairman this is his first morning presiding as chairman, and I wish him well. I cannot say I wish him extreme longevity as chairman—— [Laughter.]

Senator DOMENICI [continuing]. But he understands if that happens to be the fate of the Senate, we could surely do an awful lot worse. You will do a good job as chairman, and I look forward, in the foreseeable future, working with you. We might disagree on fiscal issues or tax issues, but I believe we do understand, with a great deal of civility, and we do have good will between us, and that counts for a lot around here.

Now, having said that, I think it is useful on the record here quickly to remind the members of the committee and our witnesses that this assessment that we are talking about here this morning is already underway at the Congressional Budget Office, as required by the Budget Act, and that their estimates, and those of the administration, will be up here on the Hill and publicly consumed and available in July or early August.

So you all are going to be talking about some things. We are going to see how close to what they say—they are a little more official than you, but not necessarily more right than you. I hope you know that. And nobody can deny that the economy has slowed down in the first half. However, again, I think it is important to point out that the budget we worked from assumed a dramatic slowdown in the economy from 5 percent growth rate last year to 2.4 this year.

That is one of the assumptions that they made, which puts them on the side of being pretty observant with reference to what was happening. And even with that projected slowdown, and with the enactment of the tax cut directed by our budget resolution, and even with the technical updates in May, Mr. Chairman, you received a letter from CBO last week that estimates a budget surplus of $200 billion for the current fiscal year. And excluding the Social Security and Medicare surplus and whatever we have already obligated, there is still a surplus estimated to be over $16 billion this year.

Now, nobody, even these distinguished economists, can predict the course of the economy with precision, particularly at this time. There is always uncertainties in any economic forecast, and surely they would acknowledge that here today. I will not even ask the question, I will just assume it.

So I think this is sort of a short-term review for us. It may be helpful. Certainly, it will not be harmful. And in the short term, there are some interesting complications for the forecasters, and I would just put them forward. What will be the impact on the economy of the $70 billion in tax credits and checks that are going to be issued in the next few months? Now, even if one says that can-

not have a big macroeconomic impact, I wonder what it will do to the consumer confidence issue, which has been turning up a little more positive of late and moving in a positive direction.

How will the Fed's 250-basis-point reduction in interest rates and the possible future reductions affect the economy in the coming months? And I note that the interest rates on 3-month T-bills are nearly 100 basis points lower today than what we assumed when we prepared the resolution, Mr. Chairman. As for me, I believe both the monetary and fiscal policy stimuli put in place since the CBO economic forecast last winter will have some positive effect. How much? Clearly, I am not smart enough to know, but some I am certain.

Clearly, there will be offsets to these economic stimuli, mostly on the global front. We cannot do much about that. We try very hard, but weakness in Europe, and Asia, and growing trade intervention-type attitude such as the EU blocking a G.E.-Honeywell and a lot of other big noises from trading partners, clearly, all of those would indicate that things may not be as good as we would like.

Let me conclude on one last point. Much of today's discussion I assume will be about productivity. That is an interesting subject, and I think we both worked on the assumption last year that Alan Greenspan was correct, that we had a new economy and productivity was substantially more than it had ever been in the past. The chairman of the Fed has repeated twice that he still believes that kind of set of differences do apply in this economy and that it will come back and the new economy will bring productivity back strong.

It is a volatile statistic that we are talking about. During the last period of rapid productivity growth, that is, from 1948 through 1993, productivity growth averaged 2.9, but was often negative. It was 2.9 average, but it was often negative, if we knew what we were doing. I am wondering whether we know how to measure productivity. But let us say, to the extent that we are all doing it, we kind of think we know.

So I look forward to the testimony this morning, Mr. Chairman, and I look forward to tomorrow's, and I hope I can be with you for the whole session tomorrow also.

Thank you very much.

Chairman CONRAD. Thank you very much, Senator Domenici. As always, you have observations that are useful to all of us, and we appreciate very much your participation.

We really have two things going on here: One is we know there is some slowdown in the economy. It appears now, what the consensus forecast, the economic growth is below that what was projected early by the Congressional Budget Office, and then we have this longer term question, the question of productivity growth.

One of the reasons we thought it was important to have this hearing is there was a very thought-provoking article in The Economist, in the May 12th edition, suggesting that the productivity growth that undergirds the long-term forecast may be overly optimistic. Certainly, it is a much higher rate of productivity growth that is in the forecast, and we saw in the 20 years from 1974 to 1995, but it is lower than the productivity growth we saw in more recent years.

One of the questions that we really need to probe today is what can we expect, reasonably expect, in terms of productivity growth over the next decade? Because it has enormous implications for the Federal budget. About every one-tenth of 1-percent change, one-tenth of 1-percent change in productivity growth, alters our projected budget surplus by over $200 billion. So this has enormous implications for the budget going forward, and that is the reason we thought it would be useful to have this hearing today.

We have a very distinguished group of witnesses, starting with Dr. Baily, who is with the Institute for International Economics in Washington. He is the former chairman of the Council of Economic Advisers under President Clinton; Dr. Bill Dudley, who is with us, as well, who is director of the U.S. Economic Research Group at Goldman Sachs and was named the managing director there in 1996. He is responsible for the economic and interest rate forecasts for the United States; and Mr. Wesbury, Brian Wesbury, who is vice president and chief economist of Griffin, Kubik, Stephens & Thompson.

We welcome you all. This is a distinguished panel of witnesses, and we will start with Dr. Baily. We would ask if you would summarize your testimony in about 7 minutes, and then we will go to the other witnesses and then have time for questions.

STATEMENT OF MARTIN N. BAILY, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BAILY. Thank you. Thank you, Mr. Chairman, Senator Domenici and members of the committee. It is a great privilege for me to have the opportunity to testify here.

You know, Harry Truman said he did not like two-handed economists—on the one hand, on the other hand—but I am going to be one, I am afraid, because I think the theme of my own testimony is that there is a tremendous amount of uncertainty, and I am echoing, Mr. Chairman, what you said earlier.

I am basically pretty optimistic about the U.S. economy. I think it is going to recover either toward the end of this year or in early next year from its cyclical problems. And I am also pretty optimistic about productivity growth going forward, thinking that it will probably be in the 2- to 2.5-percent range, which is a bit below what we had in the last 5 years, but substantially better than what we had over the 20-year period.

But at the same time—and in the Economic Report of the President that we issued in January 2001, we did talk about a new economy—but at the same time, there is a tremendous amount of uncertainty around that. And with the benefit of hindsight, I wish perhaps in the report we might have been a bit more forceful in saying that the term "new economy" really carries no guarantee of a continuation of economic growth at the same pace in the years to come that we had, and we tried to make that clear, but I am perhaps a little concerned that the term "new economy," that not only I use, but obviously a lot of other people, conveyed a little bit more certainty than actually exists and certainly more certainty that was maybe justified by the evidence or our intention.

And I note that Chairman Alan Greenspan, while he has indeed commented on the strength of productivity and been a supporter of

the new economy, he has also, I think, in his statements, talked about the uncertainty and made the same point that we do not know how long this rapid rate of productivity growth will go on.

So why is there so much uncertainty? In my testimony—and I would ask that my written testimony be introduced into the record, if that is permissible—there was a sort of view of the economy that came up I think during the days of Kennedy and Johnson, a mentor of mine, Arthur Okun, developed this notion of potential output. And that said we had a fairly predictable view of what the long-term growth of GDP was going to be, and underneath that, of course, was a view of productivity growth and labor force growth, and some fairly stable view of what kind of unemployment rate the economy could operate at.

And that meant that 10-year budget forecast, you know, maybe things were going to be less than you expected this year, but you would bounce back and maybe be a bit better than expected next year, and you would sort of bounce around this fairly stable trend of potential output growth.

I think, unfortunately, we have learned over the last 25 years or so that it "ain't" that simple, and there is much more uncertainty in trying to predict that potential growth than we had ever thought. We had this problem in the early 1970's. The forecasters at the time, careful forecasters, kept thinking we were going to go back to the period of rapid productivity growth, rapid potential GDP growth, and we kept missing the mark. And so there was a lot of overoptimism about growth in the 1970's.

There was also overoptimism in the 1980's. I think there were some, perhaps, views that the supply side effect of tax cuts were going to be larger than those that actually materialized, and so again we got some overoptimistic views of growth, and we ended up with large deficits in the 1980's.

So I think we have learned that the errors can go either way, but there is really no such thing as a stable growth of potential output that we can count on. That means, I think, from the point of view of this committee and from Congress, generally, that you have to plan the budget sort of around that uncertainty, recognizing the existence of that uncertainty, and making sure that the plans that you make are going to be consistent with either strong growth or, perhaps, somewhat weaker growth.

In my testimony, then, I talk about a sort of good news scenario. As I said, I am basically an optimist. I think we will bounce back, and I think we will get solid productivity growth, but perhaps the bad news about the good news scenario is that it is pretty much built into the existing CBO estimates, and you mentioned this already; that they had built in a 2.7-percent potential growth rate or a 2.5-percent actual growth rate of productivity and a corresponding pretty strong growth of GDP. Now, that led them to a $3.1-trillion estimate of the on-budget surplus over the 10-year period. Now, given that we have passed a tax cut, so that baseline would come down to something like $1.7 trillion.

Now, what I mention in my testimony is supposing, and I think I am going to echo something you said earlier, Mr. Chairman, that if we even drop to 2-percent productivity growth, which would still be pretty good, it would still be a lot better than we had for 20

years, that would take the estimate of the surplus down by about a trillion dollars. So just a few tenths, just a half a percentage point lower productivity growth would end us up with really much lower surplus.

Now, the other thing that I talk about is, if things, if we don't get the good news scenario, if, in fact, productivity growth does slow, perhaps slows a little bit more than 2 percent, there are a lot of things that potentially could come unraveled as a result of that; that the low unemployment, the low inflation, the strong dollar, the strong stock market, all of those things, in some sense, have been the result of this very strong productivity growth performance. So, if that starts to weaken, a lot of those things could come unraveled. We could get some return to the stagflation period that we had in the 1970's, when productivity growth slowed down.

Again, I am more optimistic than that, but I do not think we can rule this possibility out at all. After all, we had 1.5-percent growth for about 20 years. I certainly do not think we can rule out a return to that. And if that is the case, the whole budget situation changes dramatically.

CBO, in their January forecast, pointed out that a pessimistic scenario, which meant in their case a return to 1.5-percent productivity growth and some somewhat more conservative views of the revenue collection would take the $3.1-trillion on-budget surplus down to a deficit of over $500 billion. Now, given that we have had a tax cut, we would get something, $1.8/$1.9-trillion deficit under that more pessimistic scenario.

So, to wind up, and I realize that I am out of time here, in some previous testimony that I gave to the House, I outlined my view favoring fiscal discipline over large tax cuts. I think there are a number of reasons that I give that we should look ahead to the problems of the Social Security and Medicare system and the need that they will have to deal with the baby boom generation. I mention the fact that having a large tax cut at a time when we are running a current account deficit of about 4.5-percent of GDP seems to me a move in the wrong direction. We need to increase national saving, not to decrease national saving.

And, after all, the new economy that developed, developed in an environment of fiscal discipline. So, you know, if it worked, let us kind of keep that fiscal discipline going.

And, finally, I think some of the surplus projections may not be realistic on the spending side, and I know both parties want to keep spending under control, but I think there is a question of whether the spending projections really are realistic, given the need, on the defense side, and for health care, and education, and environmental investments.

So, again, this testimony focuses on the economic uncertainty that you drew attention to. I am basically an optimist, but I don't think we can necessarily plan our budget just on the basis of that optimism. We have to think of both sides and both possibilities.

[The prepared statement of Mr. Baily follows:]

Testimony Prepared for the

United States Senate
Committee on the Budget

June 27, 2001

By

Martin Neil Baily

The author is a Senior Fellow at the Institute for International Economics in Washington DC. He was previously the Chairman of the Council of Economic Advisers and a member of President Clinton's cabinet (August 1999 to January 2001). He has also served as a Member of the Council. The views expressed here are those of the author and should not be ascribed to the trustees, or other staff members of the Institute for International Economics.

Summary

U.S. economic performance was extraordinary in the 1990s, particularly after 1995. Real GDP grew at 3.6 percent in 1996 and over 4 percent in each year from 1997 to 2000. Growth actually exceeded 6 percent from the middle of 1999 to the middle of 2000. Unemployment reached the 4 percent level and inflation remained restrained, aside from the impact of rising energy prices. A key reason for this strong performance was a shift to faster productivity growth after 1995.

Unfortunately, this recent strong period provides no guarantee of a continuation of economic growth at the same pace in the years to come. On page 28, the January 2001 *Economic Report of the President* states:

> The fact of a shift in the trend of structural productivity growth does not tell us how permanent that shift will turn out to be.....We could be observing not a long-term shift to a faster productivity growth rate but simply a shift to a higher level of productivity, with faster growth for a while followed by a return to the pre-1995 trend.

Over the past 25 years our ability to predict the growth of GDP and to predict the long-term fiscal position of the economy has been poor. An important reason for this is the uncertainty in the productivity trend. Good news about trend productivity not only adds to GDP growth directly, it also generates a virtuous cycle of good news about inflation, unemployment, budget surpluses, interest rates, the stock market, and investment. Once the ball gets rolling it gathers speed. On the down side, the pattern works in reverse. A return to slower productivity would unleash a cycle of problems that could end up eliminating the projected budget surpluses. Slower productivity growth would worsen inflation and weaken the dollar. It would lower real wage growth and trigger a worsening of the wage price spiral. And of course there would be less GDP and less tax revenue.

CBO, in its January *Budget and Economic Outlook*, forecast an on-budget surplus of $3.1 trillion for 2002-2011. Since then a $1.35 trillion dollar tax cut has passed, bringing this projected surplus down to $1.75 trillion. If productivity growth were to be 2.0 percent a year, going forward—slower than CBO's forecast, but still a pretty strong performance--this would reduce the surplus by about $1 trillion, to around $750 billion.

CBO considers a pessimistic scenario with 1.5 percent productivity growth and lower revenue collection (Table 5-3). *In this case the $3.1 trillion on-budget surplus is transformed into a deficit of $525 billion—a $1.88 trillion deficit counting the tax cut.*

I remain optimistic about the economy and believe it reasonable to expect productivity growth of 2 to 2½ percent per year once renewed expansion is underway. But the current risks in the budget forecast are mostly on the downside and sound budget planning should recognize these downside risks and should not use up surpluses we do not know we have and that may never materialize. Maintaining fiscal discipline is a top priority.

Getting Perspective on the New Economy

In the *Economic Report of the President* published in January of this year, we described the extraordinary economy of the 1990s, and particularly the spectacular performance since 1995. Real GDP grew at 3.6 percent in 1996 and over 4 percent in each year from 1997 to 2000. Growth actually exceeded 6 percent from the middle of 1999 to the middle of 2000. Unemployment reached the 4 percent level and inflation remained restrained, aside from the impact of rising energy prices. Chart 1 illustrates.

These indicators of a strong economy had a counterpart in better living standards for Americans. Incomes grew strongly across the board (Chart 2), the poverty rate declined and real wages increased. The 50 percent of so of American families that own stock also saw their wealth increase sharply.

A key reason for this strong performance was the turnaround in productivity growth. After 25 years of rapid growth in output per hour after World War II, the productivity trend slowed sharply after 1973 and remained sluggish through 1995. From 1995 to 2000, a new trend emerged with productivity growing at close to 3 percent a year, signaling to many a return to the strong growth years of the 50s and 60s. An open competitive US economy was taking advantage of new technologies to increase its efficiency, changes described as a "new economy". The rate of productivity growth is a key driver behind GDP growth and increasing living standards.

With the benefit of hindsight, January's *Report* could have been more forceful in saying that the term "new economy" carried with it no guarantee of a continuation of economic growth at the same pace in the years to come. For the careful reader, the qualifications were certainly there. On page 28, for example, the *Report* states:

> The fact of a shift in the trend of structural productivity growth does not tell us how permanent that shift will turn out to be.....We could be observing not a long-term shift to a faster productivity growth rate but simply a shift to a higher level of productivity, with faster growth for a while followed by a return to the pre-1995 trend.

But despite this caveat, the term "new economy" may have conveyed more certainty about the future course of the economy than was justified by the evidence, or intended by our own use of the term.

I am basically optimistic about the future of productivity and growth in the U.S. economy. But enthusiasm for the past performance of the economy and for the continuing changes taking place should not blind us to the considerable uncertainties in forecasting the future, both short term and longer term

Why is There So Much Uncertainty?

There is a view of the economy that served policymakers well in the past as a guide to economic policymaking. This view was developed by Arthur Okun, in his days with the Kennedy and Johnson Administrations, when he defined "potential GDP" as the level of output characterized by full employment and full utilization of capital, but no excess demand pressure or over use of capital or labor. Potential output grows over time at a rate determined by the trend rate of increase in productivity and the increase in the size of the labor-force. In Okun's time, both the productivity trend and the growth of the labor force were fairly predictable. The point at which labor and capital are fully used was stable. And so potential GDP growth was also seen as predictable.

This view of the economy did not imply that short-term economic forecasting was easy; quite the contrary. In any given year, the actual level of GDP might be above or below potential, depending upon whether demand was stronger or weaker than potential GDP. Considerable experience has shown that predicting the short-term ups and downs of the economy is not something that can be done with any precision. Chart 3, for example, shows the evolution of the Blue Chip consensus forecasts for the growth of GDP in 2001. As late as November 2000, the forecasters were saying that real GDP would grow at 3.4 percent in 2001. In the latest forecast, the consensus is down to 1.8 percent.

This uncertainty about the short term has always made it difficult for the President and the Congress to predict the size of the budget surpluses that would materialize in the coming fiscal year. But in the simple Okun world I have described, uncertainty about the short term did not lead to exploding uncertainty over the longer term. As long as the growth of potential output was predictable, there might be one or two years in which recession resulted in a deficit, but this would then be offset by a year or two of rapid GDP growth when the deficit would shrink or be eliminated. The uncertainties year by year, in this view, were partially offsetting.

Unfortunately, over the past 25 years our ability to predict the growth of potential output and to predict the long-term fiscal position of the economy has not turned out to be good—to put it mildly. Some of this budget uncertainty relates to technical factors like assumptions about growth in health care costs and, most recently, the amount of revenue likely to be generated by each dollar of GDP. And, of course, subsequent legislation alters budget outcomes. But I want to focus in my testimony on the uncertainty in the economics.

Experience since the early 1970s has taught us that, contrary to the simple Okun world, there can be times when the economy does not revert back to prior estimates of its potential GDP. The economy starts to do well and continues to do well, or it starts to do badly and continues to do badly. During the 1990s, and particularly in the second half of the decade, the economic forecasts were consistently on the pessimistic side. We kept thinking that the economy must slow down, bringing GDP back closer to our estimate of the path of potential GDP. And of course, the economy kept growing rapidly.

In earlier periods, the errors were in the opposite direction. We know now that the trend rate of growth of productivity and GDP slowed after 1973. But careful forecasters at the time, thought that potential output growth would return to the more rapid pace it had achieved for the 25 years prior to 1973. The same mistake was made in the 1980s, for a different reason, when over-optimistic projections were made of the supply side effects of tax cuts.

In large part, the reason for these mistakes is the uncertainty in the productivity trend, which makes potential output growth harder to predict than we thought. But the problem is actually more complicated than this. Good news about trend productivity generates a virtuous cycle of good news about inflation, unemployment, budget surpluses, interest rates, the stock market, and investment. Once the ball gets rolling it gathers speed. Faster productivity growth lowers inflation and increases real wage growth. This improves the situation in the labor market and allows the economy to operate for an extended period with lower unemployment and higher GDP. The return to capital investment goes up, encouraging more investment, raising stock market prices and continuing the strong growth.

On the down side, the pattern works in reverse. A return to slower productivity would unleash a cycle of problems that could end up eliminating the projected budget surpluses. Slower productivity growth would worsen inflation and would likely weaken the dollar. It would lower real wage growth and trigger an adverse wage price spiral. And of course there would be less GDP and less tax revenue.

The million dollar question, or, I guess, the trillion dollar question, we face now, therefore, is whether the current slowdown will be brief and followed by a return to rapid growth, or whether we have set off down a path of slower growth and budget weakness.

The Good News Scenario

There is a case to be made that the bad news is mostly behind us. Despite the collapse of technology stocks, the overall stock market has held up pretty well and so has consumption, housing and auto sales. While there are many things I disagree with in the recently passed tax cut legislation, the immediate effect of the tax rebates will be to boost consumption later this year. The worst seems to be over on energy prices and a large part of the inventory adjustment has been completed. Core inflation has increased in the early months of this year, but overall inflationary pressures seem muted.

The likely reasons for faster productivity growth do not seem to have gone away. Intense global competitive pressure keeps companies looking for ways to cut costs and raise productivity. The advances in computing, telecommunications and software are continuing and most of the benefits of the Internet are still in the future.

But I want to caution that there is some bad news about this good news scenario: this is the scenario that is already built into the budget projections. The risks seem to be on the downside. In January, the Congressional Budget Office projected that trend productivity

would grow at 2.7 percent a year. They recognized that the cyclical growth slowdown would result in actual productivity growth below this level, but they still assumed a 2.5 percent growth rate over ten years—basically a continuation of the very strong trend of the late 1990s. In some other respects the CBO was relatively conservative in its economic estimates, so I am not saying that their predictions were out of line with the views of many economists at the time. But based on what we know now, the January estimate of a $3.1 trillion on-budget surplus in the 10-year budget horizon was premised on a continuation of very good economic news. This is reinforced by the fact that CBO is pretty optimistic in its estimates of the revenues to be expected from their economics.

Since their baseline projection was made, a $1.35 trillion tax cut has passed. Other things equal, this will reduce the baseline surplus projection to $1.75 trillion.

Consider now a scenario, based on good news, but not quite such good news. Suppose productivity growth were 2.0 percent over ten years, instead of 2.5 percent. This would reduce real GDP growth and would mean that over the period 2002-2011, the surplus would fall by about a $1 trillion.[1] The ten-year surplus would now be down to around $750 billion. And I am still talking about a good news scenario.

The Bad News Scenario

A specific reason for concern that this optimistic economic and budget outcome will not be achieved is that in the current slowdown investment in high-tech has fallen so hard. Most economists find that a major contributor to the rapid growth of the 1990s was the boom in high-tech investment. The high-tech sector itself contributed directly to faster productivity growth, and the industries buying the equipment were able to increase their productivity. But it looks now as if there was significant over-investment in this area, particularly in telecommunications. The high-tech sector is currently very weak and likely to remain so for a while and we may well not see a resumption of very high levels of investment for a while. Several economic forecasters are lowering their estimates of potential growth because of this fall in investment. Productivity growth was only 1.4 percent a year from 1973 to 1995 and a return to that level is not impossible.

In addition, the unemployment rate is rising and is likely to continue to rise. If productivity weakens, this will raise the possibility of stagflation, just as we saw in the 1970s when productivity slowed. A slowing of productivity means that unit labor costs increase faster, contributing to some combination of higher inflation or higher unemployment. The dashing of expectations about productivity growth would have an adverse effect on the stock market and investment and on consumer confidence and spending.

Finally, there are international trade and currency implications. Many experts believe the current weakness in the Euro is out of line with long run market equilibrium, so some

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[1] According Table B-1 of CBO's January Outlook, 0.1 percent slower GDP growth reduces the surplus by $244 billion. A drop of 0.5 percent a year in non farm productivity translates into a decline of about 0.425 percent a year in GDP growth. $244 billion multiplied by 4.25 yields about $1 trillion.

adjustment of the exchange rate to the dollar would be appropriate. But a sudden loss of confidence in the U.S. economy could trigger a rapid decline in the dollar and perhaps an overshooting in which the dollar falls below its equilibrium level, which would exacerbate inflation.

In short, if things start to go badly, there may be not just a minor shortfall in the budget estimates, there could be a major shortfall. In January, CBO reported a pessimistic scenario with 1.5 percent productivity growth and lower revenue collection per dollar of GDP (Table 5-3). *In this scenario the $3.1 trillion on-budget surplus 2002-2011 is transformed into a deficit of $525 billion—a $1.88 trillion deficit counting the tax cut.* This amount of downside risk in the forecast is certainly not out of the question.

Conclusions for Budget Policy

In previous testimony I have outlined my reasons for favoring fiscal discipline over large tax cuts.[2] First, if large on-budget surpluses do materialize, they should be used in part to address the long run deficit problems of Social Security and Medicare. The long run fiscal position of the federal government is not good, given that the baby boomers will soon be moving into retirement. Second, a large tax cut is particularly bad policy at a time when the United States is running a current account deficit equal to about 4 ½ percent of GDP. We need to increase national saving, not decrease it over the next ten years. Third, while a stimulus to the economy is fine now, it will not be fine later. A tax cut shifts the mix of monetary and fiscal policy, raises interest rates, discourages housing and dampens investment and productivity growth. Fourth, the new economy emerged at a time of extraordinary fiscal discipline. Fiscal discipline did not create the new economy but it helped start the virtuous cycle going. Why change now? Fifth, the surplus projections, based on existing policy, may not be realistic on the spending side. Both parties agree that Federal spending should be controlled, but both parties also agree on the importance of a strong national defense and social investments in health, education and the environment. Spending over the next ten years may continue to decline as a share of GDP, but probably not as fast as assumed in the budget projections.

My testimony today has focused on economic uncertainty. There is always great uncertainty about the path of the economy over ten years and today we face unusual uncertainty as we wait to find out more about the durability of the acceleration of productivity and GDP growth that took place in the latter 90s. I remain optimistic about the economy and look forward to productivity growth of 2 to 2 ½ percent a year once recovery is underway. But the current risks in the budget forecast are mostly on the downside and sound budget planning should recognize these downside risks and should not use up surpluses we do not know we have and that may never materialize.

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[2] Testimony prepared for the Subcommittee on Domestic Monetary Policy, Technology and Economic Growth of the U.S. House of Representatives Committee on Financial Services, March 29, 2001

Addendum: The Nature of the Recent Growth Slowdown

We are probably not currently in a recession, and there is a good chance recession will be avoided, as a result of the sound fundamentals of the economy and the prompt and effective actions of the Federal Reserve. Even without recession, however, this has been a pretty dramatic period of slowdown. Table 1 reports the extent of the declines in the rates of growth that took place in the previous postwar recessions and includes the current slowdown. The rate of economic growth prior to this slowdown was faster than the period leading up to any previous postwar recession. And the drop in the growth rate, at 4.6 percentage points is larger than occurred in many recessions. This has been a big shock to the economy, including the financial system.[3]

What have been the sources of the slowdown, compared to previous episodes? Table 2 shows, for each episode, the percentage of the decline in growth shown in Table 1 that was due to declines in the growth of inventory investment, equipment investment and so on.[4] Compared with the average of all postwar cycles, the current slowdown is not atypical. Inventories, equipment investment, and consumption all make substantial contributions. Since imports fall in a downturn, the net export component tends to support growth, hence the negative sign.

The surprising features of the current slowdown are, first, that inventories are playing a big role, despite improved inventory management methods. The new tools and techniques did not stop U.S. businesses from being caught with excess inventories. In fact the improved speed of communication in the economy may have encouraged a speed-up in the adjustment of inventories. Second, equipment investment played a much bigger role in the recent slowing of growth than in the typical recession of the past thirty years. This part of GDP had become much more stable since the 1950s and 1960s. The current investment slump is a hangover from the investment boom, including some over-investment, during the period of rapid growth. Third, other investment has held up very well. The housing sector responds to interest rates, and it slumped in early 2000 when rates were rising. Following the Fed actions to cut interest rates, the housing sector picked up, providing a buffer against the impact of the depressed manufacturing sector.

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[3] The growth slowdown is defined as the average annual rate of GDP growth over the three quarters following the cyclical peak compared to the growth over the four quarters up to and including the peak. For the current slowdown the "peak" is taken as the second quarter of 2000.

[4] The average contribution of each element of GDP to growth (reported quarterly by the Bureau of Economic Analysis) is computed for the three quarters after the peak and the four quarters up to the peak. The difference in contribution expressed as a percentage of the slowdown shown in Table 1, reflects the impact of each element of GDP to the overall slowdown Aside from rounding errors, the contributions sum to 100 percent.

Table 1: Magnitude of Economic Slowdown

	Growth Rate Up to Peak [a]	*Growth Rate After Peak* [b]	*Difference*
1948-IV	3.7	-0.7	4.3
1953-III	5.6	-2.6	8.1
1957-III	3.1	-4.0	7.1
1960-II	2.1	-0.7	2.7
1969-IV	1.9	1.3	0.7
1973-IV	4.1	-2.1	6.2
1980-I	1.5	-0.4	1.9
1981-III	4.4	-3.1	7.5
1990-III	1.7	-1.0	2.6
2000-II	6.1	1.5	4.6

a Average annual growth rate for peak quarter and three preceding quarters

b Average annual growth rate for three quarters following the peak quarter

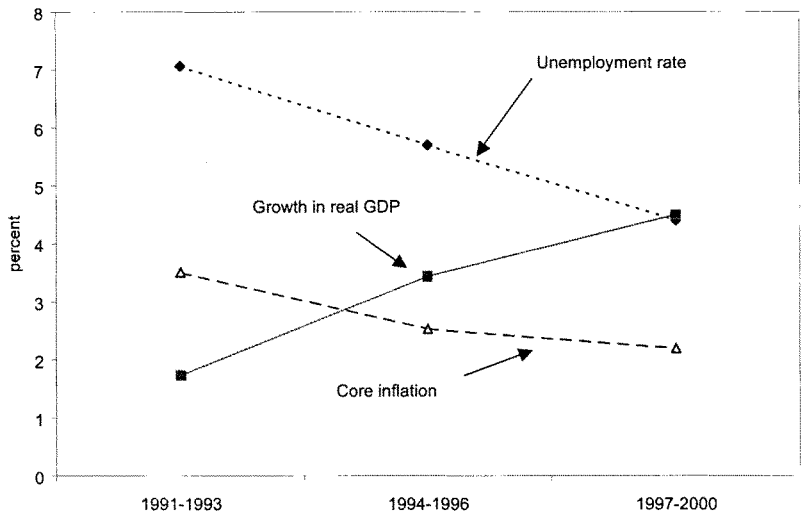
Source: Bureau of Economic Analysis, authors' analysis

Table 2: Percent Contribution to the Growth Slowdown

	Inventories	*Equipment & Software*	*Other Investment*	*Private Consumption*	*Net Exports*	*Government Consumption*
1948-IV	89.2	37.8	11.1	13.7	-55.5	3.1
1953-III	11.1	24.6	-1.6	31.4	-8.3	42.4
1957-III	22.8	26.5	2.4	30.1	18.4	-0.2
1960-II	16.0	46.0	-9.8	88.3	5.1	-45.1
1969-IV	11.5	64.7	22.7	27.1	-21.4	0.6
1973-IV	44.1	13.3	15.5	19.5	15.2	-7.7
1980-I	-2.4	28.7	13.0	34.2	-27.1	53.7
1981-III	60.7	16.5	16.3	17.4	-10.1	-1.0
1990-III	41.2	7.9	25.2	66.6	-40.8	-0.2
2000-II	43.4	34.2	-0.8	30.4	-16.0	8.5
Average	33.8	30.0	9.4	35.9	-14.1	5.4
Median	32.0	27.6	12.0	30.3	-13.1	0.2

Source: Bureau of Economic Analysis, authors' analysis.

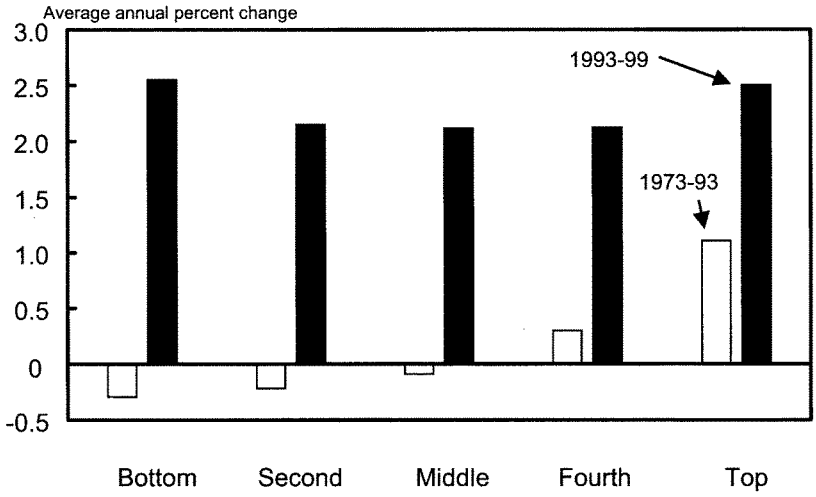
Chart 1: GDP growth, Unemployment rate, and Core inflation 1991-2000



Note: Real GDP growth is deflated by the chained 1996 dollars deflator. Inflation is derived from CPI-U-RS (less food and energy). Unemployment rate is for the civilian population.

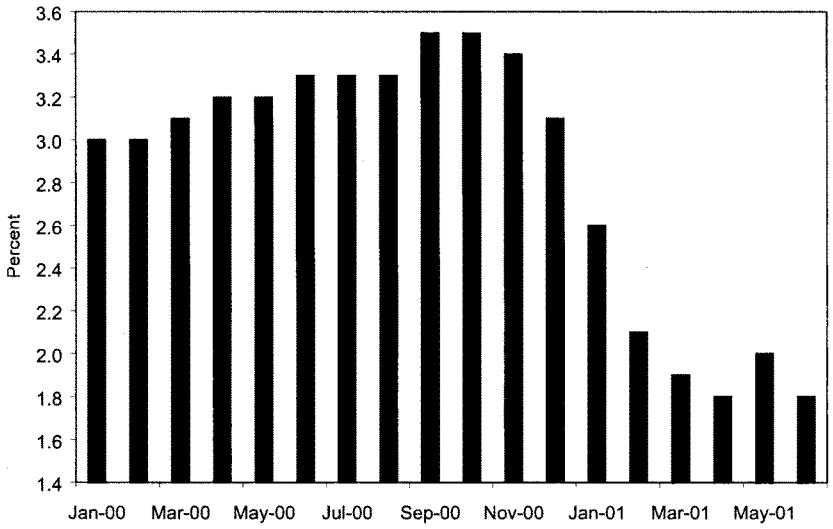
Growth in household income since 1993 has been both stronger and more equally distributed than it was over the previous 20 years.

Chart 2: Growth in Real Household Income by Quintile, 1973-93 and 1993-99



Sources: Bureau of Economic Analysis and Bureau of Labor Statistics.
Source: Department of Commerce (Bureau of Labor Statistics). Chart reproduced from Economic Report of the President 2001.

Chart 3: Changes in Consensus Forecasts of
Real GDP Gowth for 2001



Source: Blue Chip Economic Indicators, June 10, 2001

Chairman CONRAD. Thank you, Dr. Baily. We appreciate very much your testimony.

Now we will hear from Dr. Dudley. Welcome. It is good to have you here.

STATEMENT OF WILLIAM C. DUDLEY, CHIEF U.S. ECONOMIST, GOLDMAN SACHS & CO

Mr. DUDLEY. Thank you, Mr. Chairman.

I certainly agree with Martin that the budget outlook is highly uncertain, both over the next year and the next decade. And I think I agree with him that the risks are not symmetric. I think they are heavily skewed to the side that the budget surpluses fall short of projections, even assuming that Congress and the administration maintain tight control of discretionary spending.

In particular, from my perspective, the revenue estimates appear too optimistic for two reasons:

First, the amount of tax receipts generated for each dollar of economic activity is likely to decline and not only because of the tax legislation that was recently enacted. Put simply, the surge in tax receipt revenue we got during the latter half of the 1990's was not just a result of faster economic growth, it also reflected the confluence of factors such as increasing inequality in terms of income gains, a rise in the profit share of income, and a surge in capital gains tax receipts. Most, if not all, of these factors are in the process of reversing course.

Second, the long-term growth rate of the economy may not be as high as anticipated. In particular, if the investment boom of 1990 and 2000 was based on overly optimistic assumptions of future profitability, as appears to be the case, then investment spending will not recover quickly. In that event, the pace of capital deepening will slow. That suggests the productivity growth is likely to decline from its lofty 1999–2000 pace on a longer term basis.

Turning, first, to the near-term budget outlook, there are a number of reasons for concern that the current Congressional Budget Office revenue projections may be overly optimistic.

First, it appears that the profit share of income is falling sharply. For example, we estimate that the pretax profit share of GDP in 2001 will be only 8.4 percent, compared to 9.5 percent last year. This is important for the budget outlook because a dollar of profit income generates more revenue than a dollar of personal income because the average tax rate on corporate income is significantly higher.

The profit share of income is declining for three reasons. The profit share is cyclical. When the economy slows sharply, profits typically bear the brunt of the adjustment. That is happening this time. Second, profits are under pressure because compensation costs are rising more quickly because of the tightness of the labor market and due to rising energy prices. And, third, the investment bust is leading to a sharp downturn in profitability among high-tech companies.

The impact of the profit squeeze on Federal tax receipts is already becoming evident. Estimated corporate tax payments for the June 15th tax date fell sharply down more than 25 percent from just a year ago. We estimate the corporate taxes could fall $15- to

$20 billion short of the CBO's projections for the current fiscal year and $20- to $30 billion short for fiscal year 2002.

Second, personal income tax receipts could also prove to be disappointing. In recent years, these receipts have been boosted by the strength of the U.S. equity market.

The strong stock market boosted income tax receipts in two ways:

One, through the exercise of stock options which were a significant component of compensation; and, two, through capital gains generated by the rapid appreciation of the equity market. Unfortunately, we do not have good, timely data on options in capital gains income, but it is interesting to take a look at the projections of the State of California.

The State of California recently estimated that the exercise of stock options contributed more than $80 billion to personal income in 2000, up from $50 billion in 1999. This year, they project a 37-percent decline, and that is based on a NASDAQ that is assumed to rise sharply from the current level. The California budget revision statement suggests that there is going to be a sharp drop expected in California from tax receipts from that source.

If you broaden this out to the country as a whole and assume that tax option income for the country as a whole is at least two to three times the size registered for California, this could translate into a revenue shortfall from this source in the range of $25- to $40 billion.

Second, on the capital receipt side, it appears that realizations continued to rise very sharply in 2000 in response to prior rapid gains in equity prices. The problem is that such strong capital gains receipts appear unsustainable. After rising more than 20 percent from 1996 to 2001, according to CBO's estimates, if the equity market doubled, it now appears that capital gains receipts are likely to turn down. I would argued that the Congressional Budget Office's estimate that there will be only a 3-percent drop in capital gains tax receipts next year is quite optimistic in light of the fact that the stock market is down more than 20 percent from its peak in early 2000.

If you assume, instead, the capital gains tax receipts fall back to the level reached in 1999, the stock market was roughly at the same level now as it was then, that would imply a shortfall of about $27 billion relative to CBO's current projections. Taking all of these factors together, corporate tax receipts, declines in personal income tax receipts due to options, related income and lower capital gains tax receipts, I would anticipate that we will see a shortfall in tax receipts in the range of $50- to $75 billion in 2002, relative to the CBO's January projections.

Obviously, if income tax receipts disappoint in 2002, they will have negative consequences for the long-run budget outlook. But even apart from what happens in 2002, there are reasons to be concerned that the long-run budget surplus projections are too optimistic.

Most importantly, the risk is that the long-term growth rate of the economy could fall short of expectations. As you know, in recent years, productivity growth has risen, and this has caused the CBO to raise its long-term growth projections. Unfortunately, our work

suggests that some of that rise in productivity growth is likely to be unsustainable. A portion of the productivity gains was due to the investment boom which led to a rise in the pace of capital deepening and thereby increased the output per hour worked.

This can be seen quite clearly in the contrast between the contribution of capital deepening the productivity growth during the 1950 to 1998 period compared to the boom years of 1999 and 2000. In the early period, the contribution to productivity growth from capital deepening was only 0.7 percent per year. In 1999 and 2000, that spiked up to 1.6 percent a year, more than twice as high.

In our view, this rise was unsustainable because the investment boom itself could not last. It was based on profit expectations that were overly optimistic. In essence, firms mistakenly interpreted profits associated with the boom for profits that were sustainable on a long-term basis. When this error became clear, investment spending collapsed, and with it the rapid productivity gains that we have seen in 1989 and 2000.

We estimate that the rate of return on capital is consistent with the growth rate of the capital stock of about 3- to 3.5-percent per year. This compares to a peak growth rate of about 5 percent in 2000. In our view, this implies a secular trend of productivity growth right in the middle of Martin's range of 2.25 percent, conveniently, down below the CBO's estimate, which is sort of in the 2.5/2.75-percent range.

Details of our analysis of why the secular of productivity growth is only 2.25 percent going forward is contained in this paper, "U.S. Investment Boom Goes Bust," which I have distributed to the committee.

So what is the bottom line? The bottom line is this: The boom of the last few years created a temporary period of climbing profits, soaring equity prices, surging productivity growth, and rapid increases in tax revenue. Now that the boom has ended, all of these factors are moving in reverse. The result is likely to be a narrowing of profit margins, disappointing tax receipts from both the corporate and household sectors, and somewhat slower productivity growth.

The boom exaggerated the good news associated with the improvement in U.S. economic performance. That suggested that the surprises over the next year or two, and beyond, on the budget are likely to be negative ones as this exuberance wears off.

Thank you.

[The prepared statement of Mr. Dudley follows:]

Testimony by William C. Dudley
Chief U.S. Economist
Goldman, Sachs & Co.

U.S. Senate Budget Committee

June 27, 2001

My name is William Dudley. I am the chief U.S. economist for Goldman, Sachs & Co. It is my pleasure to have the opportunity to testify before the U.S. Senate Budget Committee. The views expressed in my statement are my own and do not necessarily reflect the positions or views of Goldman Sachs.

The budgetary outlook is highly uncertain, both over the next year and the next decade. However, in my view, the risks are not symmetric. Instead, they are heavily skewed to the side that the budget surpluses fall short of projections, even assuming that Congress and the Administration maintain tight control of discretionary spending.

In particular, the revenue estimates appear too optimistic for two reasons:

First, the amount of tax receipts generated for each dollar of economic activity is likely to decline, and not only because of the tax legislation that was recently enacted. Put simply, the surge in tax receipt revenue during the later half of the 1990s was not just the result of faster economic growth. It also reflected a confluence of factors such as increasing inequality in terms of income gains, a rise in the profit share of income, and a surge in capital gains tax receipts and income tax revenues generated by the soaring equity market. Most, if not all of these factors, are in the process of reversing course.

Second, the long-term growth rate of the economy may not be as high as anticipated. In particular, if the investment boom of 1999 and 2000 was based on overly optimistic assumptions of future profitability, as appears to be the case, then investment spending will not recover quickly. In that event, the pace of capital deepening will slow. That suggests that productivity growth is likely to decline from its lofty 1999-2000 pace on a longer-term basis.

Turning first to the near-term budget outlook, there are a number of reasons for concern that the Congressional Budget Office revenue projections may be overly optimistic. First, it appears that the profit share of income is falling sharply. For example, we estimate that the pre-tax profit share of GDP in 2001 will be only about 8.4% compared to 9.5% in 2000. This is important for the budgetary outlook because a dollar of profit income generates significantly more revenue than a dollar of personal income because the average tax rate on corporate income is significantly higher.

The profit share of income is declining for three reasons. First, the profit share is cyclical. When the US economy slows sharply, profits typically bear the brunt of that adjustment. Second, profits are also under pressure due to the rise in compensation costs generated by the tight labor market and rising energy prices. Third, the investment bust is leading to a sharp downturn in the profitability of information and communication technology companies.

The impact of the profit squeeze on federal tax receipts is already becoming evident. For example, estimated corporate tax payments for the June 15 tax date fell sharply, down 26.3% from a year earlier. We estimate that corporate taxes could fall about $15-20

billion short of the CBO's projection for the current fiscal year, and $20-30 billion for fiscal 2002.

Second, personal income tax receipts could also prove to be disappointing. In recent years, personal income tax receipts have been unusually strong due in large part to the strength of the US equity market.

The strong US stock market boosted income tax receipts in two ways:

1. Income was boosted by the exercise of stock options, which were a significant component of compensation, especially among high-technology firms.
2. Income was boosted by capital gains generated by the rapid appreciation of the US stock market.

Although data on options and capital gains income are not available on a timely basis, a significant shortfall could occur next spring relative both to expectations and to recent realizations. On the options side, the experience of the State of California suggests that a large drop in options-related income is likely in 2001 and 2002.

The State of California recently estimated that the exercise of stock options contributed more than $80 billion to personal income in 2000, up from about $50 billion in 1999. The State of California assumes a 37% decline in 2001 back close to its 1999 level. Even that expectation may prove to be too optimistic as it is based upon an assumption that the NASDAQ will rise sharply from its current level. The California budget revision statement notes that the NASDAQ in 1999 averaged 2800, roughly 30% above its current level.

This suggests that the shortfall in tax receipts due to a drop in options income could be as large as $40 billion. It is reasonable to assume that the total options income for the country as a whole must be at least two to three times the size registered for California. If one assumes that this options income declines by about 40% this year, that would imply a drop in such income of roughly $65-100 billion. Assuming that most of this income is taxed at the top marginal personal income tax rate, then the revenue shortfall from this source would be about $25-40 billion.

Of course, if options income were to collapse, there would be an offset in terms of higher corporate income tax receipts. That is because the exercise of the options creates an expense for the corporations that they can deduct against earnings. But with many technology firms never having been sufficiently profitable to take advantage of the options expense deduction during the boom, this offset is likely to be considerably less than one-for-one. Moreover, it presumably is already embodied in the disappointing corporate tax receipts evident for the recent June 15 tax payment date.

On the capital gains side, it appears that realizations continued to increase sharply in 2000 in response to prior rapid gains in equity prices. For example, the Investment Company Institute estimates that mutual funds paid out $345 billion in capital gains

income in 2000, up more than 40% from $238 billion in 1999. Final tax settlements in the spring of 2001 came in close to the CBO's projections, suggesting that their forecast of capital gains tax receipts for 2001 of $129 billion is probably not far off the mark.

The problem is that such strong capital gains receipts appear unsustainable. Capital gains receipts rose at more than a 20% annual rate from 1996 to 2001 according to CBO estimates, as the equity market more than doubled in value over that period. But now the equity market is down more than 20% from its peak. Yet, the Congressional Budget Office has assumed only a small drop in capital gains tax receipts next year of 3%.

A reasonable view might instead be that capital gains receipts will fall back to the 1999 level of $98 billion. After all, the equity market is at roughly the same level, and the volume of unrealized gains has diminished since 1999 given the large capital gains realized in 2000. This would imply a shortfall of $27 billion relative to the CBO's January projection.

Taking all three factors together--corporate tax receipts, declines in personal income tax receipts due to lower options-related income, and lower capital gains tax receipts, I would anticipate a shortfall in tax receipts in the range of $50-75 billion relative to the CBO's January projections for 2002, above and beyond the shortfall due to the budgetary costs associated with the recently enacted tax cut legislation.

It is noteworthy that such a shortfall in personal income tax receipts would only partially reverse the positive revenue surprises that have been evident in recent years. Over the past five years, personal income tax receipts have consistently exceeded the CBO's estimates, oftentimes by significant margins. For example, in three of those years, the forecast error was $60 billion or higher. The stock market surge undoubtedly played a large role in these forecast errors. Now that it has reversed course, at least temporarily, this suggests the risk of offsetting forecast errors.

Obviously, if income tax receipts disappoint in 2002, that will also have negative consequences for the long-run budget outlook. But even apart from the 2002 outturn, there are reasons to be concerned that the long-run budget surplus projections are too optimistic. First and foremost, of course, is the fact that the assumptions implicit in CBO's baseline budget projection will be violated. For example, Congress could enact spending measures that cause discretionary outlays to rise at a faster pace than inflation and/or make further changes on the tax side (such as adjustments to the alternative minimum tax) that reduce revenue.

Second, and the focus of the remainder of my testimony, is the risk that the long-term growth rate of the economy could fall short of expectations. As you all know, in recent years productivity growth has risen and this has caused the Congressional Budget Office to raise its long-term growth projections.

Unfortunately, our work suggests that some of that rise in productivity growth is likely to be unsustainable. A portion of the productivity gains was due to the investment boom,

which led to a rise in the pace of capital deepening and, thereby, increased the output per hour worked. This can be seen quite clearly in the contrast between the contribution of capital deepening to productivity growth during the 1950-98 period and that of the boom years of 1999-2000. In the earlier period, the contribution to productivity growth from capital deepening averaged 0.7% per year. We estimate that this spiked up to 1.6% per year during 1999 and 2000.

This rise was unsustainable because the investment boom itself could not last. It was based upon profit expectations that were overly optimistic. In essence, firms mistakenly interpreted profits associated with the boom for profits that would be sustainable on a long-term basis. When this error became clear, investment spending collapsed and, with it, the rapid productivity gains evident in 1999 and 2000.

We estimate that the rate of return on capital is consistent with a growth rate of the capital stock of about 3-3 1/2% per year. This compares to a peak growth rate of about 5% in 2000. This decline implies a secular trend for productivity growth of about 2 1/4% per year. This, in turn, implies a potential real GDP growth rate of about 3%.

This is about 0.3% per year below the Congressional Budget Office's current assumption for potential GDP growth of 3.3% per year. If our forecast were realized, this would cut the cumulative 10-year budget surplus by nearly $750 billion over the next 10 years.

The bottom line is this:

The boom of the last few years created a temporary period of climbing profits, soaring equity prices, surging productivity growth, and rapid increases in tax revenue. Now that the boom has ended, all these factors are moving in reverse. The result is likely to be a narrowing of profit margins, disappointing tax receipts from both the corporate and household sectors, and somewhat slower productivity growth. The boom exaggerated the good news associated with the improvement in U.S. economic performance. That suggests that the surprises over the next year or two on the budget are likely to be negative ones as the exuberance wears off.

Chairman CONRAD. Well, thank you, Dr. Dudley, for that sobering testimony. We appreciate your taking the time to be here.

Mr. Wesbury.

STATEMENT OF BRIAN WESBURY, VICE PRESIDENT AND CHIEF ECONOMIST, GRIFFIN, KUBIK, STEPHENS & THOMPSON, INC.

Mr. WESBURY. Thank you, Mr. Chairman, Senator Domenici and other members of the committee. I will summarize my testimony this morning, so if I could submit it for the record, I would appreciate that.

My belief is that the economy today is in what I would call a typical cyclical slowdown. We have seen many of these over history, and this slowdown that we are living through, in my opinion, is being caused by three specific factors:

No. 1, the Federal Reserve, in my opinion, raised interest rates too far in late 1999 and early 2000. That is slowing the economy in late 2000 and through today.

No. 2, tax revenues as a share of GDP hit a record level in the year 2000. I think that that also helped slow the economy down in recent months.

And then, also, the energy crisis hit. We had much higher natural gas prices, gasoline prices, oil prices. All of these things have led to a slowdown today.

As a result, if those are the three reasons for our economic slowdown, then reversing them should help the economy, and that is exactly what I think has happened. The Federal Reserve has cut interest rates dramatically this year. They will do so, again, in my opinion, this afternoon. Taxes have been cut due to recent legislation, and we will have rebates this year.

And, finally, energy prices are coming down, and the reason for that is very simple. High energy prices attracted producers. We are punching many more natural gas wells right now. We are building power plants, and as a result, national power prices are coming down and have come down dramatically this year.

As a result of these three things, my belief is that the economy will bounce back late this year or early next year and that it will bounce back strongly. In fact, I believe that year 2002 growth will come back to the 3- to 3.5-percent range, and then as we move into 2003 and beyond, we will see growth rise back to the 4- to 4.5-percent range, much like what we have seen over the past 4 or 5 years.

That is the near-term economic outlook. In terms of the longer term, there are two different views, and you are going to hear both of them today. The first was from Dr. Dudley here and Martin Baily, although Dr. Dudley focused more on the unsustainable nature of investment and the bubble in the stock market over the past few years. In this view, we benefited from these bubbles, this unsustainable investment, and that it is, as a result of that, unsustainable going into the future.

My belief is that that is not the case; that, in fact, what we have done is we have entered into a new era of economic growth in the United States, where investment in technology and equipment has raised potential growth, increased productivity trends, lowered in-

flation, and as a result the boom in revenues and the surplus that we have seen in recent years is coming from very fundamental factors. I, also, believe that these fundamental factors will continue for many, many years into the future. These productivity booms, as found by Dr. Meyer at the Federal Reserve Board, lasts for 20 to 25 years. And in a recent speech, he suggested that we are just in the beginning of a new wave of productivity increases.

One thing that is interesting about the debate about productivity is that, obviously, we have reached a point where productivity fell in the first quarter, and some people suggests that that is leading us toward a lower trend in productivity. I disagree with that. I think it is a very normal cyclical drop in productivity. In fact, if you think about it, it is caused today mainly because we are at full employment or very close to full employment in recent years. Companies had to pay hiring bonuses in order to get employees, they had to allow more flexible working hours. In other words, the cost of bringing on new employees rose dramatically. And as a result, when production slows, when the economy slows, these companies are unwilling, at first, to let go of employees. And what happens is production falls faster than employment, then productivity falls.

Unfortunately, now, the labor market is weakening. We are seeing layoffs pick up. That is not ever good news, but it is, in a sense, positive news because productivity will look better as we move into the quarters ahead just because the labor market has weakened.

One of the other interesting things is that if you look at the history of the United States, in 1990, in 1987, in the 1979 to 1980 period, and again in 1974, whenever oil prices spiked, and they did in each of those periods, productivity fell. When oil prices and energy prices came back down, productivity picked back up. And so, again, I believe that this is a cyclical, very short-term drop in productivity.

Now, the question is where do we go from here? Two problems exist. No. 1, we have a very difficult time in measuring productivity. Financial services productivity for basically 20 years was never shown to increase at all, and this was with the invention of ATMs and Internet banking, and obviously our statistical agencies have fixed those numbers, and now we show financial services picking up.

Alan Greenspan recently, back in January, focused on the medical services field. And one of the things that he saw was that productivity trends in medical services had not increased, in fact, had declined between 1990 and 1999, and he said, and told this committee, that that was implausible, and I agree with him.

As we move forward, what we need to focus on is those areas where we can see improvements in productivity. Manufacturing productivity has accelerated in the past few years. In fact, in my measurements, it is growing faster than ever in U.S. economic history, even faster than the industrial revolution. And as we move forward, my belief is that investment in high technology equipment will continue to raise productivity trends.

Let me bring up one interesting kind of microeconomic analysis point, and that is that the lumber industry today uses lasers and CAT scan machines at the beginning of a mill. They look into a log, and by looking into that log, they know the best way to cut that

log. What is amazing is that they connect these pictures of that log to a computer, and that computer has current prices for two-by-fours, one-by-twos, one-by-sixes stored into it, it knows the actual inventory of the mill, it knows all of the orders up until the last second, and as a result, they are able to maximize the profit from every log that comes into that mill. Technology is moving through every industry in doing these kinds of things, and we cannot measure the true higher profitability that is taking place today.

To summarize, I believe that the trends that the CBO has estimated, 2.7 percent per year in gains in productivity over the next 10 years, are actually low. My belief is that we will see 3-percent gains in productivity or higher as we move ahead, and 4-percent gains in real GDP or higher as we move ahead into the next few decades. And, therefore, I believe that, in fact, some of the estimates that we are hearing about the budget are very conservative, and I am very optimistic that those surplus numbers that are forecast will prove to be correct as we move forward.

Thank you.

[The prepared statement of Mr. Wesbury follows:]

The Economy, Productivity and the Budget

Brian S. Wesbury[1]

Testimony before the
Senate Committee on the Budget
June 27, 2001

Mr. Chairman and Members of the Committee, I am pleased to be here today to discuss issues surrounding the economic slowdown, its impact on productivity and the federal budget. I would like to emphasize that I speak for myself and not my employer, Griffin, Kubik, Stephens & Thompson, Inc.

After many years of stellar performance, the economy has clearly entered a period of dramatic slowdown. During the four years ending in the second quarter of 2000, real gross domestic product in the United States grew at an average annual rate of 4.5%. This growth boosted civilian employment by an average of 2.2 million jobs per year. And, at the same time, inflation-adjusted average weekly earnings climbed 1.6% per year, the fastest four-year period of growth in this measure of real incomes ever measured.

Since then, things have gone badly. Real GDP has expanded at an annualized rate of just 1.5% during the nine months ending in March. Moreover, in May 2001 civilian employment was 78,000 less than the average during the second quarter of 2000 while real weekly earnings have risen just 0.3% in the past year.

Today's economic problems are most evident in the manufacturing sector. Industrial production has contracted for eight consecutive months and new orders for durable goods are down 10.9% from year-ago levels. The high-tech sector – the engine of U.S. growth in the past four years – has been particularly hard hit with new orders for computer and electronic products down 40.8% at an annual rate in the past six months.

While clearly showing signs of weakness, consumer spending has shown surprising resilience. Adjusted for inflation, consumer spending is rising at a 2.4% annualized rate this year versus a 7.6% growth rate in the first quarter of 2000.

Weakness in the job market, when combined with high debt levels, will make it difficult for spending to accelerate in the months ahead. As a result, it is my view that the economy will remain weak for the remainder of this year.

Already, weak economic growth is reducing the growth rate of federal receipts below projections, which will cause the budget surplus to be smaller than expected this year. The important questions before us today are: How did this happen? When will it end? And, most importantly, is the U.S. now in for an extended period of economic growth that will fall below expectations?

In short, my answers are that the U.S. economy is going through a typical cyclical slowdown caused by tight monetary policy, high tax burdens and an energy crunch. Each of these problems is now in the process of being corrected. The Federal Reserve has cut interest rates enough to bring the economy back by early 2002 and taxes have been cut which will provide a boost to economic activity. In addition, high energy prices provided the incentive for a sharp boost in energy production which is already bringing prices down.

The forces that brought us strong growth in the late 1990s are still in place. High-tech investment has boosted productivity and will continue to do so at a very rapid pace in the years ahead. In addition, the tax cut – as it is phased in – will slowly increase the underlying potential growth of the economy. This suggests that CBO and OMB surplus estimates are still on track in the long-run.

Two Views

There are two views of the current economic slowdown. One of those views is that a "bubble" in investment and the stock market has caused the problems associated with the economy. According to this view, the economic growth we experienced in the late 1990s was unsustainable and a period of sub-par economic growth is now in store.

I do not subscribe to this view. While there may have been excesses during the boom and clearly some ill-advised investments were made, most of the investment in the late 1990s increased the economy's productivity and its growth potential. The esteemed Yale professor, William D. Nordhaus, in a recently published paper[2], wrote that, "there has clearly been a rebound in labor-productivity growth in recent years."

He finds that "well-measured" productivity (a measure which excludes services and other problematic sectors of the economy) accelerated to a pace of 4.65% between 1996 and 1998.

In responding to critics of the New Economy who say that productivity gains in the production of computers and semi-conductors are responsible for the surge, Nordhaus subtracts those sectors from his measurement and proves them wrong. He found that "non-high-tech" output per hour virtually doubled to a 3.0% growth rate between 1996 and 1998, from 1.6% between 1990 and 1995.

It is important to understand that Nordhaus was using data from the 1996 to 1998 period. Productivity growth actually accelerated further in 1999 and 2000. These gains in productivity boosted real incomes and corporate profits. They also boosted government revenue, creating massive surpluses in recent years.

In January, Alan Greenspan told this committee, "the key factor driving the cumulative upward revisions in the budget picture in recent years has been the extraordinary pickup in the growth of labor productivity...."[3] He went on to say that because productivity had held up well during a slowdown in aggregate demand, "the apparent increases in the growth of output per hour are more than transitory."[4]

The Fall in Productivity

This debate reached a crescendo in economic circles during recent months after a report that showed non-farm productivity fell by 1.2% at an annual rate in the first quarter. Pessimists argue that this decline in productivity is a sign that the trends in the economy are worsening.

In my opinion, however, this decline is not indicative of a drop in longer run productivity trends. In fact, it is normal to see a drop in productivity when an economy slows as rapidly as the U.S. has in the past year. Because production is falling faster than employment, output per hour of work declines. This is especially true when the economy is near full employment.

In 1999 and 2000, employers found it necessary to offer flexible working hours, hiring bonuses, and higher pay to attract workers. Employers are reluctant to let go of these high cost employees, especially if the slowdown proves temporary. But by holding on to these employees while output slumps, productivity suffers.

There are other important factors at work as well. Higher oil prices have almost always been associated with falling productivity. In the fourth quarter of 1990, in 1987, in 1979-1980, and in 1974, productivity turned negative when oil prices shot higher.

As the economy heads into the latter half of 2001, near-term developments are creating a better outlook for productivity. Energy prices are coming down rapidly, and the job market has weakened significantly. While it is never good to see layoffs, these developments bode well for productivity going forward.

More importantly, Federal Reserve interest rate cuts and the tax cut just signed into law will help boost growth in 2002. The end result will be that productivity will get back on track in the years ahead and budget revenue projections will prove to be correct.

Some Thoughts on Productivity

One of the major problems associated with any debate on the strength of productivity is our ability to accurately measure its growth rate. As we now know, service sector productivity is virtually impossible to measure. For years, financial services productivity, as measured by the Bureau of Labor Statistics, was stagnant.

With the advent of automatic teller machines and Internet banking, the statistics were clearly wrong. The same is true in the medical services field. Alan Greenspan recently said that statistics, which show a decline in medical services productivity between 1990 and 1999, are "implausible."[5]

While service sector productivity is hard to measure, new technology is creating havoc with manufacturing productivity statistics as well. For example, new technologies in the lumber industry use lasers and CT scanners to measure the exact dimensions of logs entering the mill. This information, in real-time, is then plugged into a computer that is updated to include current market prices of lumber products. The log is then cut to maximize profits.

The lumber mill may cut the same number of logs after implementing this new technology and sell the same amount of lumber, but profits margins will be higher because the process is more efficient. This improvement in profitability is not captured by standard statistical measurements and as a result, productivity is underestimated.

These types of technological advancements are proliferating in every industry. Moreover, the use of the Internet is still in its infancy and the benefits of using it are just now being discovered. As new and more important networks are developed, the underlying rate of productivity growth should accelerate further, not decelerate.

Federal Reserve Board Governor, Laurence Meyer, recently presented research that shows how productivity moves in waves, averaging 24 years in length.[6] His research suggests that, "the recent [productivity] data should be interpreted as part of another high-growth wave...."[7] Once again, this suggests that CBO and OMB forecasts are supported by the data.

Surpluses

In July 1999, I completed research that was published in the Wall Street Journal, forecasting much higher budget surpluses in the future than those forecast by the CBO or OMB.[8] The reason for my optimism was a higher productivity growth forecast than that of White House or Congressional forecasters. Fortunately, my forecast proved correct and both the OMB and the CBO have raised their productivity estimates.

The CBO now estimates that non-farm productivity will increase by 2.7% per year through 2011. Despite this revised outlook, the CBO estimates of revenue growth are very conservative. Between 2001 and 2011, the CBO estimates an average annual growth rate for federal revenues of 4.9%, but an annual growth rate for nominal GDP of 5.1%.

This would contradict history. For the past 20 years, federal revenues have grown at a 7.1% rate while nominal GDP has grown at a 6.6% rate. Even though tax brackets are now adjusted for inflation, rising real incomes push taxpayers into higher tax brackets. As a result, the CBO estimates seem well within realistic assumptions.

Conclusion

The U.S. economy has hit a rough patch caused by excessively tight monetary policy, high taxes as a share of GDP, and an energy crunch. Fed rate cuts, the tax cut and falling energy prices are now reversing these negative forces. As a result, a rebound in the economy late this year or early next year is highly likely.

Moreover, the underlying trends remain very positive. Technology investment during recent years, even investment undertaken during Y2K, is still boosting productivity, efficiency and profitability. These trends are very positive and should continue to boost the economy back to a long-run trend rate of growth of 4.0% in the years ahead. In short, the economy over the next ten years should look much like the economy did over the last five years.

The U.S. is a special place. We have attracted capital from around the world, at least partially because, as Laurence Meyer observed, "the United States was the only major country in which the dramatic surge in productivity was evident...."

There is a simple explanation for this. Tax rates are much lower in the U.S. than in most European countries or in Japan. In addition, labor markets are much less rigid in the U.S. and government spending is much lower as a share of GDP. This attracts capital to finance entrepreneurial activity, innovation and creativity. These are the building blocks of economic growth and wealth creation.

In order to continue the miracle of rapid economic growth and low inflation in the U.S. we must constantly find a way to keep tax rates and spending levels down. Allowing tax rates to climb, or federal spending to grow faster than GDP, would end the boom. This would reverse the virtuous cycle that created the budget surpluses in the first place.

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[1] Brian S. Wesbury is the Chief Economist of Griffin, Kubik, Stephens & Thompson, Inc. a Chicago-based investment bank. Mr. Wesbury previously served as Chief Economist for the Joint Economic Committee of Congress in 1995 and 1996.

[2] Nordhaus, William. 2000. *Productivity Growth and The New Economy*. NBER Working Paper 8096

[3] Greenspan, Alan. January 25, 2001. *Current Fiscal Issues*. Testimony before the Committee on the Budget, U.S. House of Representatives, Washington, D.C.

[4] Ibid.

[5] Greenspan, Alan. March 27, 2001. *The Challenge of Measuring and Modeling a Dynamic Economy*. The Washington Economic Policy Conference of the National Association for Business Economics, Washington, D.C.

[6] Meyer, Laurence. June 6, 2001. *What Happened to the New Economy?* New York Association for Business Economics and the Downtown Economists. New York, NY

[7] Ibid.

[8] Bodipo-Memba, Alejandro. July 9, 1999. *Budget Surplus Forecasts May Be Low: White House May have Scanted Productivity Gains*. Wall Street Journal, Page A2

Chairman CONRAD. Thank you, Mr. Wesbury.

We have a vote underway. Senator Clinton is the first one here and will have the first chance to question. Is the Senator able to stay or what would she prefer, that we take the committee out?

Senator CLINTON. Well, Mr. Chairman, thank you, but I am going to have to leave after I vote. So, once I go to vote, I won't be able to come back.

Chairman CONRAD. All right.

Senator CLINTON. So, if I could just maybe ask a few questions——

Chairman CONRAD. Certainly.

Senator CLINTON [continuing]. And if you could go vote and——

Chairman CONRAD. Yes. Why do we not do that. Why do you not—yes, we will.

Senator SARBANES. Hillary, would you give me just 10 seconds?

Senator CLINTON. Sure.

Senator SARBANES. I just want to congratulate Senator Conrad on becoming chairman of the committee. We look forward to serving under his leadership. I know that he and Senator Domenici have established a working relationship, which I think will prove to be positive and constructive for us, but, Mr. Chairman, I am delighted to be able to call you Mr. Chairman. I am very pleased to be here.

And I did want to thank Dr. Baily for his terrific service as the chairman of the Council of Economic Advisers——

Mr. BAILY. Thank you.

Senator SARBANES [continuing]. And for the very high-quality professionalism that was reflected by the Council under his very able leadership.

Mr. BAILY. Thank you.

Chairman CONRAD. I, Thank the Senator, and we will turn it over to Senator Clinton. And if we are not back, just recess the committee until we return.

Senator CLINTON [presiding]. Well, I would echo what Senator Sarbanes said, both about our new chairman and my great appreciation to Dr. Baily for his service in the prior administration.

You know, in listening to the testimony, I mean, it is hard I think for those of us sitting on this side of the table to know whether we have a new-era economy with new problems or old problems or an old economy with new problems or old problems. And to try to sort that out, to figure out what direction we should take is obviously something of great concern. Because the optimism, the long-term optimism that each of you expressed, I think is shared by everybody here, but how we get from here to there without causing significant damage to our fiscal position, without putting us at risk of a return to deficits and increasing debt burden which would make at least our optimism tempered by reality is the series of questions that are going to be posed by these hearings.

And before I can certainly make any decision about where I think we should go, we are going to have to do a lot of sorting out, and that is why I appreciate the committee having these hearings.

Let me just ask each of you, based on your own assessment of where we currently are, what, if any, action would you recommend this committee recommend to our colleagues that could be taken in

order to increase the upside of your picture and decrease the downside? If you want to talk short, medium, and long term, that is fine as well.

Dr. Baily.

Mr. BAILY. Well, the fiscal stimulus that has been put in place I think will be helpful in the short term in helping bring us out of the current slowdown. So I think that is there, and there certainly was a case for doing that. I think it is more over the longer term that I would be concerned. I did not support the tax cut that was passed. I think it was not as big as had been proposed, but is still larger than one that I would be willing to support.

And so I think the main action going forward, particularly given that there are a lot of, you might say, gimmicks or at least things within that tax cut that will have to be resolved as provisions phase in and phaseout, and the estate tax is repealed and then unrepealed, I would certainly urge you to consider taking the more conservative view and limiting the size of the tax cut and making sure that we don't pile on extra tax cuts to boost this even higher.

So focusing on the fiscal discipline, which I think is a big reason we had such good performance in the 1990's.

Senator CLINTON. I am sorry, but I have just been told I have to leave. They are trying to cut the vote off. And I would very like much, though, if we could, perhaps when the committee comes back into session, get the answer to my question, Mary, so that I could see what the answers are.

And I very much appreciate all three of you being here and helping us think through this "on the one hand, this/on the other hand, that" set of dilemmas.

Thank you very much. The committee is in recess.

[Recess.]

Chairman CONRAD [presiding]. Why do we not come back to order.

I, first, want to apologize to the witnesses for the interruption, but——

Mr. BAILY. It was a short break.

Chairman CONRAD. It was not too bad.

Mr. DUDLEY. Very efficient.

Chairman CONRAD. We do have to vote, and the Senate is never a predictable schedule.

I understand Senator Clinton had asked a question and not all of you had had a chance yet to answer it. So why do we not go back to her question.

Dr. Dudley, as I understand it, you were answering when she had to leave to make the vote. So, if you would like to complete your answer, and then the other two witnesses have a chance to address it as well.

Mr. DUDLEY. OK. I had not actually even started, so I will give my full answer.

Chairman CONRAD. OK.

Mr. DUDLEY. She had asked the question what could the committee do to try to ensure the greater likelihood of the upside, in terms of the outcome for the budget and the economy. I think there are two things that come to mind, from my perspective:

One, try to increase certainty about tax and spending policy. One thing that deters investment is uncertainty. And to the extent that Congress and this committee can try to create greater certainty about the likely course of Government tax and spending policy, I think that would encourage greater investment, which is the source of the productivity improvement that we are seeking to try to achieve.

Second, I think it behooves this committee, and the Government, generally, to plan for the worst and hope for the best in terms of the budget. The reason for that is that if you plan for the worst and you get the best, all that happens is you have freed up even more resources for the private sector, and so you are going to have even a better outcome in terms of economic growth and productivity performance, and I think that is quite a good thing, rather than the obverse, which is you hope for the best and get the worst. Then I think you are consigning yourself to subpar growth and poor productivity performance.

Chairman CONRAD. All right.

Mr. Wesbury.

Mr. WESBURY. Mr. Chairman, I am kind of reminded, and I have it in my testimony, a quote from Laurence Meyer, Governor of the Federal Reserve Board, where he said that the United States was the only country in which the dramatic surge in productivity was evident in the time period he was looking at, the late 1990's.

This is a question that I, myself, and many of my customers and other investors have asked a lot: Why is this surge in productivity happening in the United States alone, not in Europe, not in Japan?

My answer is really very simple, and that is that we have much lower tax rates than these other countries; our labor markets are less rigid, our Government spending is much lower than theirs as a share of GDP. In other words, we have allowed technology and entrepreneurial activity, and innovation, and creativity to really took root in the United States and for those entrepreneurs to be rewarded with low after-tax or high after-tax profits and incomes.

And so my belief is that as this committee looks at what has been a miracle in the U.S. economy in the past 5 years, and really in the past 18 years, relative to the rest of the world, is to think about those things, that we need to keep tax rates down, we need to keep the size of Government, relative to the private sector, low, and we need to keep the regulatory environment flexible enough so that entrepreneurs can truly work their magic in innovation and creativity.

And what happens when we do that is that we attract capital from around the world, we provide the right incentives here in the United States, and that is the way we maximize the upside, keep productivity strong and make certain that our budget estimates are correct or maybe even too low as we move into the future.

Chairman CONRAD. Dr. Baily.

Mr. BAILY. Well, I had an opportunity. I will just add a couple of other comments.

Let us keep in mind that the miracle economy of the 1990's, and particularly the acceleration of productivity growth in the latter half of the 1990's, took place with the tax rates that we have. I do not like paying taxes, and I think if the opportunity to cut taxes

is there, I am certainly not against it, particularly if we can provide some tax relief for low- and moderate-income families that are feeling pressed even in a good economy and are certainly pressed now that the economy is a little bit weaker.

So I am certainly not against tax cuts, as appropriate, but I disagree with Mr. Wesbury that that is the main thing to do to keep the expansion going or to—that differentiates us from Japan and Europe. I was involved in a number of studies of Europe and Japan, and I think what we found is a lot of the reason for the differential has to do with the regulatory environments, that we are less regulated as an economy; we allow much more evolution to occur in our industries; we allow companies that are no longer successful to fail and new companies that are growing and becoming successful to enter; we allow the best productivity/best practice companies to expand, even if sometimes that means that there has to be change and workers have to change jobs.

So I think the reason we have done better than Japan and Europe really is because of that openness to innovation and change. That is the most important thing.

Chairman CONRAD. All right.

Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman. I will be brief. I, again, want to thank you, all of you, and to tell you that I learn from every one of these discussions.

Clearly, I want to talk about only one subject and that is what you think about productivity. Actually, I can vividly remember 15 years ago, when we were talking about not knowing how to measure productivity, except for heavy industry, and it was pretty obvious that measuring productivity for General Motors, U.S. Steel, Alcoa was pretty easy. Once you put the formula in place, you just measured the manhours to produce whatever unit you are going to use as your constant unit. Pretty soon you find out less manhours producing more of the thing you are manufacturing, and that is productivity.

We did not know much then about the service industry and how do you measure productivity. As a matter of fact, I was pleased to hear one of you say that you are not quite sure we are even measuring productivity in some of the service industries today in a real way, and I would concur wholeheartedly that every industry that is using modern equipment versus 15 years ago has reduced the manhours that they need to handle X product, whether it be a bank, whether it be an insurance company, large or small, just keep on going. They are all over the place.

Now, what I was led to believe was that Dr. Alan Greenspan came to a conclusion, as Federal Reserve Board chairman, that we had a new economy. New economy did not mean we were at an age or at a year that is new; new meant something is happening that is different, and it is causing us to become much more productive because of high tech, which is applying across-the-board, and innovation, new products. He came to a conclusion that this new technology was, in fact, America, and America for the future.

We did ask him, before we did our marginal tax rates and other things, what he thought about surplus use, and I will not go into that at this point. But one of the things he did say is if you put

it on the debt, that would be great, and if you are not going to do that, you ought to cut marginal rates. So I am going to ask each of you a question about marginal rate cutting.

Do you still believe, in light of this little downturn, which might have lasted longer than we expected, that we are living in a new economy in America and can expect return to higher productivity rates across-the-board in American business and industry?

Could you answer that one, first. We will start with you, Dr. Baily.

Mr. BAILY. You want me to just take that question?

Senator DOMENICI. Just that question.

Mr. BAILY. Just that question. I think we are in a new economy, and I think we will return to stronger productivity growth than we experienced for 20 years after 1973, but I do not know for sure whether that is right, and I do not think we should—as Bill Dudley said, we should hope for the best and plan for the worst. So I think that we need to recognize that, as yet, we do not know how long this strong productivity growth is going to last. I am hopeful, but I do not think we know yet.

Senator DOMENICI. I thank you, but I am not sure that I heard Dr. Dudley say that he does not think we are operating in a new economy.

Could you answer for yourself?

Mr. BAILY. I did not mean to answer for you, Bill. I am just quoting your earlier comment.

Mr. DUDLEY. I actually do think we are in a new economy, and I would characterize the new economy maybe somewhat differently than others. It is a new economy that, in my mind, is much less cyclical, much less recession prone. We have had two very long-lived business expansions in a row, 1982 to 1990, and hopefully from 1991 to today, although there is some question of whether we are still in a business expansion or not at the current moment.

This is due to a variety of things, trade liberalization, deregulation of the financial system, just-in-time inventory management, and I think it is important that this drop in the cyclicality of the economy I think it also may help explain why we have been experiencing higher productivity growth. Because if the economy is less cyclical, that reduces the riskiness of new investment, and if you get more new investment, that raises productivity growth.

The key question, though, which I raise is by how much? And what I am really arguing is not so much that productivity growth has not increased. I think it has. The 2.25 percent that we are looking for the long-term secular trend to be is much higher than what we experienced from 1973 to 1975. However, I do not think we are going to go back to where we were in 1999 and 2000. I think that productivity experience was due, had a cyclical component due to very rapid GDP growth. I think it had a component that was also unsustainable because it was due to a boom in technology investment that was not sustainable on a long-term basis.

So I am optimistic that the economy is quite a bit better than it was. I am just not willing to quite buy into the idea that 1999–2000 is where we are going back to.

Senator DOMENICI. Thank you very much.

Mr. Wesbury.

Mr. WESBURY. I do believe we are in a new economy. I think that, in fact, we can see seeds of it all the way back to the early 1980's. The period from 1965 to 1982 was miserable for the economy, high inflation, many recessions. The stock market went nowhere for 17 years, and then all of a sudden, in the early 1980's, things started to improve, and they have slowly accelerated in a sense, especially into the late 1990's.

My belief is that the reason for that change, from the miserable 1970's to the much better 1980's and 1990's, was marginal tax rate reductions that took place in the early 1980's, regulatory reform, lower Government spending over the time, and also the Federal Reserve, with Chairman Volcker and Chairman Greenspan, broke the back of inflation. And when you put all of those things together, that is what has led to this boom.

The other overlaying factor is technology. And the Internet and computer technology is much different than any other technology we have seen before, and I am sure you have heard about this on this committee, but we are now living with increasing returns to investment rather than diminishing returns to investment. As we add more people to a network, a fax network, a cellular phone network or an Internet network, in fact, productivity accelerates, and as a result, I am very optimistic in the future about the direction of productivity and, in fact, think we are not only in a new era economy, but we are repeating the 40-year kind of cycle that we saw in the Industrial Revolution at the turn of the last century.

Senator DOMENICI. Mr. Chairman, I will not ask another question. I will just close with an observation and another thank you.

I think, Dr. Dudley, you are correct in your analysis. There are a number of things that happened in America because we got this new economy, one of which I do believe is that the cyclical nature of the downturn will get farther and farther apart, and I think that is a direct result of the kind of economy we have that is new.

I am concerned, today, about two phenomenon: The impact of the high dollar, which we are beginning to hear an awful lot about. We continue to assume it is great for America, but we are having more and more American businesses saying they wonder whether it is. I am not going to ask you all about it today, but it is a very important thing.

And my last observation is that productivity is the key in our country, but we do not know the impact of a no-grow world, a world that is not growing even with us having high productivity. If Japan stays in the sink, and Europe cannot grow, and none of those other countries that were big growing centers grow, I am not sure even our productivity can carry us along to sustain long-term heavy growth. Something has to change in those countries also.

If I had time, I would ask you both of those questions, but I yield at this point.

Chairman CONRAD. Thank you, Senator Domenici.

We will go to Senator Stabenow, who is next on the questioning list.

Senator STABENOW. Thank you, Mr. Chairman.

First, let me just make a statement concerning the new economy. I believe, also, we are in a new economy. I think we all understand that we are moving to a new economy much more based on tech-

nology and information. As we look at the priorities for all of us as a country, that is one of the reasons why I support education so strongly because we have not talked about it yet today, but while we, on the one hand, need to increase and update our technology and investments on the business end, every business owner I know is talking to me about a skilled work force as being the other half of the pie in order to make sure that we can truly have workers that can use the technology and the information.

And so I do not want to spend time, you are welcome to comment on that, but I do want to say that there is more to this picture than just what we have talked about so far today in terms of education.

I would also comment that I think that there have been a number of policy changes that have gotten us where we are today. I would question whether tripling the national debt in the 1980's got us to where we are today, and I am concerned about going back to that.

And that raises, I guess, and Mr. Baily, I would like to ask you, you talk about, on Page 6 of your Conclusions for Budget Policy, you indicate that the tax cut could end up driving up interest rates. I wonder if you could speak to that and also to the reality, for most working people and families, there has been a tax cut put forward, but if interest rates, in fact, go up, could that wipe out any benefit for the average person buying a home or a car or putting their children through college and worrying about student loans and so on?

I am deeply concerned about what happens to my constituents when interest rates go up.

Mr. BAILY. I think you are right to be concerned. I think if we undermine the fiscal discipline that we have had, then that will have an impact on interest rates and it is bound to make interest rates a little higher than they would otherwise have been. And that does impact families; those who have student loans, those who have auto loans, those who have mortgages and so on. So, the tax cuts may help the people who are paying a lot of taxes and they get their taxes reduced, but for a lot of families that are not paying much tax, they are not going to see a big benefit from the tax cut that is being passed. So, for them, perhaps—I do not know exactly how the balance would work out. You would have to look case-by-case, but I think there is a danger, yes, that they would be not really better off as a result of this tax cut because their interest costs would have gone up.

Senator STABENOW. I am wondering, to followup on that for any of the panel, back during the discussion with the tax debate, I joined with Senator Evan Bayh from Indiana, Senator Olympia Snowe from Maine, to put forward an economic trigger, a budget trigger, so that, in fact, if the dollars did not come in as anticipated, any tax cut, any phase of that or spending, would be held in suspension until the revenue was available to pay for it. So we did not go into that or use Medicare or Social Security Trust Funds to pay for the tax cut.

As we look at the revision that is coming in terms of CBO forecasts and so on, and the anticipation of revenues not being available to the extent that we thought, I would welcome any comments about this whole question of our benefit to the country of going into debt right now, in terms of impact on interest rates or impact on

other areas of the economy, the use of Medicare and Social Security to pay for spending, whether that be a tax cut or other kinds of spending, and whether or not any of you would believe that we ought to, in a sense, put into place some kind of a trigger or continue to work on that notion, so that we are not going back into debt as a country.

Mr. DUDLEY. If I could just address some of your points; first of all, on the point of education, I could not agree more wholeheartedly. Productivity growth is partly due to the quality of the labor input, and if you can improve the quality of labor, you are going to get more productivity as a result, and education, obviously, has a lot to do with the quality of the work force that we have. So I agree wholeheartedly with that.

As far as the issue of interest rates being higher due to the tax cuts, I would actually argue that you have already seen the effect this year, in terms of interest rates. The Federal Reserve has cut short-term interest rates by 250 basis points as we speak, probably a little bit more than that later this afternoon, yet mortgage rates are at about the same level as they were at the beginning of the year; and it is very, very likely that the shift in the budget policy is one reason why mortgage rates have not fallen this year. So there is no question that change in fiscal policy does have consequences for mortgage rates and the cost of housing.

Senator STABENOW. If I might just interrupt—excuse me for just one moment—to emphasize that point, are you indicating then that, in the long-term, that in order to adjust for potential deficits down the road, that we are not seeing interest rates, long-term interest rates, going down?

Mr. DUDLEY. I think it is fair to say that if you had not had the tax cut legislation passed, if it had failed or had not happened—which is obviously a counterfactual that we will never be able to test—economists love these things—I think it is fair to say that long-term interest rates, mortgage rates, would be considerably lower than they are right now. Congress will debate about how much lower, but I think that most economists would agree there would be some effect.

Senator STABENOW. If you wanted to proceed further on the question of the triggers.

Mr. DUDLEY. Turning to the issue of the triggers, I can certainly understand the motivation for triggers. You do not want to spend money before you actually have it in hand. I think the one thing about triggers, though, that scare economists a little bit is that it could make fiscal policy pro-cyclical, in the sense that let's say the economy is weak and you do not have tax receipts and so therefore your budget surplus declines, maybe turns into a deficit, and then you cannot cut taxes because the trigger mechanism comes into play.

Say you are actually constrained from following this fiscal policy stimulus that might be appropriate in that environment. I think that the idea of triggers makes sense, though, in principle, but I would enact it a different way. I think you should not basically enact 10-year packages of tax cuts. I think it makes more sense to enact tax cuts for the next year or two, and then, when you get

down the road 2 years, you see where the surplus is, yo see if you can afford to cut taxes further, and then you do it at that time.

So it embodies the same idea of triggers, not spending the money before you actually realize it. But it does not lock you into a mechanism that could make fiscal policy pro-cyclical, which can be dangerous.

Senator STABENOW. Sure. I think we are saying the same thing, just a different mechanism.

Mr. WESBURY. Well, if you do not mind, I would like to comment on that, Senator, and disagree with some of the statements that have been made. The whole argument that the shrinking budget debt or total Federal debt or budget deficit is actually reducing interest rates, is based on a theory called crowding out. In other words, when the Federal Government borrows, it pushes private borrowers out of the market, and therefore it drives up interest rates.

If you look at how we came to surpluses today from deficits just a few years ago, though, the real driver of that has been higher tax revenues; and when I look at the economy, whether you tax money from the private sector or whether you borrow money from the private sector, you have crowded out investors and business people and individuals either way. So, in other words, moving from deficit to surplus has actually resulted just by shifting from borrowing to more tax revenues; and, in fact, it still takes the same amount of money out of the private sector. The real way to reduce interest rates over time is not to play around within the debt or the deficit or even worry about it, but to really focus on the size of the Federal Government relative to the economy as a whole, because that is the real crowding out, and last year taxes hit a record share of GDP, 20.6 percent of GDP, and anything that we can do to take less as a share of GDP will cause less crowding out in the future. If you really want to look for an effect on interest rates, that is where you will get it. It is not this idea that the debt or the deficit has a huge role in the level of interest rates.

Senator STABENOW. I realize, Mr. Chairman, my time has run out. I would just make a comment and just indicate that I, with all due respect, would disagree with the evidence in terms of the 1990's and what happened when we paid down the debt and balanced our budget and made investments in education and technology. I think everyone would agree the 1990's were a pretty good time because of—which actually was a very different policy than what you are talking about. So I welcome the opportunity to debate that more at another time, but I very much appreciate the panel's being here, and, Mr. Chairman, I yield back.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I appreciate your holding this important hearing. It seems to me the very clear message is that Congress better take seriously the prospect of all this uncertainty in the budget planning process. You have made that case very well and our witnesses have, also, and I want to ask you just a couple of questions with respect to this point. Senator Stabenow, I think, highlighted some of the concerns of our constituents, given the uncertainty—and we hear this at town hall meetings.

What would you tell people who come to a town hall meeting in Coosbay, Oregon, and say, "I'm looking at all of this and I really do not have a crystal ball. What do you think I ought to do as somebody who is trying to think about my kid's future, facing the prospect of paying for long-term care for my parents?" What would your counsel be to that person trying to find their way through some of this uncertainty, making that decision for themselves?

Mr. BAILY. Well, that is a big question. I will try to give some answers, anyway. I basically agree with the point that Bill Dudley made earlier, which is that rather than trying to enact a 10-year package of taxes, we should look at the budget situation as it unfolds, and so the uncertainty will be—even over the next couple of years, we will get a better picture of how quickly the economy bounces back and the extent to which we get a resumption of strong productivity growth. So that letting the economic conditions unfold and learning more, and then responding to that over time, I think, is the right way to do it.

There is a tradeoff there, and actually——

Senator WYDEN. I understand the point, and I think you have made it very well. I want you to try to tell us what you would say to a family trying to cope with the uncertainty that you all have addressed this morning. I know that you have made the case to us, and I think very persuasively, about some of the tradeoffs we are going to have to make. But I would like to try to bring this home to people in the way that they bring it to us, and that is they look at this uncertainty and they are saying, "Gosh, Senator, where do you think I ought to be going right now, in terms of planning our future?"

Mr. BAILY. Well, I think the answer at the family level in a way is the same. If you have a very good year, and many people did last year or over the last expansion, I do not think you react to that, because your income has gone up, you got a lot of bonuses this year, that is not necessarily the right moment to go out and buy an expensive new house and an expensive new car. It is probably the right time to say let's save some of this and see if my income continues to do well this year.

Perhaps many of your constituents today are finding that their incomes have gone down, and they are having to face some of the uncertainties there. I am a believer that government plays a legitimate role in trying to provide a safety net for families that are in trouble. I think one of the big problems that families today have is if they lose their job, or maybe even sometimes when they keep their job, they are facing lack of health-care coverage, they are concerned that if they lose their job, how are they going to get another one?

So anything we can do to provide better access to health-care for people who lose their jobs or whose incomes are weak, anything we can do to offer training and education so people can acquire the skills that they need to deal with an uncertain economy, those are some of the things that will help families, I think, that are faced with this uncertainty.

Senator WYDEN. So let's ask your associates. Families come and they read about these reports, what would your advice be?

Mr. DUDLEY. I certainly agree with Martin, that you do want to save when times are good for the possibility of that rainy day, when times are not good. I think you also need to save because I think most people in the U.S. are probably not saving enough to generate the retirement that they really hope for. With the stock market being so strong over the last 10 years or so, I think it has created a bit of an illusion about how high the returns are going to be from the stock market on a very long-term basis. They are not going to be as high as they have been, in my opinion.

They are higher because the economy's performance improved dramatically, from 1982 to 1999–2000. That is a onetime deal, and I think the big thing that we have to convince people is that they need to plan a little bit further ahead for what is going to happen when they get older or their parents get older and they need to plan for retirement.

Senator WYDEN. See, that is the central question. It is hard for them to plan with all this uncertainty. You have hit the central question, is we really would like to start building a new savings ethic in this country, and I have introduced legislation a number of times over the years to get people to start thinking about purchasing private, long-term care insurance. But what has happened, and I think the case that Chairman Conrad has made is it is very hard to do that kind of planning with the uncertainty that you have documented.

Mr. DUDLEY. Right. I agree, and obviously people value consumption today quite a bit more than they value consumption five or 10 years from now. But I think we have to articulate to them why the returns that were available in the stock market are probably not going to be quite as high, but they still could be very healthy, but not quite as high as what we have experienced. We also have to recognize, to the extent that we can convince people to save more, that generates other benefits for the economy, because it increases the amount of capital available to fund private investment. So it is good for them, I think. It is also good for the country as a whole, because that is one vehicle by which you can actually drive up productivity growth on a longer-term basis.

Senator WYDEN. Mr. Wesbury, did you want to add anything?

Mr. WESBURY. Sure, Senator. First of all, I agree with a lot of the things that have been said. Savings is very important. Investing in the future is very important, and we have discussed here this morning about how important education is, and that is, but much of that is under the control of individuals, that they take the time and invest the resources that they need in re-educating or continuing their education in the future.

One of the interesting things, and I think very positive things that has happened for individuals over the past 10 years, is that we have seen—actually, over the past 18 years—is that we have seen the number of investors and savers increase dramatically. There are 100 million individuals in this country that own stocks today, and this is the highest total we have ever seen. It is the highest share of citizens in this country that have owned stocks, that we have ever seen, and I think that is a very positive development.

So what I think we need to do is to provide the kind of the environment where those resources will continue to grow in the future, and that environment, in my opinion, is one with low taxes, small government and less regulation that allows companies to become more profitable, that allows incomes to go up, and that is the way we increase our wealth over time. One last point, and that is that we are always uncertain. In the midst of very strong growth, things are uncertain. In the midst of very weak growth, they are uncertain.

But one thing has been very, very consistent in the United States for over 200 years, and that is that we have continually increased our wealth and our standard of living. Our stock market has continually—not every year, not even over every 15 year period—but it has climbed. So by saving and putting resources away and believing in the United States as being a very, very special place, with entrepreneurs and with creation and with innovation and investment, we can believe in the future of our country, and I think that is what I would suggest people do, believe in the future and have faith, even though we will go through cyclical swings every once in awhile.

Senator WYDEN. I see my time is up. I would only say, particularly in response to you, Mr. Wesbury, that if you look at the big increase in the number of people who got into the stock market, we have seen a big chunk of that in the last eight or 10 years, and I think we have had economic policies that have encouraged that. I think what the chairman and I and others are concerned about is that we have policies that read that kind of certainty in the future, and I am prepared to support a whole host of policies that will do that. I voted, for example—I was one of the small number of people to have a capital gains tax cut now, because I thought that would build on some of what we did over the last 8 years.

What I am concerned about is the cumulative effect of this 10-year program, what will happen if the surpluses do not materialize, and I think that is causing much of the uncertainty that your two colleagues were talking about, and I think the difference of opinion on this panel, and that, of course, is raising the possibility that it could interrupt the progress that we have made in the past 10 years, of increasing the investor class.

So, Chairman Conrad, I think you are making an awfully important point, and I look forward to continuing to explore this with you in the future.

Chairman CONRAD. Thank you, Senator Wyden. Thank you for being here and thank you for your excellent questions. I have just a few questions I would like to ask the panel before we end this hearing, and we are expecting a vote very soon. So, if you do not mind, I would just like to go back to the panel, and first let me say I think it has really been an excellent panel. Each of you is an outstanding witness. I could not be more pleased for my first hearing as chairman to have three such excellent witnesses. I appreciate it very much.

Mr. Dudley, I would like to go first to you, because you had some very specific estimates with respect to the effect on revenue of the Federal Government of the short-term economic slowdown. As I heard you describing it, looking at corporate profits, looking at indi-

vidual income, looking at capital gains realizations, you were saying that you would anticipate in fiscal year 2002, that the revenue that was anticipated in the CBO forecast might be reduced by some $50-$75 billion; is that correct?

Mr. WESBURY. That is correct.

Chairman CONRAD. Could you just review, for the record and for the committee, the individual elements that you had gone through, that led you to that conclusion?

Mr. DUDLEY. There are three elements that really make that up. The first is we have had a very sharp contraction in corporate profits this year, which can affect corporate tax receipts both this year and next, and we estimate that that shortfall is going to be on the order of $20-$30 billion for fiscal 2002, relative to the CBO's projections. It is due to a weaker economy. It is due to the fact that the weaker economy has fallen disproportionately on the corporate sector.

Second, we think that options income is going to decline, commensurate with the decline that we have seen in the equity market. This is much more difficult to forecast for two reasons: One, we do not have good data on options income; and, two, there is an offset. To the extent that options realizations fall, it actually could tend to boost corporate tax realizations, because options income—when these options are exercised, it creates a depreciable expense at the corporate level.

But I certainly would expect that this is worth at least another $10-$15 billion at minimum. And last, capital gains tax receipts; the CBO is estimating a 3-percent decline in capital gains receipts in 2002, from 2001, which to me seems very optimistic, given that the equity market now is down more than 20 percent from its peak, if you look at the broadest index, the Wilshire 5,000. It seems to me that a more reasonable target would be the level of capital gains tax receipts in 1999, given the fact that the stock market is roughly at the same level as we were then, and the amount of unrealized gains is lower now, because we obviously realized a lot of gains in the year 2000.

So I would guess that that would all contribute to another $20-$25 billion shortfall in personal income tax receipts, most of that occurring probably next spring, when we get the final payments for the 2001 tax year.

Chairman CONRAD. Let me turn to the other two members on this question, and ask you if this is something you have analyzed and whether you would agree or disagree with what Dr. Dudley has just discussed? Dr. Baily?

Mr. BAILY. I have not done a separate analysis, and I have not obviously checked those figures, but I would support what Bill Dudley says. I think those are very reasonable estimates of what is likely to occur. Certainly, back when I was on the council and we were more involved with doing specific budget projections, we found, in general, that the January CBO projections were more optimistic than our administration projections, as to the revenue that could come from any given set of economic assumptions. So if the actual revenue comes in a bit below that, that would not be a surprise.

Chairman CONRAD. All right. Mr. Wesbury.

Mr. WESBURY. Yes, Mr. Chairman, I am in agreement. I have not done a thorough breakdown of every category of revenue estimation for the budget in 2002, but my forecast for the economy is for very weak growth for the rest of this year. That will reduce tax revenues in April of next year and for the next fiscal year, and I would not argue a great deal about Dr. Dudley's forecasts. I believe that they are probably very, very close to what will actually happen.

Chairman CONRAD. Could I ask you, Mr. Wesbury, what is your assessment, prediction, for economic growth for this year, in your latest work?

Mr. WESBURY. Sure. My forecast is that actually we will see a decline in real GDP, fourth quarter over fourth quarter of this year, of about 0.1 percent, so a very slight decline. If you look at a year over a year growth, it comes in a little bit under 1 percent growth for the total year.

Chairman CONRAD. Let me go to the second question that is really the focus of this hearing, because that is kind of the short-term side. I appreciate very much your testimony on that. That is helpful to the committee, because we are asked all the time to advise our colleagues, what are we looking at for next year, and this will be useful in those discussions. In fact, I am going to a meeting of all the committee chairmen at 12:30, and I am going to be sharing with them what I have heard here this morning, about next year.

The second question is the longer-term question on productivity. Again, Mr. Dudley, I read The Economist piece, and that relied heavily on your work that suggested instead of 2.7 percent productivity growth or 2.5, when one factors in the slowdown this year over the next 11 years, that you are anticipating that perhaps a more realistic assessment—and do not let me put words in your mouth. If you disagree with my characterization, please say so. But as I read this, you are indicating that your work suggests that a more realistic expectation of productivity growth over the forecast period is perhaps 2.25 percent.

Mr. DUDLEY. That is correct.

Chairman CONRAD. It sounds, I'm sure, to somebody listening, "Boy, that's very, very minor differences." But very small differences here make very large differences with respect to anticipated revenue over the 10-year period. Can you tell the committee if I have characterized correctly your conclusion, and give us a little broader view of why you believe that is a more realistic expectation.

Mr. DUDLEY. That is our conclusion, 2.25 percent, and, obviously, that is a point estimate. There is uncertainty around that number. Martin Baily used figures of 2.0 to 2.5 percent, and I feel very comfortable with that kind of confidence interval. The logic of why we reach that conclusion is as follows. Productivity growth stems from three factors, improvements in quality of labor input, more capital, and what is called multi-factor productivity, which is the part that you really cannot identify the output as being increased by adding any identifiable inputs. It is really the good stuff. What happened in the late 1990's is we had a very rapid acceleration in the pace of capital depending due to the investment boom. So the contribution to productivity growth from that source went up dramatically.

Chairman CONRAD. When you say capital deepening——

Mr. DUDLEY. More capital per worker, high levels of investment, giving workers more capital to work with. Therefore, their output goes up. That is great if it is sustainable. But, in our opinion, the rate of capital deepening that we had in 1999 and 2000 is not sustainable. It was a boom where we did actually have some overshooting, and the reason why we think that boom was unsustainable was that the profit expectations people had when they made that investment were unrealistically too optimistic . We are going through right now the disappointment with those profit expectations, and so investment is coming down very, very sharply.

The tough thing is estimating, well, where is this all going to settle out in the long run? What rate of capital deepening is sustainable over the long run? If we say that 1999–2000 was too high, and it was about 5 percent per year, where are we going to end up over the long run? We created a model that is contained in our longer paper, "U.S. Investment Boom Goes Bust," and what it does is try to estimate what kind of capital deepening pace is sustainable on a long-term basis, and based on the return on capital that we see in the economy, we estimate that pace of capital deepening that is sustainable on a long-term basis is about 3.0–3.5 percent a year, lower than the 5-percent we had in 1999–2000, and that is why we have taken down our estimate of long-term secular productivity growth to about to 2.25 percent a year.

Having said that, 2.25 percent a year is not that bad. It is much higher than the average productivity growth from 1973 to 1995, which was about 1.5 percent a year, and if you think about it in terms of how rapidly you double your standard of living, you basically double your standard of living in about 25—you know, about 30 years. That is not bad when you really think of it in those terms, each generation you can double your standard of living. So 2.25 percent is not bad. It is just not as good as where we were in 1999–2000.

Chairman CONRAD. Final question, and then I am going to ask the other two to comment on both parts of your answer: The implications of that lower productivity growth for revenue for the Federal Government is, with the projected on-budget surplus of $3.1 trillion you are suggesting a third of that would disappear, if this productivity growth was as you suggest.

Mr. DUDLEY. The CBO has projected that potential GDP growth over the next 10 years will average 3.3 percent, using a productivity number of a little bit over 2.5. If you use our lower productivity growth number of 2.25, you get potential GDP growth of about 3 percent, so three-tenths of a percent difference. If that all seeps through to the actual growth rate of how fast the economy actual grows, which is a reasonable assumption, if the Federal Reserve does its job properly and pushes us to full employment, that would reduce the revenues of the Federal Government, using the CBO's own figures, by somewhat over $700 billion over that 10-year time horizon.

So, according to the CBO, for every tenth-of-a-percent reduction in growth over a 10-year time horizon, you lose $245 billion of revenue. So even small differences in the growth rate, as you have pointed out, Mr. Chairman, lead to fairly large revenue consequences for the Federal Government.

Chairman CONRAD. Dr. Baily, what is your reaction to what Dr. Dudley has suggested, both with respect to this productivity growth question over the decade and the question of the implications for the Federal budget?

Mr. BAILY. Well, I agree with much of what he said, and as I mentioned in my written testimony, the same set of figures, essentially, that if you drop productivity growth down, that feeds into lower GDP growth, and I agree with the CBO's number, that you will get about a $245 billion reduction. So if you go from 2.5 to 2.25, you will be down by $700 billion.

I certainly would not be surprised, however, and again, I have emphasized here the uncertainty as much as being able to say precisely what the number is going to be. If you go down to 2 percent productivity growth, and you are losing about $1 trillion from the deficit, and as CBO itself points out, if you went down to 1.5, which is what we had for 20 years or more, then you are no longer in the surplus range. You are really talking about deficits on the on-budget side.

In terms of being able to estimate what the productivity trend is going to be, then I think we all learned the same set of models in graduate school, and I think those are good models. But, again, I think there is more uncertainty around them. In my own view of past history, I think the very close link between capital investment and productivity is not quite as close as these models suggest, and that if you look over a long period of time, that the trends in labor productivity are not always very well-projected by the short-run movements or even the medium-term movements of capital investment.

I think that the effect is right, the more capital you get, the faster productivity grows, but I think there is more uncertainty around that arrangement. So, in the current situation, I think a key open question is, given the huge investment boom that we had, does that mean that companies have enough high-tech capital and can take advantage of it, and we can continue to get productivity growth of 2.5 percent, conceivably even more than that, or I think 2.5 is probably about as high as I want to go, or are we now seeing that the strong productivity growth of the 1990's was in part due to unusually favorable circumstances?

Quite a bit of this growth occurred in industries like wholesale and retail trade. We know that there was a huge spending boom in the 1990's. There was hugh throughput going through all the retail and wholesale establishments, which was one reason they were able to increase productivity growth, not the only reason, but it helped them to do that. So some of the sort of temporary factors that helped us in the latter part of the 1990's, I think, may be less likely to prevail going forward. So my bottom line is very close to what Bill Dudley said, 2.0–2.5 percent, I think, is the most likely range. But, again, I am not quite as confident that we can exactly model what is going to go on, and so that is why I stress the uncertainty in those projections.

Mr. DUDLEY. I would agree that it is highly uncertain, for the record.

Chairman CONRAD. All right. Mr. Wesbury, on those two questions, if I could get your commentary, in terms of productivity

growth going forward and the implications for the Federal budget, and I know you have already spoken to this question, but I think it is good to have it as part of a summation here, as well.

Mr. WESBURY. And I agree. I think that is a good idea. One of the things that I have done in the past, July, 1999, the Wall Street Journal called the, the newspaper, and one of the reporters on the newspaper wanted to know what would happen to Federal budget surpluses if the CBO was actually underestimating productivity, and at that time the CBO was forecasting productivity growth of a little less than 2 percent a year, and I am quoted, and my numbers are in that article, saying that productivity would be much higher and the surpluses would be much higher in the future. Fortunately, that forecast proved to be correct, and as a result both the OMB and the CBO raised productivity forecasts recently, and I believe correctly so.

Let me comment real quickly on capital deepening. One of the interesting things that we saw during 1999 and the early part of 2000 had a great deal to do with Y2K. My firm, in particular, an investment bank in Chicago, bought a new computer, new servers—a new computer for every single person, new servers, new software. We replaced our entire computer system in 1999 to prepare for Y2K. I would suggest that we have not seen the full benefit of that investment in my firm to date, and we will continue to benefit from those investments in the future.

What is interesting is we have not bought new computers this year, except piecemeal, when we add a new worker here or there. As a result, I believe that the benefits of that technology investment, that capital deepening, still continue to this day, in my firm, and, I think, also in the Nation as a whole. In fact, I am more optimistic, and when it really comes down to it, it is a half-a-percent maybe per year, but as you have pointed out, that is a great deal over a 10-year budget period. I am much more optimistic about productivity as we move into the future.

I think productivity will actually come in at 3 percent per year, possibly even a little bit higher. We are seeing the impact of centuries, millennium of innovation and creativity accelerate today. We can go back and look at thousands of years of inventions, and see how each one begets new ones, and the pace of innovation continues to quicken. We see innovation in the biotech field, not just in the computer field, and we are having massive gains in healthcare and health services productivity today. We are seeing computers on the Internet move to a wireless network, and that will also come with massive gains in productivity, and as a result, I am very optimistic about the future, and I would argue that these CBO and OMB estimates of 2.7 percent growth in productivity are well within the realm of possibility and well within the realm of uncertainty that exists.

One last point, and that is that the CBO forecast that, over the next 10 years, Federal Government revenues, even with a 2.7 percent gain in productivity, will increase 4.9 percent per year, on average. That same forecast has nominal GDP growing at a 5.1 percent annual pace. So, in other words, they see revenues growing slower than the economy. Just as a point of reference, in history, over the last 20 years, revenues have always grown faster than the

economy, and the reason is very simple, and that is people are pushed into higher and higher tax brackets as real income grow. Even with brackets adjusted for inflation today, we will see that, and therefore my forecast is that we will actually see revenues over the next 10 years grow faster than real GDP, and that leads me to believe that these CBO estimates are actually on the conservative side, estimating that revenues will grow slower than GDP, which is not what history has shown us.

Chairman CONRAD. First of all, I hope you are right. I think all of us do. I really very much hope you are right. I do not think we can plan our fiscal affairs based on that, I really do not, because I used to have to forecast the revenue for my State. That was one of my responsibilities. I remember we had one young economist here during the budget resolution debate, and he said, "You know, what we have seen is that, when estimates are always wrong on the low side, that that tends to continue," and I say to him, "Yes, it tends to continue until it does not," because I remember very well the 1980's. I remember in my State, that is one of the largest oil producers, and they were telling us oil prices were going to $100 a barrel. Well, they did not go to $100 a barrel. They did not go to $50 a barrel. They did not go to $40 a barrel. The result was a substantial shortfall in what was projected, and I just remember that so clearly. It is indelibly linked in my memory with forecast uncertainty, and I think we have got to acknowledge forecast uncertainty when we are budgeting around here, and be conservative with respect to what we project.

Let me conclude now and again thank this panel. You have just been excellent, and I think we have gotten to the heart of questions we wanted to discuss here today; one, the short-term weakening that all of you have testified to, and, as I hear you, you have all agreed that we should anticipate next year some shortfall from forecast, and then a very real difference in terms of the longer-term question on productivity growth, which is so central to the longer-term forecast.

Mr. Dudley, you and Mr. Baily were indicating some skepticism about the amount of productivity growth that is forecast, and that has significant implications for the budget over the 10 years.

Mr. Wesbury, if I can characterize what you have said, hopefully correctly, that you think this is well within reason, what is in the forecast, and that, in fact, you think it may be on the conservative side. That is the great thing about our country. We can have three outstanding, highly qualified witnesses before this committee and have a real difference of opinion, and that is what helps inform the work of this committee. I am very much appreciative of your being here today and taking time to share your wisdom and knowledge with the committee. With that, we will close the hearing.

[Whereupon, at 11:59 a.m., the committee was adjourned.]

HOW BIG IS THE REMAINING SURPLUS?

THURSDAY, JUNE 28, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Nelson, Stabenow, and Clinton.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. We will bring this hearing to order.

There is currently a vote on, on the Senate floor, and I went to vote quickly so that I could come and we could start the hearing because there is going to be another vote soon. So, hopefully, we can get in opening statements and begin testimony before the next vote.

I want to welcome everyone here this morning for our hearing on how big is the remaining surplus. We have a distinguished group of experts with us today who have all followed the Federal budget very closely for many years, and all have played an important role in urging the President and Congress to maintain fiscal discipline. For that, the country owes you our thanks.

We have with us this morning: Robert Greenstein, the executive director of the Center on Budget and Policy Priorities; Robert Bixby, the executive director of the Concord Coalition; and Carol Cox Wait, the president of the Committee for a Responsible Federal Budget. Welcome to you all.

I am just going to make a very brief opening statement and then go to the witnesses. Let me just start with a chart because the fundamental question before us today is how big is the remaining surplus.

Available Surplus Assuming Bush Tax Cut, Defense Request and Other Budget Policies
(Total budget surplus excluding the Social Security and Medicare Trust funds)

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May surplus	**92**	**95**	**125**	**155**	**173**	**225**	**279**	**324**	**385**	**459**	**525**	**2,745**
Tax bill and other enacted	74	38	90	107	107	135	151	160	167	187	129	1,272
Other budget resolution policies	10	27	29	32	38	42	56	60	64	69	72	488
Bush defense request 1/	-1	12	16	18	20	21	23	24	26	28	33	220
Subtotal	83	76	135	157	164	198	230	244	257	283	234	1,980
Interest	2	6	12	21	30	42	56	73	91	110	131	572
Total	85	82	147	178	195	240	286	317	347	394	365	2,551
Remaining surplus	**6**	**12**	**-22**	**-23**	**-21**	**-15**	**-7**	**7**	**37**	**65**	**160**	**193**

1/ Assumes $18.4 billion add above Bush April budget request adjusted for inflation in all subsequent years. 27-Jun

This chart shows starting with the Congressional Budget Office May surplus projection; that we had $2.7 trillion of non-Social Security, non-Medicare surplus over the next 10 years available to us. Of course, since then, we have enacted a tax bill that reduces that amount by nearly $1.3 trillion.

Changes in the Total Budget Surplus Since May

($ billions)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-11	%
Total Surplus (CBO May)	**304**	**353**	**400**	**437**	**508**	**578**	**641**	**718**	**806**	**883**	**5,629**	
Changes since May												
Tax Cuts:												
Tax bill	38	91	108	107	135	152	160	168	187	130	1,275	
Other tax changes	1	2	2	3	3	2	2	2	2	2	19	
Debt service	4	8	14	21	29	39	50	61	74	87	389	
Subtotal, tax cuts	42	101	125	131	167	192	211	231	263	219	1,683	**45%**
Spending legislation:												
FY 2001 supplemental	10	8	7	8	8	8	8	8	9	9	83	
FY 2002 appropriations agreement	11	16	14	16	17	18	18	19	19	20	167	
$40 billion anti-terrorism supplemental	26	21	21	22	22	22	23	23	24	25	229	
Airline assistance	4	4	2	1	0	0	0	0	0	0	11	
Other legislation enacted to date	1	0	1	1	2	1	2	1	1	1	13	
Debt service	4	9	11	14	18	21	25	29	34	39	203	
Subtotal, other legislation	56	57	57	62	66	71	76	81	87	93	706	**19%**
Economic and technical changes	207	201	172	154	132	96	94	97	102	110	1,366	**36%**
Total changes since May	305	359	354	347	368	359	381	409	452	422	3,755	**100%**
Resulting surplus/deficit	**-1**	**-5**	**46**	**90**	**143**	**219**	**260**	**309**	**354**	**461**	**1,874**	
Totals w/o Social Security	**-142**	**-162**	**-131**	**-108**	**-76**	**-27**	**-6**	**25**	**52**	**138**	**-437**	
Totals w/o Social Security & Medicare	**-170**	**-193**	**-165**	**-142**	**-114**	**-66**	**-44**	**-11**	**19**	**114**	**-772**	

Note: Senate Budget Committee estimates based on legislation enacted through December 20 and updated economic and technical assumptions. 10-Jan

We also have a budget resolution that has passed that takes out an additional nearly $500 billion, and then we have the defense request that the President is sending up to us that has a request in 2002 for over $18 billion, and the 10-year effect of that proposal, if you adjust it every year for inflation, is $220 billion.

Then you have the associated interest costs with those three items, and you can see that the non-Social Security, non-Medicare surplus is largely gone. In fact, it is gone in 5 years, the years of 2003, 2004, 2005, 2006, 2007. We are already into the Medicare Trust Fund, and by a fairly substantial amount. So it is not good enough just to look at 10-year totals. We also have to look at the year-by-year effects of what is being proposed and what has already passed.

Let's go to the next chart that looks at this in a little different way. In this chart, we start with the May budget resolution surplus, which showed $471 billion available. That is after the budget resolution. That is after the tax cut, $471 billion available over the 10 years. But then, if we adjust that by the Bush defense request, again, if we take the number he is asking for in 2002 and ramp it up simply by inflation, that gives you a 10-year effect of $220 billion.

Available Surplus Assuming Resolution Policies, Defense and Education Adds, and Possible Economic Revisions
(Surplus excluding the Social Security and Medicare HI Trust Funds)

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
May resolution surplus	**6**	**25**	**-5**	**-4**	**1**	**11**	**21**	**39**	**72**	**104**	**206**	**471**
Bush Defense request 1/	**1**	**-12**	**-16**	**-18**	**-20**	**-21**	**-23**	**-24**	**-26**	**-28**	**-33**	**-220**
Possible IDEA funding	**0**	**-3**	**-7**	**-10**	**-13**	**-15**	**-18**	**-20**	**-21**	**-22**	**-23**	**-154**
Possible economic revisions 2/	**-8**	**-20**	**-22**	**-22**	**-19**	**-16**	**-15**	**-13**	**-12**	**-14**	**-13**	**-165**
Interest	**0**	**-0**	**-1**	**-3**	**-5**	**-7**	**-9**	**-12**	**-15**	**-19**	**-23**	**-94**
Revised resolution surplus/deficit	**-2**	**-11**	**-51**	**-56**	**-55**	**-49**	**-44**	**-30**	**-3**	**22**	**115**	**-162**
Raid on Medicare	**-2**	**-11**	**-41**	**-43**	**-42**	**-45**	**-43**	**-30**	**-3**	**0**	**0**	**-257**
Raid on Social Security	**0**	**0**	**-10**	**-14**	**-13**	**-4**	**-1**	**0**	**0**	**0**	**0**	**-41**

1/ Assumes Bush defense request in FY 2002 budget, plus $16.4 billion in 2002 and all subsequent years (adjusted for inflation).
2/ SBC estimates of possible economic revisions. Revised: 27-Jun

If you then look at a possible increase for education, because there is no new money in the budget for education, we have just

passed an authorization bill that says the Congress is prepared to pass more than $350 billion of new funding for education. That is an authorization bill.

I think all of us know that is unlikely to all be appropriated, but if we just take the IDEA portion of it, the Disabilities Act portion of it, which is $154 billion, and then, third, if we adjust the forecast because we all know that economic growth was slower than anticipated in CBO's forecast, if we adjust that by even a low-end adjustment of $165 billion over the next 10 years—and we are hearing that CBO may adjust their forecast by $200 billion to $300 billion—if we take just a low-end estimate of $165 billion, you can see the result.

The surplus is gone. The raid on Medicare is in every single year, including 2001. Only in 2002 and 2011 is there not a raid on Medicare, but every other year, 2001, 2002, and on through 2009, we are raiding the Medicare Trust Fund, and by substantial amounts; in fact, so substantial that we also are raiding the Social Security Trust Fund in five of the years, 2003, 2004, 2005, 2006, and 2007.

The first chart I showed was not assumptions. The first chart I showed that indicated we are headed into the Medicare Trust Fund was based on the budget resolution that has passed, was based on the tax bill that is passed, was based on the defense recommendation the President's people have made.

This chart goes further and looks at not only the defense add that the President is proposing, but also a potential adjustment to education. Everybody says it is the top priority, and, yet, there is no new money in the budget for education. I think it is reasonable to anticipate money will be added, and, also, a revision to the forecast that I think is pretty clearly coming.

Economic growth in all likelihood is not going to be 2.4 percent this year, as was included in the forecast. The blue-chip consensus now is 1.8 percent. If those things happen, the results are very clear. We have a dramatic and substantial raid on Medicare of over $250 billion, and a raid on the Social Security Trust Fund as well of over $40 billion.

This is important information for our colleagues. It is important information for the country. It is important information for our colleagues because of the eight reserve funds. Seven of them are tied by a requirement that they can only be triggered if we are not invading the Medicare Trust Fund. That is the requirement that is tied to seven of the eight reserve funds.

The only reserve fund that is not so encumbered is the reserve fund for the prescription drug benefit. All of the other reserve funds have that requirement. So that is the overview of where we are and where we think we can reasonably anticipate we are headed.

It tells me that we are on very thin ice. It tells me that we already have a problem, and that that problem is likely to grow given the defense request the President is sending, given the bipartisan support and overwhelming support for additional funding for education that is not included in the budget, and given the fact that the strong prospect is for a reduction in the forecast given the current economic weakness.

Yesterday, we had a hearing in which we heard from top economists. One of them predicted that 2002 Federal revenue will be reduced by $50 billion to $75 billion below the forecast. That is just for 2002.

Let me put up the chart again that shows our projection under a possible economic revision. We only took out $20 billion in 2002. We only took out $20 billion. Mr. Dudley, the chief economist for Goldman Sachs, told us yesterday, he believes the revenue next year will be reduced by $50 billion to $75 billion.[3]

The other two economists, including the former chairman of the Council of Economic Advisors under President Clinton, agreed with that assessment.

The Republican witness also agreed with that assessment that we could anticipate a reduction in revenue next year of $50 billion to $75 billion.

Again, I want to emphasize we have put in our estimates only a $20-billion reduction. If, instead, we get the kind of lowering of revenue that was testified to here yesterday, obviously the situation is much more serious, but we will know better as we get to the August reestimate.

With that, I want to turn to our witnesses and, again, thank them each for coming. We will start with Robert Greenstein, the executive director of the Center on Budget and Policy Priorities, who has been a watch dog on Federal budget affairs for as long as I can remember, somebody with deep credibility on these issues.

Welcome.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. GREENSTEIN. Thank you, Mr. Chairman.

Mr. Chairman, you have presented me with an unexpectedly difficult task today now that you have put together this outstanding staff. I do not have that much to add to your opening statement, but let me try and go through the analysis.

As you have just indicated, the problem is that when you take into account the tax cut and the budget resolution, that little surplus remains after 2002, really not after 2002 until you get toward the end of the decade, nothing at all, for example, in 2003 through 2006.

It is true——

Chairman CONRAD. Maybe I can ask you to pull the microphone a little closer.

Mr. GREENSTEIN. Certainly.

Chairman CONRAD. These microphones, as you will recall, are—you have to speak almost directly into them.

Mr. GREENSTEIN. We hear some people say, some on the Hill, that if you take the Social Security—if you take the surplus—this is what our first chart shows. If you take the surpluses, project it at $5.6 trillion outside Social Security—$5.6 trillion for the whole budget, and you subtract the Social Security and Medicare hospital insurance surpluses and you subtract the cost of the tax cut as officially estimated by the Joint Tax Committee and the official esti-

[3] CHART NOT AVAILABLE AT PRESS TIME.

mates in the budget resolution, it appears that $500 billion remains over 10 years, and that is sometimes cited as evidence that there is room for lots more tax cuts and initiatives, but that $500 billion assumes that all the subsets are honored in the tax cut, that there will be no extension of expiring tax credits, not increase in defense spending such as just proposed, and that the unrealistic levels of non-defense discretionary spending in the budget resolution will be adhered to, also that there will be no natural disasters.

So, if we begin to move to some more realistic assumptions, the first thing we find when we go to the next chart is that more than 40 percent of this supposed $500 billion occurs in 2011 and is largely an artifact of the sunset of the tax bill at the end of 2010. Once you take that into account, there appears to be, if you look at the middle column on this table, Table 3 in my testimony on page 4—there appears to be $287 billion left, but that $287 billion is a significant overstatement because it omits the cost of various must-pass items and other items very likely or virtually certain to pass that are not in the budget resolution.

Let's take just one, extending the expiring tax credits, the extenders. This table, Table 4 in the testimony, simply reflects the enacted tax cut, the budget resolution, and extending the expiring tax credits, nothing else. Nothing else.

If you look at this table, you see that there already is nothing left in 2003 through 2006, nothing at all. A little bit later in the decade, but nothing in those years, and this table itself is overly optimistic, is unrealistic because it leaves out the following. It has none of the new defense requests from Secretary Rumsfeld, $18 billion in budget authority in 2002. A conservative estimate is that that will ultimately translate into 200- to $400 billion over 10 years in defense.

Non-defense appropriations. The budget resolution is unrealistic here. It assumes cuts in non-defense discretionary programs of $45 billion over 10 years below the CBO baseline, below today's level adjusted for inflation. If within that minus $45 billion, areas like education and health research are to be increased, the rest of non-defense discretionary would have to be cut more deeply. History suggests such reductions are unlikely even in times of budget deficits, and, certainly, in time of budget surplus where neither the President nor the congressional leadership is making a public case for such cuts.

As you know, the rhetoric has consistently been that there is plenty to meet all needs. A more prudent and realistic assumption is that appropriations for non-defense discretionary will at least grow with inflation and the U.S. population; that is, stay constant in real per-capita terms. That, by the way, is the standard President Bush used as the appropriate standard for measuring changes in discretionary spending during the Presidential campaign when he was discussing spending changes in Texas during his tenure as Governor.

Even that may be an understatement. Over the last 15 years, appropriations for non-defense discretionary have remained constant as a share of the economy, of GDP, which means they have risen faster than inflation and population. So I am making the conservative assumption here that even though they stayed even with

GDP and rose in real per-capita terms if years of deficits, that they will fall as a share of GDP and only remain constant in real per-capita terms in this period of surpluses, and that assumption requires $200 billion more for an NDD that is reflected in the budget resolution.

The budget resolution has no money for natural disasters like floods, which you know well in North Dakota, hurricanes, earthquakes, and the like. Those have been averaging 5- to $6 billion a year. These figures, which show nothing left in 2003 to 2006, have no assumption on the alternative minimum tax, which will push as many as 20 million additional tax—the new tax bill will push as many as 20 million additional taxpayers under the AMT. As you know, there is relief from that through 2004 only, and it then expires. And as I know you are aware, the Joint Tax Committee recently issued an estimate that if the sunsets in the tax bill are not applied, if the bill is extended as its supporters say they would like it to be, that the additional cost is $386 billion over 10 years. That is not reflected in these figures.

Prescription drugs, these figures assume $300 billion over 10 years. That is about the cost of Senator Graham of Florida's bill. Under that bill, beneficiaries would have to pay half of the premiums, and to get coverage that offset about half of the cost of the drugs, analysts like Bob Reischauer and others question whether Congress ultimately will be able to provide a drug benefit that is that limited. I am not questioning that you may not pass an initial bill for $300 billion, but as it goes into effect, one can count on the public asking for what it views as a more adequate drug benefit. These figures have nothing at all for Social Security or Medicare solvency.

Many of us—I think Bob probably shares my view on this—are concerned that in the absence of some general revenues as part of a Social Security solvency package, if you do not have that, that the choices will be so tough, that we will pass no solvency package at all and kick the can down the road again.

The items that are left out of these figures could reach $200 billion in 2003 through 2006 when there is already no money left. They could reach close to $2 trillion over the decade as a whole. So the bottom line is that unless Congress wishes to borrow from the Medicare or Social Security Trust Funds, hardly any of the available surplus remains after 2002 to address this range of defense and domestic needs.

The conclusion I draw from this, the first conclusion, is that the policymakers here badly need to adopt and adhere to a policy of holding the cost of the tax cuts over 11 years to the $1.35 trillion that is in the budget resolution which means that any new tax cuts, including repeal of the subsets in the tax law must be paid for by scaling back other provisions in the tax cut that haven't taken effect yet, by merely, in my view, people at upper income levels, by other revenue-raising measures such as closing on productive tax breaks, or by a combination of those approaches.

The principle here is that set forth in a recent New York Times editorial. Further tax cuts that exceed the amount Congress allotted for tax cuts in the budget resolution must be paid for either by scaling back the new tax cut law or providing offsetting revenues

in other ways. Even with that set, excruciating choices would remain, large defense increases, adequate funding for non-defense discretionary, funding to help restore Social Security solvency, a more adequate drug benefit, and other important domestic and international needs will complete for the very limited resources that remain.

To address that problem, Congress probably is going to have to either go into the trust fund surpluses, raise still further revenues, or cut popular programs, and I think that without additional resources, it will probably be impossible to enact measures to restore long-term Social Security and Medicare solvency.

The bottom line is the tax cut overreached, and the worst thing we could do is to overreach further before we start addressing the problems that we have already put ourselves in.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Greenstein follows:]

TESTIMONY OF ROBERT GREENSTEIN
Executive Director, Center on Budget and Policy Priorities
before the
Senate Budget Committee
June 28, 2001

I appreciate the opportunity to appear before the Senate Budget Committee. I am Robert Greenstein, executive director of Center on Budget and Policy Priorities. The Center is a policy institute that focuses on fiscal policy issues and has a particular interest in the effects of government policies on low- and moderate-income families.

The subject of this testimony is the state of the projected budget surplus following approval of the Congressional budget resolution and enactment of the recent tax-reduction legislation.

Overview

Congress has repeatedly expressed its intention to "wall off" the surpluses in the Social Security and Medicare Hospital Insurance trust funds. Taking into account the recently signed tax cut law with an official cost of $1.35 trillion over 11 years, along with the other initiatives in the Congressional budget resolution (for a prescription drug benefit, payments to agricultural producers, efforts to reduce the number of uninsured, etc.), the remaining surplus outside the Social Security and Medicare Hospital Insurance trust funds appears to be about $500 billion between 2002 and 2011. This does not mean, however, that $500 billion remains available for further tax cuts or program expansions. The estimate that $500 billion remains is based on a number of unrealistic assumptions, including the following.

- The figure assumes that the $1.35 trillion package of tax cuts, as signed by the President, will actually expire on December 31, 2010, and several other provisions of the new law — including a measure providing relief from the Alternative Minimum Tax — will expire between 2004 and 2006. It is unrealistic, however, to assume the wholesale expiration of the tax cuts after 2010 or termination of AMT relief after 2004.

- The figure assumes there will be no extension of the various expiring tax credits, such as the research and experimentation tax credit. Of course, these tax credits are virtually certain to be extended.

- The figure assumes appropriations for non-defense programs over the next decade will be strictly limited to the level assumed in the budget resolution, which is $45 billion *below* what is needed for these programs simply to keep pace with inflation (i.e., $45 billion below the CBO baseline) and much farther below what is needed for these programs to remain constant in real per-capita terms (i.e., for the appropriation levels for these programs to keep up with inflation and changes in the size of the U.S. population). Past experience strongly indicates that the

Table 1

CBO's April Projection, Adjusted for Enacted Tax Cuts
(Ten-year total, 2002-2011, in trillions of dollars)

Total budget surplus in CBO's April projection	$ 5.6
less: Social Security surplus	2.5
less: Medicare HI surplus	0.4
"Available" surplus (excluding Social Security and Medicare HI surpluses)	2.7
Enacted tax cut:	
Official Joint Tax Committee cost estimate	-1.3
Resulting increase in interest costs	-0.5
Cost of enacted tax cut, including interest	-1.7
Other items in the budget resolution:	
Program initiatives (prescription drugs and others)	-0.5
Resulting increase in interest costs	-0.1
Cost of the other items in the budget resolution	-0.6
"Available" surplus (excluding Social Security and Medicare HI surpluses) after enacted tax cuts and initiatives in the budget resolution	0.5

Note: May not add due to rounding.

level which the budget resolution assumes for non-defense appropriations is unrealistic and unattainable. The bipartisan interest in boosting funding for education, health research, and other areas makes it even more unlikely that this level will be met.

The $500-billion-remaining-surplus estimate also fails to include any allowance for natural disasters such as floods and hurricanes or for the defense spending increases the Administration has requested this week and will request in future years.

When the budget resolution figures are adjusted to reflect more realistic assumptions — such as an assumption that the research and experimentation credit and the other tax "extenders" will be renewed — very little surplus remains after 2002 outside the Social Security and Medicare Hospital Insurance trust funds. In fiscal year 2003-2006, no such surplus remains.

Table 2

Additional Costs Included in the Congressional Budget Plan
(Ten-year total, 2002-2011, in billions of dollars)

Entitlement benefits, mandatory spending, and miscellaneous receipts:	
Prescription drugs / Medicare "reform"	300
Agriculture and natural resources	74
Health insurance programs, net	57
Other mandatory spending and revenues (including SEC fees)	48
Appropriated programs:	
Defense	35
Non-defense	45
Net spending increases in the budget plan	469
Resulting increase in interest costs	121
Total additional costs	590

Notes: May not add due to rounding. The health program changes shown above encompass the Family Care and Family Opportunity expansions of Medicaid/SCHIP, expenditure increases for health insurance coverage generally, increases for Medicare home health payments, and a tightening of the "upper payment limitation" regulations in Medicaid to prevent unwarranted payments to states

Current Budget Projections and the Tax Cut

In April, the Congressional Budget Office (CBO) released revised ten-year budget projections showing a unified budget surplus of $5.6 trillion over the ten-year period from 2002 through 2011. The surplus outside the Social Security and Medicare Hospital Insurance trust funds, which we refer to here as the "available surplus," is smaller — $2.7 trillion over the decade.

These CBO projections do not account for the newly enacted tax cuts. According to the official estimate of the Joint Committee on Taxation (JCT), the tax cuts cost $1.275 trillion over the ten-year period from 2002 through 2011 (and the more familiar figure of $1.350 trillion when the costs in 2001 are included). CBO's projected surplus will be reduced by that amount. The surplus also will be reduced to reflect the increased interest payments on the debt that will be paid as a result of the tax cuts. (Enactment of the tax legislation means that surpluses will be smaller and the debt larger than CBO projected in April; therefore, over the next decade, interest on the debt will be higher than CBO projected in April.) Using CBO's standard methodology for estimating interest costs, the increased interest payments on the debt will total $383 billion over the next ten years. The available, ten-year surplus is consequently reduced from $2.7 trillion to $1.1 trillion as a result of the tax cut.

Table 3

The Surplus After Tax Cuts and the Congressional Budget Plan
(in billions of dollars)

		2002	9-year total through 2010	10-year total through 2011
Available surpluses after the tax bill		53	779	1,087
less:	Cost of remaining policies in Congressional budget plan (from Table 2)	-21	-401	-469
	Resulting increase in interest costs	-1	-91	-121
Remaining available surplus (excluding Social Security and Medicare HI)		31	287	497

Notes: May not add due to rounding. This table assumes that the $28 billion in "Family Care" funds in the budget plan are expended over more than the first three years of the budget period.

The Congressional Budget Resolution

The Congressional budget resolution calls for some additional expenditures, including $300 billion over ten years for a prescription drug benefit and "Medicare reform." Table 2 lists the major costs assumed in the Congressional budget plan, beyond the tax cut.

If Congress approves the expenditures called for in the budget resolution, the available surplus will be reduced to approximately $500 billion over ten years, as Table 1 shows. This is the $500 billion figure sometimes cited as reflecting the amount remaining for further tax cuts, defense spending increases, and various domestic spending items.

Taking Into Account More Realistic Assumptions

This $500 billion figure, however, can not be taken at face value. First, more than 40 percent of it occurs in 2011 and is largely an artificial result of the scheduled expiration of the tax cuts after 2010. As Table 3 shows, only $287 billion remains in 2002-2010. Second, these figures overstate the remaining surplus because the tax bill and the Congressional budget resolution omit the costs of various "must pass" items and other measures that are very likely or virtually certain to become law.

Let's consider one area where "must pass" legislation is not taken into account — the extension of the expiring tax credits popularly known as the "extenders." These tax credits are

Table 4

The Incredible Shrinking Surplus
dollars in billions

		Ten-year total (2002-2011)
Available surplus after the tax bill and the budget resolution		**497**
less::	continuation of research and experimentation credit and other "extenders"	78
	resulting increase in interest costs	15
Remaining surplus		**404**

remaining in 2002	remaining in 2003-2006	remaining in 2007-2010	remaining in 2011	Ten-year total (2002-2011)
31	**-3**	**185**	**192**	**404**

Notes: May not add due to rounding This analysis assumes that the $28 billion contained in the budget resolution for health insurance initiatives will be spread over seven years rather than being concentrated entirely in 2002-2004.

scheduled to expire every few years and always are extended on a bipartisan basis. One such credit is the research and experimentation tax credit, currently authorized through 2004.

President Bush's budget proposed to make this credit permanent, a move that enjoys overwhelming bipartisan support. Congress left that proposal out of the tax bill, knowing that extension of the credit will be enacted as part of a subsequent piece of tax legislation. Congress evidently intends to extend the other expiring tax credits as well. Extending these credits will cost $78 billion over ten years.

Table 4 shows the size of the available surplus when the cost of extending the expiring tax credits is taken into account. Over the ten-year period through 2011, about $400 billion appears to be available. But only about $200 billion remains in the 2002-2009 period. And *over the four-year period from 2003 to 2006, the surplus is entirely gone*; there is no room beyond the budget resolution and the continuation of the expiring tax credits. (There would have been no room beyond the budget resolution in 2002 either had the conferees on the tax bill not used a gimmick to shift $33 billion in existing corporate revenues from the last few days of 2001 to the first few days of 2002.)

In addition, it seems likely that when CBO updates its forecast in August, it will lower its surplus estimates for at least the next few years. If so, the surplus that appears to be available in 2002 will be smaller, and the figures for 2003-2006 could deteriorate as well.

What Else Has Been Left Out of these Estimates?

Table 4 indicates that claims of significant remaining surpluses are largely a mirage after 2002 if Congress intends to abide by its promise to avoid deficits in any year outside the Social Security and Medicare Hospital Insurance trust funds. There is little or no money left. Yet the figures in Table 4 do not provide a full picture of the coming budget squeeze, as they do not include any of the following likely costs.

- ***Defense*** — The budget resolution contains slightly less for defense than the Bush budget as submitted in April, but Secretary Rumsfeld is about to increase the Administration's FY 2002 request by $18 billion. Additional requests will be forthcoming for subsequent fiscal years. A conservative estimate is that these requests may total between $200 and $400 billion over ten years above the figures in the budget resolution.

- ***Non-defense appropriations.*** The budget resolution proposes to *cut* non-defense discretionary programs. Expenditures for these programs would be reduced by $45 billion over ten years below the CBO baseline (i.e., below the levels needed to keep pace with inflation). If, within that constrained total, favored areas such as education and health research are to be increased, the reductions in other areas must be deeper. History suggests such reductions are very unlikely to be made, especially since neither the President nor the Congressional leadership has made a public case for such budget cuts. To the contrary, the public rhetoric has been that there is plenty to meet all needs.

  A more prudent and realistic assumption is that appropriations for non-defense discretionary programs will grow with inflation and the U.S. population — that is, that the real per-capita level of funding for this part of the budget will remain constant. This will entail $200 billion more in expenditures over ten years than the level assumed in the budget resolution. (If appropriations keep pace only with inflation but not with population growth, the purchasing power of the resources available for non-defense appropriated programs will shrink on a per-person basis. If applied to funding for education, for example, this would mean that as the student population increased, each student or classroom would have less real resources.) Adjusting for inflation and population is the same standard that President Bush used during the presidential campaign and that the Bush White House has used in recent months in describing changes in state spending in Texas during Mr. Bush's tenure as governor.[1]

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[1] For example, the George W. Bush for President official web site states: "When adjusted for inflation and population, state spending will increase by only 3.6 percent between 1994-1995 and the end of the 2000-2001 biennium." Similarly, the *Dallas Morning News* reported: "Wednesday, [Governor Bush] said an 'honest comparison' of spending growth should take inflation and the state's increasing population into account" (October

History indicates that Congress will at least keep funding for non-defense discretionary programs constant in real per-capita terms (i.e., even with inflation and population growth). Over the past 15 years, appropriations for non-defense discretionary programs have risen at a faster average rate than this; during these years, expenditures for non-defense discretionary programs have remained constant as a share of the U.S. economy, a rate of growth that is consistent with the Congressional Budget Office's long-term forecast of the path of non-defense discretionary spending.

The assumption we use here — that non-defense discretionary spending will stay even in real per-capita terms (i.e., remain at today's level, adjusted for inflation and population growth) — is a conservative assumption; under it, spending on these programs would fall from 3.4 percent of GDP to 3.0 percent of GDP by 2011, which would be the lowest level on record. Expenditures for these programs has been a fairly constant 3.4 percent of GDP over the past 15 years, even though most of that period was one of substantial deficits. Since Congress kept these programs constant as a share of the economy during periods of deficits (meaning that during those years, Congress increased funding for these programs in real per-capita terms), the assumption that non-defense programs will simply keep pace with inflation and population in coming years and thus will fall as a percentage of GDP is surely a cautious one. It is not realistic to assume these programs will be cut in real per-capita terms in times of surpluses.

- ***Natural Disasters*** — The President's budget sensibly included an allowance of approximately $55 billion over ten years for natural disasters (e.g., floods, hurricanes, and earthquakes) to reflect the historical average level of expenditures on natural disasters. The congressional budget resolution removed the allowance. These costs, however, will still be incurred.

- ***The Alternative Minimum Tax (AMT) and Other Sunsets in the Tax Bill*** — The tax bill will push as many as 20 million additional taxpayers under the AMT. As a result, some or all of the tax cuts that many taxpayers think they have been given will be taken back by the operation of the AMT. Some of these taxpayers are middle class, though many are quite well off. The tax bill contains a section that provides relief from this phenomenon, but that provision sunsets after 2004.

  Likewise, the tax bill contains two new tax breaks that sunset in 2005 or 2006. And every remaining provision of the tax cut sunsets in 2010. The Joint Tax Committee estimates that reversing these sunsets (and providing sufficient AMT relief so the new tax law does not subject additional taxpayers to the AMT) would cost $386 billion over ten years. (It may also be noted that extending the entire

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28, 1999).

Prescription Drugs and the Hospital Insurance Trust Fund

Some Members of Congress have suggested that "walling off" Social Security and Medicare HI nonetheless permits a prescription drug benefit to be financed out of the HI surplus. The argument is that Congress intended to "reserve Medicare for Medicare" and that using the Medicare HI surplus to finance a prescription drug benefit does not violate that intention.

This argument sounds sensible at first blush. But there are only two ways in which the HI surplus could finance a prescription drug benefit. Under the first method, prescription drugs would be considered a cost of Medicare Part A (i.e., part of Medicare Hospital Insurance). Because this approach would use the HI surplus to pay for a drug benefit, it would shrink the HI surplus and cause the Medicare Hospital Insurance trust fund to become insolvent much sooner than it otherwise would.

Under the second approach, prescription drugs would be financed from the general fund, and Congress would allow a deficit in the general fund up to the cost of the prescription drug benefit. Under this approach, the solvency of the HI trust fund would not be diminished; instead, the surplus in the HI trust fund would be lent to the Treasury to cover the deficit caused by the prescription drug benefit. Under this approach, the Medicare HI surplus would no longer be used solely to reduce debt; the bulk of the surplus would be used instead to help fund the rest of government, which would be in deficit because of the new prescription drug benefit.

tax bill beyond its scheduled expiration would cost $4.1 trillion in the second decade of this century, even before interest costs are taken into account.)

- ***Prescription Drugs*** — The budget resolution reserves $300 billion in 2004-2011 for the cost of a prescription drug package. This amount would cover a limited set of benefits. For example, CBO has estimated that Senator Graham's prescription drug benefit proposal, which requires beneficiaries to pay half the premiums ($55 per month) and about half the cost of purchasing prescription drugs, would cost $318 billion over ten years.[2] Many analysts, such as Robert Reischauer, former director of CBO and now president of the Urban Institute, have questioned whether Congress ultimately will be able to provide a drug benefit the public finds adequate for $300 billion over ten years. The *initial* prescription drug legislation may be designed to cost about $300 billion, but benefits may be enriched in subsequent years when the public sees how limited a drug benefit the initial legislation provides.

[2] The Graham bill also includes a $250 annual deductible. It reduces beneficiary cost-sharing from 50 percent to 25 percent once a beneficiary incurs $3,500 in out-of-pocket costs (except for premiums) in a year. In addition, the government pays 100 percent of prescription drug costs once a beneficiary has paid $4,000 in out-of-pocket costs in any year.

Social Security and Medicare Reform

An omission from the Congressional budget resolution is any plan to deal with the long-term financing problems that beset the Social Security and Medicare Hospital Insurance trust funds. As is well known, these trust funds are accumulating assets now that will be drawn down when the baby-boom generation retires, and the trust funds eventually will become insolvent if nothing is done to prevent that from occurring.

The payroll tax increases and Social Security and Medicare benefit cuts that will be needed to bring these trust funds into long-term balance if no additional resources are provided to these programs are unacceptably large from a political standpoint. They cannot pass. This is why nearly every plan in recent years to restore long-term Social Security solvency has relied in part on transferring some of the surpluses projected in the non-Social Security budget to the Social Security Trust Fund. (It also is why no member of either party has advanced a plan that would fully restore long-term Medicare solvency.)

President Clinton proposed transfers of non-Social Security surpluses to Social Security. So did the Social Security plan put forward in the last Congress by then-Ways and Means Committee chairman Bill Archer and Social Security subcommittee chairman Clay Shaw. The plans proposed by Reps. Jim Kolbe and Charles Stenholm in the House and Senators Gregg, Breaux, Grassley, and others in the Senate also include such transfers.

Restoration of long-term solvency to these trust funds is likely to prove politically impossible without additional resources from the rest of the budget; otherwise, the magnitude of the Social Security and Medicare benefit cuts or payroll tax increases needed to restore long-term solvency will almost surely doom any solvency plan. Prudent budgeting consequently entails making an allowance for these transfers. The Congressional budget resolution makes no such allowance.

- Finally, there are a number of other significant needs that policymakers and the public may wish to address, such as further steps to reduce the number of Americans who lack health insurance, efforts to reduce child poverty, and action to restore long-term solvency to Social Security and Medicare (see box on page 9).

As Table 5 shows, the costs of the measures on the foregoing list could reach $200 billion or more in the period 2003-2006, a period in which there currently appears to be no room left. These measures could cost close to $2 trillion over the ten-year period. In short, the surplus that remains after the tax cut is insufficient to meet the demands that will be placed on the federal budget either in the short run or the long run.

Addressing this Dilemma

Unless Congress wishes to borrow from the Medicare Hospital Insurance or Social Security trust funds, hardly any of the available surplus will remain after 2002 to address this

range of defense and domestic needs. This strongly suggests that the first step policymakers ought to take is to adopt —

Table 5
Additional Costs That Have Not Been Accounted For
in trillions of dollars

	Four-year total, 2003-2006	Ten-year total, 2002-2011
Remaining surplus after tax cut, budget resolution policies, and extension of expiring tax credits (from Table 4)	none	0.4 trillion
Additional potential costs that have not been accounted for:		
Defense appropriations	0.1 - 0.2	0.2 - 0.4
Non-defense appropriations	0.1	0.2
Natural disasters	*	0.1
Relief from the Alternative Minimum Tax (AMT) and extension of "sunsets" in the tax bill	*	0.4
Realistic costs of a prescription drug benefit	*	0.1
Social Security and Medicare reform / solvency	0	0.5
Interest on all of the above	*	0.2
Total, potential costs not accounted for	0.2 - 0.3	1.7 - 1.9

Note: May not add due to rounding. "*" indicates less than $50 billion.

and to adhere to — a policy of holding the cost of the tax cuts to the $1.35 trillion over 11 years the budget resolution provided for tax reductions.

This means any new tax cuts — including repeal of the various sunsets in the new tax law — should be paid for by scaling back provisions of the tax law that have not yet taken effect (particularly provisions heavily tilted toward those at the top of the income scale), by other revenue-raising measures such as closing unproductive tax breaks, or by a combination of these approaches. (An exemption might be considered for extension of the research and experimentation tax cut and other expiring tax credits not included in the new tax law.) The basic principle here is that set forth in a recent *New York Times* editorial: further tax cuts that exceed the amount Congress allotted for tax cuts in the Congressional budget resolution should be paid for either by scaling back the new tax-cut law or providing offsetting revenues in other ways.

Even with such a step, exceedingly difficult choices would remain. Large defense increases, adequate funding for non-defense discretionary programs, funding to help restore

Social Security solvency, a more adequate prescription drug benefit, and other important domestic and international needs will compete for the very limited resources that will remain. To address this problem, Congress likely will have to use part of the Social Security and Medicare surpluses, raise further revenues (or scale back other elements of the tax cut before they take effect), or cut popular programs. I would note that without additional resources, it may be impossible to enact measures to restore long-term Social Security or Medicare solvency.

The history of the early 1980s may prove to be instructive here. In 1981, Congress and a new President passed a tax cut too large for the budget realities of the time. Congress and the Administration subsequently found that they needed to revisit that tax cut in two of the next three years and ultimately reduced its size about 30 percent.[3]

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[3] Since the income tax code was not indexed for inflation at the time the Reagan tax cut was enacted, a portion of that tax cut simply offset the effect that future inflation otherwise would have had in raising taxes. The tax increases enacted in 1982-1984 offset an even larger share (i.e., more than 30 percent) of the portion of the Reagan tax cut that reduced taxes as a share of people's incomes rather than simply offsetting the effects of inflation.

Appendix

HOW REALISTIC ARE THE NON-DEFENSE DISCRETIONARY FUNDING LEVELS IN THE PRESIDENT'S BUDGET AND THE BUDGET RESOLUTION?

The Administration's budget is often said to include a four-percent increase in fiscal year 2002 in funding for discretionary programs. Sometimes this is assumed to mean that *non-defense* discretionary programs are slated for a four-percent increase. That is not the case; the claimed four-percent increase does not apply to non-defense discretionary programs. Funding for these programs would rise only 1.1 percent in fiscal year 2002; and after adjusting for inflation, funding for these programs would *fall* 1.6 percent. After adjusting for inflation and population growth, the decline would be 2.5 percent. The funding level assumed for non-defense discretionary programs in the Congressional budget resolution is modestly, but not substantially, higher. Neither the level in the President's budget nor the level in the budget resolution seems realistic.

Avoiding Distortions in Measuring the Change Proposed in Funding For Non-defense Discretionary Programs

The first step in measuring the change proposed in funding for these programs is to avoid distortions that mar such a comparison. The often-cited four-percent-increase figure, which is supposed to apply to discretionary funding as a whole rather than to non-defense discretionary funding in particular, is derived through a methodology that contains several significant distortions. Some of these distortions make the proposed increases in funding for discretionary programs look larger than they actually are; other distortions make the proposed increases look smaller than they are.

- The figures used to generate the four-percent-increase figure rely on inconsistent treatment in 2001 and 2002 of funding for relief from natural disasters. As of today, the level of funding in 2001 for relief from natural disasters is low; this is both because the current fiscal year has yet to be completed and because this year has been relatively free so far of major disasters. The President's budget for 2002 proposes a reserve fund for natural disasters, which would include an amount equal to the average annual level of spending on disasters in past years. These funds would not be able to be used unless disasters actually occurred. The figures used to generate the four-percent-increase figure compare the limited amount used for disasters so far in 2001 to the full amount that would be placed in the reserve for fiscal year 2002, under the President's budget, with the supposed increment in funding counted as an increase the Administration is proposing in discretionary funding. It is, of course, nothing of the sort; if more disasters occur in 2001, Congress will provide the requisite funds, and if no disasters occur in 2002, none of the funds in the proposed reserve could be used. Accordingly, to conduct a

valid comparison of discretionary funding levels for 2001 and 2002, funding in both years for natural disasters needs to be set to the side.

- A second problem is raised by the fact that the amount the last Congress appropriated for discretionary programs for 2001 is artificially low because that Congress used "timing shift" gimmicks. Under these gimmicks, some of the funding that would normally have been recorded as being provided for certain programs in 2001 (but not spent until 2002) was instead recorded as being provided for 2002, through the mechanism of "advance appropriations." The sole function that this maneuver served was to make 2001 funding look smaller *on paper* than it actually is. As a result of this gimmick, increases in 2002 in the Administration's budget in several program areas appear larger than they actually are, because a proposed 2002 funding level is compared to an artificially low 2001 funding level.

  The President's February 28 budget document itself contains a discussion that explains that a major distortion of this nature occurs in education funding. According to that document, the President's budget "provides a $4.6 billion, or 11.5 percent, increase in total budget authority for the Department of Education." But when the budget "corrects for the distortion of advance appropriations, [it] provides a $2.5 billion, or 5.9 percent increase, for Education Department programs..."[4]

  To produce analyses of year-to-year changes in funding levels that are not distorted by such gimmicks (and for other reasons), the Congressional Budget Office produces an estimate of what the level of discretionary funding would be in 2002 if all appropriations bills were "frozen" at their 2001 level, with the gimmicks removed. As budget analysts recognize, the appropriate way to analyze the dimensions of proposed increases in discretionary funding for 2002 is to compare the levels proposed for 2002 to this CBO "freeze baseline."

- There also is one area where the figures used to generate the four-percent-increase figure *understate* the Administration's proposed funding increases. The area of understatement is in transportation programs. The understatement occurs because the figures that underlie the four-percent calculation do not include programs funded from the transportation trust funds, even though these are discretionary programs controlled through the annual appropriations process. These programs should be included. Since the President has proposed increases in these programs,

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[4] *A Blueprint for New Beginnings*, Office of Management and Budget, February 28, 2001, page 103.

failing to include the programs results in an understatement of the increase in discretionary programs the President is seeking.[5]

The Results

When these distortions and omissions are corrected, an appropriate comparison can be conducted, using CBO's freeze baseline. Such an analysis produces the following findings:

- The President's budget includes an overall discretionary funding increase of 5.3% for FY 2002, when the new defense increase is included. But the proposed increase for non-defense discretionary programs is 1.1%.

- If one adjusts for inflation (to account for the fact that as prices increase, the same level of funding will provide a lower amount of services), non-defense discretionary programs face *cuts* of 1.6% under the President's budget.

- It is appropriate also to account for population growth, as the number of people using these services is likely to increase as the population grows. This final adjustment shows that funding for non-defense discretionary programs would be reduced 2.5% relative to the 2001 funding levels. In other words, funding for non-defense discretionary programs would be reduced 2.5% in real, per-capita terms.

The non-defense discretionary funding levels agreed to in the Congressional budget resolution are modestly higher. Under the budget resolution, funding for non-defense discretionary programs would rise 2.8% before inflation is taken into account. After accounting for inflation, these programs are left with no increase over FY 2001 levels. After accounting for population growth as well as inflation, these programs would face a 0.9% funding reduction.

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[5] A final adjustment is needed to remove distortions in funding patters for low-income housing programs. A portion of housing assistance is financed by multi-year contracts that were funded in their entirety many years ago when the contract periods began. The funding for these contracts was recorded in past years. As a result, the funding levels for assisted housing are understated for both 2001 and 2002. Unfortunately, the degree of understatement is not the same in both years, and this produces distortions in measuring changes in discretionary funding. An appropriate comparison of changes in funding levels for discretionary programs entails removing this distortion, which is done by comparing the proposed funding level for housing assistance in 2002 to the funding level that would be needed in 2002 to freeze the number of assisted housing units at the 2001 level, assuming no inflation in the cost of housing.

Funding Increases or Decreases for Non-Defense Discretionary Programs
percentage change from 2001 to 2002

	In dollar terms	Adjusting for inflation	Adjusting for inflation and population
President's Budget	1.1%	-1.6%	-2.5%
Congressional Budget Resolution	2.8%	0.0%	-0.9%

Even these figures make these levels sound more realistic and attainable than they are likely to be, since these figures represent an *average* across all non-defense discretionary programs. Within these averages, certain program areas would see increases. Others consequently would experience significant decreases.

Under the President's budget, for example, areas that would see increases include Congressional operations (an increase of 17.1%), health research and training (11.1%), expenses for the White House and supporting agencies (8.1%), international affairs (5.4%), education (5.3%), and veterans benefits and services (4.5%). (Note that none of these figures are adjusted for inflation or population growth.) But to provide these increases while keeping overall non-defense discretionary funding within the proposed aggregate levels, the increases must be offset by substantial reductions in other non-defense discretionary programs. Some of the budget areas that would see funding decreases under the President's budget are energy (-12.5%), community and regional development (-7.8%), natural resources and environment (-5.6%), low-income housing (-3.3%), administration of justice (-1.5%), and training, employment, and social services (-1.2%). Moreover, since these figures represent changes in funding *before* taking inflation or population growth into account, the actual decreases in services in these program areas would be considerably larger than these figures imply. Decreases of this nature do not seem realistic, especially in a time of budget surpluses.

The Size of the Available Budget Surplus – A Fact Sh et

Jun 26, 2001

There are several ways to calculate the size of the "available" budget surplus, which is defined here as the surplus excluding the Social Security and Medicare Hospital Insurance trust funds. One approach estimates where we stand today based on CBO's latest projections of the baseline plus the tax bill. A second approach measures where we will stand at the end of this fiscal year assuming enactment of all other policies in the FY 2002 Republican Budget Resolution. A third approach adds the recently announced defense request for 2002 from President Bush and a fourth adds amounts for education. A final option factors in possible economic revisions that could occur in August. The Senate Budget Committee will update these estimates throughout the year in order to inform the Congress on the status of the trust funds.

1. Baseline Surplus + Tax bill

CBO's most recent budget baseline projected that the "available" surplus would total $92 billion in 2001, $95 billion in 2002, and $2.7 trillion over the ten-year period 2002-11. The recently enacted tax bill lowered these amounts to $16 billion in 2001, $52 billion in 2002 and $1.1 trillion over ten years.

2. Baseline Surplus + Tax Bill + Other Budget Resolution Policies

Policies assumed in the budget resolution have a claim on the available surplus since they are protected from budget act points of order in the Senate. Adding the cost of these policies to the estimates of the baseline (plus enacted legislation) reduces the available surplus to $6 billion in 2001 and $25 billion in 2002. This estimate lowers the ten-year surplus from $504 billion in the original budget resolution to $471 billion. The HI trust fund is raided to the tune of $5 billion in 2003 and $4 billion in 2004.

3. Baseline Surplus + Tax Bill + Other Budget Policies + Defense

In late June, Secretary Rumsfeld requested an additional $18.4 billion in budget authority above the President's defense request for fiscal year 2002. This third measure of the surplus factors in this request (adding the same increment in subsequent years, adjusted for inflation). The overall surplus declines to $193 billion over ten years and the raid on the HI trust fund totals $88 billion between 2003-07.

4. Baseline Surplus + Tax Bill + Other Budget Policies + Defense and Education

The budget resolution fails to provide any new resources for education and the Congress is expected to address this deficiency this year. Estimates of possible additional expenditures for education reduce the available surplus by $154 billion. Under this scenario, the "available" surplus declines to $6 billion in 2001, $9 billion in 2002, and $3 billion over the ten years.

5. Baseline Surplus + Tax Bill + Budget Policies + Defense and Education + Economic Revisions

An economy that is slightly weaker than CBO has forecast could further reduce the size of the available surplus by $165 billion or more over the next ten years (SBC estimate). Under this scenario, the raids on the Medicare and Social Security trust funds total $257 billion and $41 billion respectively. The raids would be even larger if gimmicks in the tax bill (including the sunset) were removed.

Measures of the "Available Surplus"

(Total budget surplus excluding the Social Security and Medicare Trust funds; $ billions)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May Baseline Estimates of the "Available Surplus"											
92	95	125	155	173	225	279	324	385	459	525	2,745
1. Baseline Surplus + Tax Bill											
16	52	26	33	46	62	90	116	157	198	308	1,088
2. Baseline Surplus + Tax Bill + Other Budget Resolution Policies											
6	25	-5	-4	1	11	21	39	72	104	206	471
3. Baseline Surplus + Tax Bill + Other Budget Resolution Policies+ Defense											
6	12	-22	-23	-21	-15	-7	7	37	65	160	193
4. Baseline Surplus + Tax Bill + Other Budget Resolution Policies + Defense and Education											
6	9	-29	-35	-36	-33	-29	-17	10	35	128	3
5. Baseline Surplus + Tax Bill + Budget Policies + Defense and Education + Economic Revisions											
-2	-11	-51	-56	-55	-49	-44	-30	-3	22	115	-162

Revised 27-Jun-01

Available Surplus Assuming Bush Tax Cut, Defense Request and Other Budget Policies
(Total budget surplus excluding the Social Security and Medicare Trust funds)

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May surplus	**92**	**95**	**125**	**155**	**173**	**225**	**279**	**324**	**385**	**459**	**525**	**2,745**
Tax bill and other enacted	74	38	90	107	107	135	151	160	167	187	129	1,272
Other budget resolution policies	10	27	29	32	38	42	56	60	64	69	72	488
Bush defense request 1/	-1	12	16	18	20	21	23	24	26	28	33	220
Subtotal	83	76	135	157	164	198	230	244	257	283	234	1,980
Interest	2	6	12	21	30	42	56	73	91	110	131	572
Total	85	82	147	178	195	240	286	317	347	394	365	2,551
Remaining surplus	**6**	**12**	**-22**	**-23**	**-21**	**-15**	**-7**	**7**	**37**	**65**	**160**	**193**

1/ Assumes $18.4 billion add above Bush April budget request adjusted for inflation in all subsequent years. 27-Jun

Available Surplus Assuming Resolution Policies, Defense and Education Adds, and Possible Economic Revisions
(Surplus excluding the Social Security and Medicare HI Trust Funds)

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
May resolution surplus	**6**	**25**	**-5**	**-4**	**1**	**11**	**21**	**39**	**72**	**104**	**206**	**471**
Bush Defense request 1/	**1**	**-12**	**-16**	**-18**	**-20**	**-21**	**-23**	**-24**	**-26**	**-28**	**-33**	**-220**
Possible IDEA funding	**0**	**-3**	**-7**	**-10**	**-13**	**-15**	**-18**	**-20**	**-21**	**-22**	**-23**	**-154**
Possible economic revisions 2/	**-8**	**-20**	**-22**	**-22**	**-19**	**-16**	**-15**	**-13**	**-12**	**-14**	**-13**	**-165**
Interest	**0**	**-0**	**-1**	**-3**	**-5**	**-7**	**-9**	**-12**	**-15**	**-19**	**-23**	**-94**
Revised resolution surplus/deficit	**-2**	**-11**	**-51**	**-56**	**-55**	**-49**	**-44**	**-30**	**-3**	**22**	**115**	**-162**
Raid on Medicare	**-2**	**-11**	**-41**	**-43**	**-42**	**-45**	**-43**	**-30**	**-3**	**0**	**0**	**-257**
Raid on Social Security	**0**	**0**	**-10**	**-14**	**-13**	**-4**	**-1**	**0**	**0**	**0**	**0**	**-41**

1/ Assumes Bush defense request in FY 2002 budget, plus $18.4 billion in 2002 and all subsequent years (adjusted for inflation).
2/ SBC estimates of possible economic revisions. Revised 27-Jun

Chairman CONRAD. Thank you very much.

Let me just say that the second vote has now started. I think the best thing to do is to recess the committee. I will go over to the floor to vote and return. That will probably take 10 minutes. So let's anticipate resuming at 10:40.

[Recess.]

Chairman CONRAD. We will resume.

Let me just say that this is one of those mornings. As you know, Congress is trying to get out for the July 4th break, and so every committee is meeting. There are multiple committee meetings. There is a contentious bill on the floor. We just had two votes. I have had five colleagues just come to me as we were over in the chamber apologizing, saying they are coming at some point during this hearing, but we understand all the conflicts the Senators have, especially on a day like this.

Let me go next to Robert Bixby, the executive director of the Concord Coalition.

Welcome to the committee. Thank you very much for coming. Please proceed with your testimony.

STATEMENT OF ROBERT L. BIXBY, EXECUTIVE DIRECTOR, CONCORD COALITION

Mr. BIXBY. Thank you, Mr. Chairman. Thank you for inviting me to appear today to discuss the likely size of the Federal budget surplus in light of the recently passed tax cut and other potential commitments.

I am here representing the Concord Coalition, a bipartisan organization chaired by your former colleagues, Warren Rudman of New Hampshire and Sam Nunn of Georgia. I spoke to both of them earlier this week, and they asked me to pass along their bipartisan greetings to you and the other Senators.

As Congress now turns its attention from tax cuts to spending, it is an appropriate time to assess the remaining size of the surplus. Aside from the $1.35 trillion, 11-year tax cut, the budget resolution assumes new mandatory spending of about $460 billion, a contingency fund of nearly $900 billion, and $2.4 trillion worth of debt reduction. It all adds up on paper, but only if today's long-range economic projections are accurate and only if a number of questionable assumptions are made that tend to understate likely expenses and overstate likely revenues.

Spending increases beyond the budget resolution level or additional tax cuts risk dipping into the Social Security and Medicare Trust Fund surpluses. Hovering over all of this is the near certainty that the long-range projections on which these decisions are based will be wrong, perhaps by several hundred billion dollars in either direction.

The immediate danger is not that the budget will, again, fall back into overall deficit, but that in such good times, too many commitments will be loaded onto the thin ice of long-term projections.

With that as background, let me turn to the question at hand, which is how big is the remaining surplus. There are really two ways of answering this question. It could be answered in a technical sense by looking at the most recent CBO baseline and subtracting the effect of the tax cut, which as of now represents the only legislative claim on the surplus. Using this calculation, the remaining 10-year surplus, excluding Social Security and Medicare, is $1.08 trillion.

The second way of answering the question is to look not just at the effect of the tax cut, but also at the spending assumptions contained in the budget resolution. The result is what might be called the available surplus because it accounts for claims on the surplus that have not yet been translated into legislation. Subtracting the effect of the budget resolution policy reduces the available surplus to about $500 billion.

It is important to note, however, that almost all of this supposedly available surplus comes in the final 5 years of the 10-year projection. There is a small surplus we figure of somewhere around $26 billion in 2002, not including the defense increase requested

this week by the President, but the available surplus in fiscal years 2003 through 2005 is essentially zero.

Beyond the budget resolution policies, it is also relevant to look at the likelihood that certain assumptions made in the baseline may prove to be unrealistic. Prominent in this regard are the assumptions that discretionary spending will hold at the level of inflation for 9 years, beyond 2002, and that the various sunset provisions in the tax cut will actually go into effect.

If discretionary spending grows at 4 percent a year rather than the 2.6 percent assumed in the baseline, then the remaining $500 billion of available surplus would be consumed. If discretionary spending keeps pace with GDP growth by increasing at roughly 5 percent annually, then the surplus would be reduce by about a trillion dollars. Either of these spending assumptions seems more realistic than the baseline.

Another questionable assumption is that several expiring tax provisions, including the recently passed tax cut, will sunset before 2011. Adjusting for the effects of the sunsets, including relief from the alternative minimum tax, would require an additional $500 billion of the surplus.

In short, the combined effects of the tax cut adjusted for AMT relief and ignoring the sunsets, the budget resolution mandatory spending policies, the extension of expiring tax breaks, and figuring a 5-percent annual discretionary spending growth would, if all enacted, eliminate the entire available surplus and produce a non-Social Security, non-Medicare deficit of approximately a trillion dollars. This sum would, of course, be covered by the Medicare and Social Security surpluses. So there would still be a total or unified surplus under current economic projections even if all of this new spending and tax cuts took place.

What would be lost, however, is the opportunity to use the full extent of the trust fund surpluses to better prepare for the demographically driven challenges ahead.

Let me say a few words about the effect of the tax cut because that is the only legislative claim that we have right now on the surplus.

One of the most controversial parts of that, of course, is the sunset provision, to presume that everything will expire in 2010, and, of course, there are some mini sunsets that occur before 2010. It is unlikely that those would be allowed to go into effect, and so the net effect of the sunset provisions is to understate the likely effect of the tax cut on the surplus. If all of the sunset provisions are taken together, including interest costs, the toll on the surplus is probably closer to $2.2 trillion than 1.35.

The combination of backloading and sunsets makes the ultimate fiscal effect of the tax cut difficult to assess, but one thing that I would caution you about either in August or for January when the next CBO baseline comes out is that they will have to assume that all of the sunset provisions go into effect, and that will tend to distort the baseline. In January, it will distort it quite a bit because there will be 2 years at the end of the surplus projection which are quite large, which will assume that the sunset takes place. So, in cumulative, there will be a much bigger surplus, and there will be a strong temptation because we all use these 10-year numbers to

say, "Well, we have got X-trillion to deal with," when, in fact, it is heavily backloaded and based almost entirely on an unrealistic assumption that nobody believes is going to happen.

Another thing that makes it difficult that I mentioned before is the effect of discretionary spending. The baseline assumes roughly inflation. It is likely, it will have at least 4-percent growth. I think it is likely that we may have more. I would like to keep it obviously as low as we possibly can. I think we have an obligation to do that, but assuming too low a rate of discretionary spending growth, in light of all of the increased defense spending and education spending that people want to do, results in a surplus projection that is simply inaccurate, and the danger, of course, is that people will then want to use that unrealistic baseline to cut taxes or increase spending further.

Let me just sum up by saying, Mr. Chairman, that today's major budgetary decisions must not be viewed through a short-term lens. Fiscal discipline is the key to providing for the unmet needs of the future.

Somehow sufficient resources must be set aside to meet the huge retirement and health care costs associated with the coming senior boom. The time to address this long-term challenge is now while the demographics are favorable and the budget is in surplus. The surpluses provide an important opportunity to help meet this challenge, but only if we are careful to preserve them.

Budget surpluses must not be used as an excuse to abandon fiscal discipline. As the recently passed tax cut demonstrates, there is great temptation.

I have attached a surplus scorecard which I want to emphasize is not a prediction. It just shows how easily a $5.6-trillion surplus—and it can be eroded—even if we assume that it is all there, and you had a hearing yesterday that went into some of the economics. We do not know whether the surplus will be there or not.

So the bottom line from the Concord Coalition's perspective is that we should be using today's surplus to help prepare for the challenges that we know are coming down the road. So that is why we had a lot of skepticism about the tax cut and feel that spending needs to be as tightly constrained as possible.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bixby follows:]

HOW BIG IS THE REMAINING SURPLUS?

Committee on the Budget

United States Senate

June 28, 2001

Testimony of Robert L. Bixby

Executive Director, The Concord Coalition

Overview

Mr. Chairman, Senator Domenici, and members of the Committee, thank you for inviting me to appear today to discuss the likely size of the federal budget surplus in light of the recently passed tax cut and other potential commitments. I am here representing the Concord Coalition, a bipartisan organization dedicated to strengthening the nation's long-term economic prospects through prudent fiscal policy. Concord's co-chairs are former Senators, Warren Rudman (R-NH) and Sam Nunn (D-GA).

The Concord Coalition is greatly heartened by the dramatic improvement in the federal government's fiscal condition over the past few years. When the 1990s began the nation was mired in large and growing deficits. Today, the budget is in surplus and is projected to remain there for several years. Debt held by the public has declined for three years running, and further reductions are expected in the years ahead.

Given all the good news, some may be tempted to conclude that fiscal discipline is no longer needed. Some may also be tempted to conclude that debt reduction is no longer important or that it will happen without effort. And others will assume that Social Security, Medicare, Medicaid and other age-related entitlement programs have been "saved" by the prosperity of recent years. Unfortunately, none of these conclusions are correct.

The challenges of an aging society include fiscal pressures that cannot be remedied simply by assuming that projected budget surpluses will bail us out. The inevitable growth in spending on age-related entitlement programs will put pressure on discretionary spending, revenues, and public debt. Tough choices will need to be made to avoid burgeoning public debt in the future.

In the years ahead, Congress and the Bush administration face the critical challenge of adopting a framework for using near-term budget surpluses to help fill the huge long-term gap in federal entitlement programs, and to further the nation's continued economic well being. This is certainly a more welcome challenge than eliminating budget deficits, but it is every bit as vital. And fiscal discipline is every bit as important.

So far this year the budget debate has not centered on the long-term challenge but on the extent to which taxes should be cut. Meanwhile, it has been assumed that spending will be reined–in. Turning that assumption into reality could prove to be a far more difficult task than cutting taxes — particularly in light of recent proposals to increase spending on defense, education, agriculture, Medicare and Social Security.

As Congress now turns its attention from tax cuts to spending it is an appropriate time to assess the size of the remaining surplus. Aside from the $1.35 trillion 11-year tax cut, the FY2002 budget resolution assumed new mandatory spending of $460 billion over 10 years, a "contingency fund" of $897 billion, and $2.4 trillion worth of debt reduction.

It all adds up on paper, but only if today's long-range economic projections are accurate and only if a number of questionable assumptions are made that tend to understate likely expenses and overstate likely revenues. Spending increases beyond the budget resolution level or additional tax cuts risk dipping into the Social Security and Medicare Part A trust fund surpluses, which lawmakers have promised to reserve for debt reduction and/or needed structural reform of these programs.

Hovering over all of this is the near certainty that the long-range projections on which these decisions are based will be wrong — perhaps by several hundred billion dollars in either direction. The immediate danger is not that the budget will quickly fall back into overall deficit, but that in such good times too many commitments will be loaded onto the thin ice of long-term surplus projections.

How big is the remaining surplus?

With that as background, let me turn to the question at hand: how big is the remaining surplus? There are really two ways of answering this question. It can be answered in a technical sense by looking at the most recent CBO baseline and subtracting the effect of the tax cut, which as of now represents the only legislated claim on the surplus. Using this calculation, the remaining 10-year surplus excluding Social Security and Medicare Part A is $1.08 trillion.

The second way of answering the question is to look not just at the effect of the tax cut but also at the spending assumptions contained in the budget resolution. The result is what might be called the "available surplus" because it accounts for claims on the surplus that have not yet been translated into legislation. Subtracting the effects of budget resolution policies reduces the available surplus to about $500 billion. It is important to note, however, that almost all of this supposedly available surplus comes in the final 5 years of the 10-year projection. There is a small surplus of about $26 billion in FY2002, not including the defense increase requested this week by the President. The available surplus in fiscal years 2003 through 2005 is essentially zero.

Beyond the budget resolution policies it is also relevant to look at the likelihood that certain assumptions made in the surplus projection will prove to be unrealistic. Prominent in this regard are the assumptions that discretionary spending will hold at the level of inflation for the nine years beyond 2002, and that the various sunset provisions in the tax cut will actually go into effect. If discretionary spending grows at 4 percent a year rather than 2.6 percent as assumed in the baseline, then the remaining $500 billion of

available surplus would be consumed. If discretionary spending keeps pace with GDP growth by increasing at roughly 5 percent annually, then the surplus would be reduced by about $1 trillion. Either of these spending assumptions seems more realistic than the baseline. Discretionary budget authority has grown by an average of 6 percent over the past three years and will grow by 7 percent this year if the President's defense request is simply added to the $661 billon budget resolution total without offsets.

Another questionable assumption is that several expiring tax provisions, including the recently passed tax cut, will sunset before 2011. Adjusting the for the effects of the sunsets, including relief from the alternative minimum tax, would require an additional $500 billion of the surplus.

In short, the combined effects of the tax cut (adjusted for AMT relief and sunsets) the budget resolution mandatory spending policies, the extension of expiring tax breaks, and 5 percent annual discretionary spending growth would, if enacted, eliminate the entire "available" surplus and produce a deficit of approximately $1 trillion. This sum would be covered by the Medicare and Social Security surpluses, so there would still be a total, or unified, surplus under current economic projections even if all of this new spending and additional tax cuts took place. What would be lost, however, is the opportunity to use the full extent of the trust fund surpluses to better prepare for the demographically driven fiscal challenges ahead.

Remaining surplus in the short-term — Fiscal Years 2001 and 2002

The "off-budget" Social Security surplus seems safe this year and next. Moreover, the projected on-budget surplus seems sufficient to set the bar higher by also reserving the Medicare Part A trust fund surplus. While this goal is clearly within reach, it will require fiscal restraint and a cooperative economy.

The FY2001 tax rebate and the shift of $33 billion in anticipated corporate revenues into FY2002 leaves a thin margin of about $6 billion above the Social Security

and Medicare Part A surpluses this year. In addition to the tax rebate, the budget resolution authorized $5.5 billion in additional mandatory spending for agriculture this year and about $3 billion more in discretionary outlays. On June 1, President Bush submitted a FY2001 supplemental spending request within the budget resolution limit. But there is little room to add anything to the President's request without offsets. Doing so would require dubious emergency designations, or a waiver of the discretionary spending limit contained in the budget resolution. While these options would get around the spending limit they would not change the bottom line, and so the surplus would be diminished.

Given that three-quarters of the fiscal year has already passed, it is unlikely that Congress will be able to spend too much more in FY2001 than currently anticipated even if it wants to. That does not mean, however, that a non-Social Security, non-Medicare surplus is assured. With a small margin for error any unexpected increase in the cost of current programs or a drop in projected revenues over the remaining months of FY2001 could cause an unintentional dip into the Medicare Part A surplus (See Appendix A.) As a practical matter, there is no available surplus remaining this year.

As for FY2002, Congress must struggle to maintain the tight budget resolution target of $661 billion in new discretionary budget authority — an increase of roughly 4 percent over this year, but a marked decrease from the 6 percent average annual growth of the past three years. Complicating the picture is the Bush Administration's recommendation for an increase of about $18 billion in defense spending. The budget resolution allows for an adjustment in defense spending, provided that it does not cause a non-Social Security, non-Medicare (HI) deficit. While there appears to be room for the President's request in 2002, the real question is the extent to which the on-going strategic defense review causes a higher discretionary spending assumption and lower surplus projection over the long-term. Presumably, the FY2002 request is only a down payment on higher increases to come, and it is not realistic to assume that higher defense spending can be entirely carved out of the existing non-defense baseline. In other words, the defense request for FY2002 should not be viewed in isolation. It is not intended to be a

one-time plus-up, but the beginning of a higher defense baseline. This simply underscores the point that, absent a new surge in surplus projections, Congress will have some tough trade-offs to make between spending, tax cuts and savings.

As for mandatory spending, the budget resolution assumes increases for items such as agriculture and health insurance assistance totaling about $19 billion in FY2002. Legislation must be enacted to actually spend this money. If no such legislation is enacted, the surplus will be higher. Again, this involves a trade-off. But assuming that the budget resolution policies are enacted, the current non-Social Security, non-Medicare FY2002 surplus appears to be about $26 billion. (See Appendix B.) The defense increase will take a substantial portion of this, but the exact amount will depend on the outlays generated by the President's request for $18 billion in additional budget authority. Undoubtedly, legitimate emergency spending will also claim a portion of this small "available" surplus.

The shift of $33 billion in revenues from this year into next is a bookkeeping gimmick apparently designed to ensure a non-Social Security, non-Medicare surplus in FY2002. However, it undoubtedly will result in higher spending. If the revenue were to remain in FY2001 it would go to debt reduction because it is too late in the year to spend it. But when shifted into FY2002, most of it becomes available to spend.

Another complicating factor in next year's outlook is uncertainty about whether continued slow economic growth will cause a reduction in CBO's most recent revenue projections. In January, CBO estimated that a mild recession of about the same size as the 1990-91 recession would cause a $65 billion drop in the FY2002 surplus. While it does not appear that the economy has entered a recession, the slow growth experienced so far in FY2001 raises the possibility that FY2002 revenues will be lower than currently projected. To a certain extent, that effect has already been seen. Between January and May, CBO lowered its revenue projections by $20 billion for FY2001 and by $10 billion for FY2002.

Remaining 10-year surplus — FY2002-2011

The May 2001 CBO baseline update essentially confirmed the January surplus projection of $5.6 trillion over 10 years. Included in the $5.6 trillion total is the $2.5 trillion Social Security trust fund surplus and the $400 billion Medicare Part A trust fund surplus.[1] The non-Social Security, non-Medicare Part A projected surplus is $2.7 trillion. Under the budget resolution assumptions and policies, the Social Security and Medicare surpluses can theoretically remain untouched throughout the next 10 years. But there is very little room for error, and even though the projected surplus over the next 10 years is enormous, most of it has been spoken for or may be needed for things that were not included in the budget resolution's long-term assumptions. It is also important to note that the projected surplus excluding Social Security and Medicare is heavily backloaded, with only 28 percent of it coming in the next five years.

A. Uncertainty in surplus projections

Before reviewing in more detail the current and potential claims on the surplus, it is important to keep in mind that 10-year budget projections are highly uncertain. There is an unfortunate tendency to discuss these numbers as if they were a lottery payout, or money in the bank. They are projections, and as the CBO will be the first to say, they are highly uncertain projections.

Prior to 1992 CBO did not make 10-year projections. It is therefore impossible to establish a fair 10-year track record. However, CBO has been able to evaluate its track record of five-year projections. Its conclusions:

- Five-year projections have been off, on average, by 3.1 percent of GDP even after adjusting for the effects of legislation.

[1] For The Concord Coalition's perspective on the Medicare surplus see, "What Medicare Surplus?" Facing Facts Alert Vol. VII, No.2 March 22, 2001. Available under Facing Facts Alerts at concordcoalition.org.

- Applying that average error to the current baseline means that the projected total surplus of $508 billion in 2006 could be off by more than $400 billion in either direction.

- Ten-year projections are likely to be less accurate than five-year projections.

Given the historic error rate, Congress could well find itself with a much smaller surplus, and a non-Social Security *deficit* within the next five years, even without the tax cut, a prescription drug benefit, or any other surplus-eroding legislation. It is true that the numbers could also be wrong on the low side, as they have been in recent years. As a matter of prudent fiscal planning, however, it is best to err on the side of caution, particularly in light of the fiscal pressures that are certain to occur beyond the 10-year budget window as the baby boomers begin to draw their Social Security benefits and qualify for Medicare. Dealing with unexpected good news is much easier than dealing with unexpected bad news. The options are more pleasant.

It is also relevant to note that nearly two-thirds (64 percent) of the projected $5.6 trillion 10-year surplus comes in the *second* five years when, if history is any guide, the projection is likely to be off by several hundred billion dollars each year.

Discretionary spending — a key variable

Adding to the uncertainty of long-term projections is the assumption that must be made about the growth rate of discretionary spending. The 10-year surplus that is now being dedicated to tax cuts, new entitlement spending and debt reduction "lockboxes" is heavily dependent on the assumption that discretionary spending, which includes defense, will grow no faster than the rate of inflation. This is a very fiscally responsible goal, but it is far from certain to be achieved. The table below demonstrates how different today's 10-year surplus projection is if it is assumed that discretionary spending grows at a higher, and probably more realistic, pace than assumed in the budget resolution. It will

take a level of fiscal restraint not seen in recent years to simply validate the surplus that is now being divvied up.

Alternative scenarios for discretionary spending FY2002-2011*

Rate of Growth	Additional spending	Interest	Surplus decrease
4 percent	$430 billion	$70 billion	($500 billion)
5 percent**	$840 billion	$150 billion	($990 billion)
6 percent	$1,265 billion	$235 billion	($1,500 billion)
7 percent	$1,720 billion	$310 billion	($2,030 billion)

* Concord Coalition estimates based on the May 2001 CBO baseline
** Similar to anticipated GDP growth

B. Current claims on the surplus

Assuming that the 10-year surplus projection is accurate, it is clear that a substantial portion of it has already been claimed. To begin with, the projected $2.5 trillion "off-budget" Social Security surplus is dedicated to debt reduction or reform of the program. The budget resolution also sets up procedural protection for the $400 billion Medicare Part A trust fund surplus, although it permits use of this money for a Medicare reform plan that improves access of beneficiaries to prescription drugs.

By far, the largest claim on the remaining surplus is the tax bill signed into law by President Bush on June 7. This $1.35 trillion 11-year tax cut is heavily backloaded and riddled with gimmicks. Because most of its provisions are phased in slowly, nearly 60 percent of the tax cut occurs in the last five years (2007-2011), when today's surplus projections are in their most uncertain period. Many of the individual provisions are even more backloaded.

Tax provision	2001-2006 % of cost	2007-2011 % of cost	Year of full phase in
Overall plan	41	59	2010
Rate reductions	45	55	2006
Child credit	36	64	2010
Marriage penalty	29	71	2008
Estate and Gift	18	82	2010
Pensions and IRAs	44	56	2008

Source: Joint Committee on Taxation, May 26, 2001, Estimated Budget Effects of H.R. 1836.

Fitting the tax cut into the available surplus requires the following assumptions:

- Today's surplus projections are accurate or too pessimistic to begin with
- Discretionary spending will grow no faster than the rate of inflation for 10 years
- The sunset will be allowed to take effect, causing a massive tax increase in 2011
- Congress will do nothing as the number of Americans subjected to the Alternative Minimum Tax (AMT) grows from 1.4 million to 35.5 million in 2010, canceling out a portion of the tax relief the bill purports to give
- Congress will allow dozens of popular tax breaks, which have been routinely renewed in the past, to expire
- Social Security reform will not require resources from the non-Social Security surplus
- A Medicare prescription drug benefit will cost no more than the 10-year $300 billion set aside for this purpose in the budget resolution

Alone, each of these is a questionable assumption. It stretches credibility to believe that all of them will come to pass.

A cloudy sunset

One of the most confusing and controversial aspects of the tax bill is that the entire thing is presumed to "sunset" at the end of 2010. This remarkable assumption made it possible to cut taxes by a greater amount in the first 10 years of the plan than would otherwise have been possible without technically exceeding the $1.35 trillion 11-year limit imposed by the budget resolution. If taken literally, the sunset provision means that as of January 1, 2011:

- The top rate will rise from 35 percent back to 39.6 percent
- All other rates will go up by 3 percentage points
- The new 10 percent bracket will be eliminated
- The "marriage penalty" will reappear
- The maximum annual contribution limit for IRAs will revert to $2,000 from $5,000
- The child credit will revert to $500 after having risen to $1,000 just 12 months earlier
- The estate tax will come back to life, like Dracula rising from the grave, one year after its supposed demise in 2010

Obviously, the sunset provision should not be taken literally. The very absurdity of the result guarantees that it will never happen. The real significance of the provision is that it allowed lawmakers to temporarily avoid making hard choices about which tax cuts would have to be eliminated from the bill to fit within the carefully negotiated budget resolution limit of $1.35 trillion over 11 years.

Moreover, there are some mini-sunsets in the bill that also artificially depress the cost estimate. For example, the Alternative Minimum Tax (AMT) provision, which costs $14 billion from 2001-2005, terminates at the end of 2004. A new above-the-line deduction for higher education expenses is assumed to sunset after 2005. It is no more

likely that these mini-sunsets will take effect than it is that the overall sunset will occur in 2010. They are simply scorekeeping gimmicks.

All of the sunset provisions, taken together, result in an artificially low cost estimate for the total bill. According to a preliminary estimate by the Joint Committee on Taxation, without the sunset provisions the 11-year revenue loss from the tax cut would rise by $138 billion to a total of $1.49 trillion. Adjusting the Alternative Minimum Tax to prevent the tax cut from causing an even more dramatic rise in the number of AMT ratepayers than under pre-tax cut law would add another $200 billion over 10 years. Finally, the cost of permanently extending a number of current tax breaks scheduled to expire including the research and development tax credit, adds another $120 billion. In other words, instead of the assumed $1.35 trillion revenue loss over 11 years, the number is closer to $2.2 trillion including higher debt service cost.

The combination of backloading and sunsets makes the ultimate fiscal effect of the tax cut difficult to assess. Its official cost estimate assumes that all of the phase-ins and sunsets will occur on schedule. But two Congressional elections and a Presidential election will take place before the final round of rate reductions is effective, and before most of the "marriage penalty" relief even begins. There will be four Congressional elections and two Presidential elections before the estate tax is repealed and the child credit reaches $1000. It is fair to question whether such delayed provisions will remain frozen in place over such a long period before taking effect. However, for purposes of assessing the 10-year budget outlook it must be assumed that they will.

Unfortunately, it must also be assumed by CBO that the sunset provisions will take effect as planned. This is a very troublesome assumption because it will artificially inflate future surplus projections, particularly for the years 2011 and beyond. If Congress chooses to maintain the sunset provisions as the ultimate "trigger" to protect against optimistic projections, it should also ensure that new policies be assessed against a baseline that accounts for the tax cut as if the sunset provisions didn't exist. The fiction

that the sunsets will take place as planned should not be indulged to justify larger tax cuts or higher spending.

New mandatory spending claims

The tax cut is not the only current claim on the 10-year surplus, but it is the only one that has been enacted into law. The budget resolution assumes new mandatory spending of $460 billion over 10 years.[2] Most of it is contained in "reserve funds" designated for specific purposes. The fact that Congress has set aside these reserves in the budget resolution does not mean that the money will actually be spent. Specific legislation must be passed and signed into law by the President before the mandatory spending reserves will have an effect on the budget. However, for purposes of assessing the available surplus, it is appropriate to subtract the new mandatory spending contained in the budget resolution because it represents Congressional intent.

In the language of the budget resolution, aside from the Medicare prescription drug provision, legislation to unlock each of the reserves, "may not when taken together with all other previously enacted legislation reduce the on-budget surplus below the level of the of the Medicare Hospital Insurance Trust Fund surplus in any fiscal year covered by this resolution."

C. Items not included in the budget resolution that may decrease the surplus

In addition to existing claims on the surplus, there are a number of other initiatives that enjoy substantial support in Congress or the Administration. Turning these initiatives into legislation will affect the surplus. Any such list involves subjective judgment, and cost estimates are dependent upon how each policy is actually implemented. But it would be surprising if the surplus were not reduced by legislative action on at least some of the following items:

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[2] This number is $486 billion when measured against the May CBO baseline.

- **Defense increases** — The budget resolution includes $3.65 trillion in budget authority for defense over the next 10 years. But Secretary of Defense Donald Rumsfeld is conducting a broad ranging review of national security policy, and many expect him to conclude his review by requesting substantial increases in the defense budget. This year's request for an additional $18 billion is the first installment, but the potential fiscal impact of the defense review will likely not be seen until the President's FY2003 budget request is submitted in February 2002. However, making room for an increase without raising the overall level of discretionary spending or without making corresponding cuts in the defense budget would require a virtual freeze in non-defense discretionary spending. That is not a realistic prospect.

- **Education increases** — The Senate version of the budget resolution contained nearly $300 billion over 10 years in new mandatory spending for education, much of it earmarked for guaranteed funding of the Individuals with Disabilities Education Act (IDEA). Ultimately, this provision was removed in the House-Senate conference before final passage of the budget resolution. But shortly thereafter, the Senate voted to increase IDEA funding by $150 billion over 10 years in an amendment to its bill reauthorizing the Elementary and Secondary Education Act (ESEA). The House version of the education bill does not include 10-year guaranteed funding for IDEA. Regardless of whether the Senate or House position prevails on the question of guaranteeing IDEA funding, it seems likely that more money will be spent on this and other education programs than is contemplated in the budget resolution.

- **Alternative Minimum Tax reform** — The AMT, which was designed to prevent wealthy taxpayers from using a combination of deductions and tax breaks to pay little or no income taxes, is not indexed for inflation. Over the years, the number of taxpayers subject to the AMT has been slowly increasing. But without reform, the number of taxpayers subjected to the AMT will shoot up from 1.4 million this year to 35.5 million in 2010. The recently passed tax bill is

responsible for about 15 million of these prospective new AMT ratepayers. As a result, a growing number of taxpayers will not receive the full amount of the tax cut they have been led to believe they will get. Given that the goal of the tax cut is to give money back to the taxpayers, it seems unlikely that Congress will take away with one hand what it gives back with the other. Correcting this problem is estimated to cost about $200 billion according to the Joint Committee on Taxation. Even with this correction, the number of taxpayers subjected to the AMT will rise to over 20 million by 2011. Thus, it is likely that additional modifications will have to be made to address the AMT problem that already existed before the tax cut.

- **Expiring tax provisions** — Several tax provisions ("extenders") are scheduled to expire between 2002 and 2011. The largest is the research and development tax credit. Although most observers believe that these provisions will be extended most of them were left out of the tax bill. Permanently extending the provisions scheduled to expire this year along with the popular research and development tax credit would lower revenues by about $120 billion over 10 years.

- **Social Security reform** — While President Bush has appointed a Commission to recommend actions to ensure the long-term sustainability of Social Security, the budget resolution does not reserve anything from the non-Social Security surplus for this purpose. Strictly speaking, Social Security reform need not require a contribution from the non-Social Security surplus. But if, as reported, the Social Security commission recommends that personally owned accounts be created within the system the thorniest question will be how such accounts should funded. As a frame of reference, using 2 percent of taxable payroll to fund a personal account reform plan would require roughly $1 trillion over the next ten years. One source of such funding is the Social Security surplus, which by definition is already dedicated to the payment of future retirement benefits. However, given the strong desire of many lawmakers to reserve the Social Security surplus for debt reduction only, and the clear need for a source of up-front funding to make

the personal account concept work, it seems very likely that a contribution from non-Social Security revenues will be necessary.

- **Emergency spending** — Supplemental emergency appropriations are designed to allow Congress to fund natural disaster relief, military operations, and other unforeseeable events that develop after the regular appropriations bills have been passed. The President's Office of Management and Budget (OMB) estimates that the average annual amount spent on natural disaster relief is $5.6 billion. According to CBO, the average annual amount of total emergency appropriations, excluding Gulf War expenses, between 1991 and 1999 was $8.9 billion. Nevertheless, the budget resolution contains no earmarked funding to deal with natural disasters, or other emergency needs. A House provision setting up a designated emergency fund of $5.6 billion in the FY2002 budget was deleted in conference with the Senate. If history is any guide, however, the money will be needed whether it is recognized in the budget resolution or not. Over 10 years, routine emergency spending is likely to cost anywhere from $50 to $90 billion.

What about the "contingency fund"?

To account for these and other uncertainties involved in any 10-year budget, the budget resolution reserves approximately $900 billion in what has been called a "contingency fund." This $900 billion simply represents the portion of the non-Social Security surplus that is not committed to tax cuts, new spending, and interest costs.

The first claim on the contingency fund is the Medicare Part A trust fund surplus, which unlike Social Security is an "on-budget" item. Removing the Medicare Part A surplus from the contingency fund lowers the total to about $500 billion. There is ample reason to doubt whether the likely costs of anticipated defense and education increases, AMT reform, renewal of expiring tax provisions, Social Security reform, emergency spending, and interest costs, can all be covered by this $500 billion contingency fund.

IV. Beyond the 10-year budget window

Today's major budgetary decisions must not be viewed through a short-term lens. Fiscal discipline is the key to providing for the unmet needs of the future. Somehow, sufficient resources must be set aside to meet the huge retirement and health care costs associated with the coming "senior boom." The time to address the long-term challenge is now, while the demographics are favorable and the budget is in surplus. The surpluses provide an opportunity to help meet this challenge — but only if we are careful to preserve them.

Absent from the budget debate so far is the one issue that will determine government's size and shape in the new century--the long-term growth in entitlement spending. Neither side has any plan to slow that growth. In fact, to the extent that leaders are talking about entitlements at all, it is to advocate adding new ones. Nevertheless, in advance of developing a plan for dealing with the future financing requirements of Social Security and Medicare, Congress and the President have enacted a tax cut that, if all the questionable sunsets are ignored, totals almost $2 trillion.

The current trend in entitlement spending remains unsustainable.

- The three biggest benefit programs for seniors—Social Security, Medicare, and Medicaid—now consume 43 percent of the federal budget, up from 15 percent in 1965. On the current course they will consume roughly 80 percent of budget outlays by 2040.

- All told, OMB projects that these three programs will nearly double as a percent of GDP by 2040, from about 7 percent to over 14 percent.

- According to the 2001 Trustees' report, Social Security outlays will exceed earmarked tax revenues by a widening margin starting in 2016. By 2025, Social Security will face an *annual* cash shortfall of over $400 billion. By 2038, the last

year the trust funds are technically solvent, the *annual* shortfall will be over $1 trillion.

- To cover these deficits, the trust funds will have to redeem their IOUs from the Treasury. And to come up with the cash, Congress will have to hike taxes, cut other spending, consume surpluses if they exist, or borrow from the public—exactly as if the trust funds never existed.

- This year, all Social Security benefits could be paid for with a tax rate of 10.5 percent of payroll. By 2040, the Trustees project that they will cost 17.7 percent of payroll. Add in Medicare Part A and the projected burden rises to 24 percent of each worker's taxable paycheck.

- The recent prosperity has not lowered Medicare's long-term cost rate. Nor has it altered the demographic, social, and technological forces driving up the future cost of health care. Far from it: Following the recommendation of an official technical panel, the Trustees this year increased their projection of Medicare's long-term cost rate by a staggering 60 percent.

This year's dynamic of cutting taxes while planning to raise spending creates the threat of renewed non-Social Security, non-Medicare deficits and may result in failure to reduce the public debt to the low levels now projected. Savings from deficit reduction, and now surpluses, have helped provide the capital to increase the productivity of American workers — a major factor in the record growth of the last 10 years. Further gains in productivity will become especially urgent when the retirement of the huge baby boom generation virtually halts the growth in the size of the U.S. work force.

But even improved productivity is not a complete solution.[3] Closing the gap between what government promises and what it can afford will require someone to give

[3] See, Concord Coalition Facing Facts Alerts, "The New Economy: No Fiscal Cure-All," Vol. VII, No. 5, June 11, 2001 and "The Budget Issue Everyone Is Avoiding," Vol. VII, No.4, April 26, 2001.

something up. The one way to mitigate the sacrifice is to boost national savings in advance of the age wave. Continued debt reduction is the government's most direct contribution to net national savings. Increasing national and personal savings is the single most effective policy the government can pursue to promote long-term economic growth and retirement security. As public debt is reduced, other policies such as retirement savings accounts also play an important role. Household savings are nowhere near adequate to prepare for ever-lengthening retirements.

Earlier this year, The Concord Coalition's urged Congress to consider establishing a system of mandatory, individually owned retirement accounts to help families build a more ample nest egg while alleviating concerns that future budget surpluses will result in either higher spending or in a large build up of government-owned private sector financial assets. We still believe that this would be the best way to use our prosperity of today to prepare for the fiscal challenges of tomorrow. But funding such a savings program will be far more difficult, if not impossible, if the bulk of the surplus is devoted to new spending programs or large escalating tax cuts.

Budget surpluses must not be used as an excuse to abandon fiscal discipline. But as the recently passed tax cut demonstrates, the temptation is great. The following Surplus Scorecard demonstrates how easily today's surpluses could be consumed. *It is not a prediction.* Congress may or may not take action on several of the items listed. The Surplus Scorecard is intended to be a hard choices reality check. Large as the surplus appears, policymakers must still set priorities. And they must do so within the context of two very important caveats:

- The surplus is only a projection, and the further out it goes the more uncertain it becomes
- More certain, because it is driven by demographics, is the challenge of affording the baby boomers' retirement and health care costs.

Relying on today's surpluses to enact a series of large escalating new commitments, such as the recently passed tax cut or a Medicare prescription drug benefit, in advance of developing a plan to fund the unfunded entitlements we already have is to rely on the unreliable while ignoring the inevitable.

Th Surplus Scor card FY2002– 2011 as of June, 2001

Unified budget surplus		$5.6 trillion	
Social Security surplus	-	$2.5 trillion	
On-budget surplus	=		$3.1 trillion
Reserve Medicare Part A surplus	-	$400 billion	
Available surplus	=		$2.7 trillion
Actions to date			
Tax Cut (H.R. 1836) (including debt service)	-	$1.66 trillion	
Remaining available surplus	=		$1.08 trillion
Budget resolution spending commitments			
New mandatory spending	-	$460 billion	
Non-reconciled tax cuts	-	$20 billion	
Discretionary savings	+	$10 billion	
Debt service	-	$110 billion	
Remaining available surplus	=		$500 billion
Potential actions			
Discretionary spending grows at five percent per year	-	$840 billion	
Ignore tax cut sunsets	-	$140 billion	
Renew expiring tax breaks	-	$120 billion	
Adjust Alternative Minimum Tax	-	$200 billion	
Guarantee IDEA funding (S.1)	-	$150 billion	
Veterans' retirement/disability (S170)	-	$40 billion	
Debt service on the above actions	-	$300 billion	
Potential new commitments	=	$1.79 trillion	
Remaining available surplus (assuming all of the above)	=		-$1.29 trillion

APPENDIX A

FY2001 Surplus at-a-glance*

Total:	$275 billion	
Social Security:		-$156 billion
On-budget surplus:	$119 billion	
Medicare Part A:		-$28 billion
Remaining surplus:	$91 billion	
Tax cut (H.R. 1836):		-$41 billion
Corporate tax shift:		-$33 billion
Agriculture increase:		-$5.5 billion
Supplemental, etc.:		-$3 billion
Debt service:		-$2 billion
		-$84.5 billion
Remaining surplus:	**$6.5 billion**	

*Based on the May 2001 CBO baseline.

APPENDIX B

FY2002 Surplus at-a-glance*

Total:	$304 billion	
Social Security:		-$172 billion
On-budget:	$132 billion	
Medicare Part A:		-$38 billion
Remaining surplus:	$94 billion	
2001 revenue shift:	$33 billion	
Remaining surplus:	$127 billion	
Tax cut:		-$71 billion
Mandatory increase:		-$19 billion
Discretionary increase:		-$4 billion
Debt service:		-$7 billion
		-$101 billion
Remaining surplus:	**$26 billion****	

* Based on the May 2001 CBO baseline.
** Does not include defense increase

Chairman CONRAD. Thank you.

Next, we will hear from Carol Cox Wait, who is the President of the Committee for a Responsible Federal Budget. Welcome, Carol. We are glad you are here.

STATEMENT OF CAROL COX WAIT, PRESIDENT, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Ms. WAIT. Thank you, Mr. Chairman.

I, too, bring greetings from your former colleagues, Henry Bellman, Bob Chimel, Bill Frenzel, Tim Penny, and the rest of my board.

Before I even turn to my prepared testimony, I have to say I spent entirely too much time on the other side of that dais at a point in time when we were running very, very large budget deficits, trying to find $8 billion over 3 years for a violent crime prevention trust fund. I wake up at night sometimes wondering how we do not think we can somehow, some way, get by with this wonderful largesse that we find facing us today.

I have to first congratulate both you and the former chairman, now Ranking Member, Senator Domenici. I have spent much, much too much of my life scolding you not to say something nice when you do something good. In the Ranking Member's case, I think he deserves credit for managing to get through a budget. In your case, we are enormously The question you ask us today is how big is the budget surplus, and not taking anything away from all of the careful analysis that my colleagues here have done and your staff have done, we do not know. It is as simple as that, and when we forget that fact, we risk making huge mistakes. We know more about the near-term numbers than we do about numbers 10 years out, but we do not know exactly how big the budget surplus is.

Quite frankly, we are concerned that you left too much money on the table in 2002 after the tax cut relative to the amounts that are available in subsequent years. Until about 2006, you never have enough money again, the same amount of money again, and it would be a very peculiar set of public policies that used up the 2002 surplus without driving you into the Medicare, Social Security Trust Fund surplus in 2003 to 2005.

In that respect, this summer's reestimates may help you. If they reduce the amount of money that is available in 2002 and produce some more normal pattern in 2002 through 2006, it may be good for public policy.

I will say to you that I did talk to Rudy Penner and to Bob Reischauer before I came here, and both of them would say that the surpluses that we face, even if you assume you could be wrong $1 trillion in either direction over the next decade, and that is, quite frankly, easily possible, tell you that the economy and the country are in really pretty good shape. Even if the budget surplus were a trillion dollars less than it is projected to be over the next decade, the budget of the United States would be in much better shape than it has been for a very long time.

Reviewing the facts, there are a couple of conclusions that we reach and would like to share with you because we keep talking about saving surpluses, and we think it is important to use more, rather than less money to buy down debt, but Government saved

by retiring debt, we do not put money in a piggy bank someplace. We do not create budgetary resources to spend in future years by doing so except to the extent that we have interest savings in the out years, but the extent to which that results is best illustrated in Rudy's paper that we quote at length in our testimony.

If you actually reduce the deficit by a trillion dollars more or less over the next decade, you would have about a 50-, $60-billion change in your interest savings in 2011, and I am the first to say that 50-, $60 billion is serious money, but it only goes so far to alleviate the problems that we face several years out.

It is easy to lose track of the orders of magnitude of the numbers that we are throwing around today. If you used only the Social Security Trust Fund surplus to retire debt over the next decade, you would retire debt and amounts greater than the total budget of the State of California, which is a third larger than the budget of the State of New York. It is as much as the total economies of some very good-sized countries, and I give you a list of 20 odd of them just added to my testimony for information.

We are concerned that the numbers are so big and the uncertainty is so great that the temptation is to resort to back-of-the-envelope, ad-hoc recalculations. We are concerned that, yes, you need a baseline for budget enforcement, but we do not need to redo that baseline every other day.

I confess to having done a little bit of the back-of-the-envelope calculations when we did our table that we gave you just showing what the surplus is after the tax cut, but I stayed away from assumptions about future political behavior because I do not know what you are going to do in the future.

As a matter of fact, Mr. Chairman, you have more control than almost anybody else over what is going to happen in the future because you have so much control over the release of the reserve funds in the budget for so many different purposes.

I have to say that so far this year, the budget resolution has been more successful than I would have thought it was going to be. I do not like worth a darn the way the tax cut was put together. I would have much preferred to seen constant policies constantly implemented over a decade, but the fact of the matter is that the tax cutters did what they did to stay within the limits of the budget resolution. As much as I abhor the sunset provisions as a technique to do so, unlike some other budget gimmicks, they are real. You are going to have to pass laws, and the President is going to have to sign them, or revenues are going to go up, not down, relative to the baseline.

The supplemental is the first one in I do not know how long that follows the budget resolution and so far has not become a Christmas tree full of ornaments.

The House Ag Committee last week acted within the budget for the extra farm money this year. I think we had John Boehner, Saxby Chambliss, Charlie Stenholm, and the Democrats on the committee to thank for that, and I hope the Senate will follow suit when the bill gets over here.

The budget resolution assumes more than $500 billion in new spending, and if I were doing political prognostications, just based on the pace of activity in this Congress so far this year, I would

be skeptical that you can actually get in place all of those policies if you got cracking right now and tried to do so.

Once again, however, the release of the money for those policies is very much subject to the control of the chairman of this committee.

With respect to surpluses, I would like to comment also that the total or unified budget surplus is the number that has economic impact. It measures the impact of the Federal Government on the balance of the economy.

The Social Security. The on-budget or non-Social Security surplus has taken on a very important political impact. It has helped us to ensure that we are reducing debts by very large amounts of money, and that is a very useful thing. Quite frankly, I think the party that first thinks and articulates the thought that something is more important than saving Social Security for Social Security purposes will do so at their peril, I really believe that has become a line in the sand. That is at least as completing as the norm of budget balance has been for most of our political lives.

I think the on-budget surplus less HI is a little bit more tenuous. It is the new kid on the block. It appears to me to be a proxy for those who think we ought to be saving more than we would do if we saved only the Social Security Trust Fund surpluses. The budget resolution says you cannot use that money for anything but the Medicare prescription drug benefit, and I think using Medicare money for Medicare programs actually makes sense indeed. I do not think Medicare drug prescription benefits makes sense without Medicare reform, and if you do Medicare reform, that actually alleviates the problem that we are going to face when the baby-boom generation begins to retire. Spending the Medicare HI Trust Fund surplus to do so would be a very good investment, indeed.

I am going to jump and close by giving you the one bit of advice I have for now that I think can actually do something positive about the fiscal policy situation now. That is that it seems to us urgent for Congress to adopt caps for appropriations sooner rather than later.

For those who say that 661 is a line in the sand and they won't vote for anything more than that, my response is every day you wait to vote, you are going to wind up spending more money than you otherwise would do.

For those who say that they did not want to do it on a supplemental in the Senate because it took 60 votes, I say if you do not have 60 votes for the catch, you will not be able to enforce them, anyway.

It is really urgent, Mr. Chairman, for you and Senator Domenici and Mr. Nussle and Mr. Spratt and whoever else has to be in the room to get together and decide how much is too much and write those amounts into law. Certainly, for the balance of this Congress, I would say for 3 to 5 years. It is the one thing you can do now that can help to bring order to this process because it seems, against the backdrop of these very large numbers that we are all throwing around every day, that the appetite for money is just bottomless. It does not matte whether it is the Defense Department or whether it is Bob's comments about how much more it is going to take for a prescription drug benefit.

We do not talk anymore about $1 billion or $5 billion or $8 billion or $10 billion. We are talking in multiples of $50 billion. Look at how the numbers have gone up from 587 to 630 to 681 to 680 and change. There is no right level of spending. That is a political question, but you all need to resolve it politically in some broad sense, write the caps into law, and then enforce them and we will all be better off if you do.

With that, I will stop and take any questions you may have.

[The prepared statement of Carol Cox Wait follows:]

Testimony

on

The Size of Surpluses Remaining after the 2001 Tax Cut

by

Carol Cox Wait, President

Committee for a Responsible Federal Budget

The Committee for a Responsible Federal Budget is a private nonprofit educational organization dedicated to educate the public about the Federal budget, the budget process and other issues that may have macro economic impacts. Located at 220½ E Street Northeast, Washington, DC 20002. Telephone (202) 547-4484. Fax (202) 547-4476. Email crfb@aol.com.

before the

Committee on the Budget

United States Senate

June 28, 2001

Mr. Chairman, Senator Domenici, Members of the Committee, thank you for inviting us to testify today.

Having so often sounded like a scold, I would like to begin by congratulating both the new Chairman and the former Chairman (now Ranking Member).

Senator Domenici is to be congratulated for putting together a bipartisan budget in difficult and unique circumstances—

- A 50/50 Senate
- A new President; and
- Against the backdrop of huge surplus projections.

Even those who do not agree with the policy or the process admire your persistence and determination.

We congratulate you, Chairman Conrad, on your commitment and determination to enforce the budget resolution. No Congressional leader, Democrat or Republican, in the House or Senate has faced a similar dilemma since Speaker Tip O'Neill in 1981. Like you, the Speaker opposed the budget resolution. Like you, he questioned the wisdom of the policies embodied in the resolution. Also like you, the Speaker took the position that once Congress passed a budget he was duty-bound to enforce it.

Understanding that you and your leadership opposed the resolution, we want to take this opportunity to express our admiration for your commitment to fiscal discipline and the budget process.

You ask, how large is the remaining budget surplus? Our first reaction is that Congress and the Administration left too much money on the table in Fiscal Year 2002. Attachment 1 is a table that illustrates the problem. The on-budget surplus (with or without HI) is larger in FY 2002 than in any other year until FY 2006.

This summer's re-estimates may help. That is to say, if the August re-estimates they may reduce the projected surplus for next year more than they reduce the projections for FY 2003-FY 2005 they could produce projection patterns more amicable to sensible policy choice. Unless you plan on another tax rebate next year, we fear that this pattern could bode badly for the years between 2002 and 2006.

Rudy Penner, a Member of our Board of Directors, well respected economist and former CBO Director is the author of *Errors in Forecasting.*[1] Under the heading, *The Usefulness of Flawed Forecasts,* Rudy writes—

[1] The Urban Institute, Washington DC, April 2001

"It has been shown that forecasts become rapidly less reliable as the forecast period is extended. Forecasts for periods beyond five years are not totally misleading, but it would be foolish to believe that they provide anything but the crudest indication of the nation's fiscal health. Given constant policies, the surplus for 2011 was projected in January 2001 to be $889 billion or 5.3 percent of GDP. There is, however, a good chance that the final outcome could be twice that figure or zero, even without policy change.

"On the other hand, there is only the tiniest possibility that 2011 could see a deficit in the range experienced between 1982 and 1986, when the unified deficit varied between 4.0 and 6.1 percent of GDP. Although the uncertainty is enormous, the estimates indicate that the nation's budget is very likely to remain healthy or at least not become extremely unhealthy for the next 10 years."

Under the heading, *Congress should devote more effort to analyzing the risks of outcomes that may occur because the forecast is wrong,* Rudy writes—

"As noted above, it now appears highly unlikely that we will return to the dangerous deficits of the 1980's even if current projections turn out to be overly optimistic. In contemplating tax cuts or spending increases, Congress faces a more symmetrical set of risks. If it avoids a major tax cut and the projections become consistently more optimistic, the nation will not have the increase in private consumption that otherwise might have been enjoyed. If Congress passes major tax cuts and the projections become more pessimistic, the nation may not save as much as it should, given the approaching retirement of the baby boomers. In particular, future surpluses may fall short of the surplus in the Social Security trust fund—a goal not enunciated by the majority of Congress.

"There may be a slight asymmetry of risks, in that it is probably somewhat easier to cut taxes and increase spending if projections become more pessimistic. However, Congress did manage to raise taxes and restrain civilian spending during the 1980's, and how they should be balanced is much less apparent.

"Because of the currently superb fiscal situation, it should also be emphasized that the risks of being wrong are not very large. If between now and 2011, $1 trillion less in debt is retired than planned, interest payments will be $50-$60 billion higher than anticipated, representing about 2.5 percent of outlays. Economic growth will be minutely lower, but if the shortfall is not the result of slower-than-anticipated growth, consumption will be higher in the interim. The effect on the nation's well-being will be trivial relative to the $17 trillion GDP expected in 2011. If the shortfall is the result of lower-than-anticipated growth, it is appropriate to lower the target for the surplus in any case. The lower growth will cause a significant loss of welfare, but the fiscal policy mistake will not."

Simply reviewing the facts leads us to two conclusions—

1. Governments save by retiring debt, but we do not put money in a piggy bank. The money (except for interest savings) will not be available to pay program costs in future years. Reducing debt today may make it easier to borrow in the future, but it does not create budgetary resources to meet public service needs in future years (except of course for the interest savings).

   Reducing debt held by the public by $1 trillion less than current plans would increase interest costs in 2011 by $50-$60 billion. Make no mistake, $50-$60 billion dollars is serious money. And there is a very real trade-off between interest costs and funds available for programs. But the interest saving is all that we gain in budgetary terms by retiring debt held by the public.

2. It is very easy to lose track of the sheer magnitude of the numbers we are throwing around in our current budget debates. Simply using the Social Security trust fund surplus to retire debt, will reduce debt held by the public by amounts greater than the entire budget of the State of California each year—and by amounts greater than the GDP of some pretty good size countries, such as Columbia or Saudi Arabia.[2]

   Budget resolutions and budget enforcement require a baseline—a benchmark or point of departure. Baselines cannot and should not change with every daily or weekly economic report. Given the magnitude of current surplus projections, any adjustments that may be made this summer likely will seem trivial in the overall scheme of things. [And as we remarked at the top of this testimony, if those changes diminish the FY 2002 surplus relative to FY 2003-FY 2005 they may actually prove to be helpful.]

   The budget resolution now in place provides the needed benchmark for tracking legislation. Sure, the numbers will change. But sanctioning change too frequently or at intervals too close can only lead to further criticism and confusion. In the House Budget Committee hearing yesterday there was a lot of kidding about "back of the envelope" and "cocktail napkin" re-estimates—and we confess to a little bit of that when we constructed the table at attachment 1. But you should stick with the resolution for purposes of budget enforcement. You simply cannot use "back of the envelope" or cocktail napkin" forecasts and projections for enforcement purposes.

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[2] See attachment 2 for a list

Many Members and staff already believe that the budget process is confusing and lacks transparency. Given your commitment to strong budget enforcement, Mr. Chairman, anything you can do to make the process seem more stable and more understandable probably will make your job easier.

There have been some notable successes enforcing the resolution in the month or so since its adoption.

- We are not crazy about the way they did it, but the tax-writers kept the tax bill within the limits in the resolution.

  Many will decry the sunsets and delayed implementation of some popular provisions in that bill as old-fashioned gimmickry. But, if you dislike the policies underlying the tax cut and/or if you are concerned about future shortfalls, you should welcome the sunset provisions. Congress must act and the President must sign one or more new laws, or else revenues rise compared to current projections.

- The supplemental follows the budget resolution. For the first time in years, a Presidential request for supplemental appropriations has not become a Christmas tree with all the trimmings.

- The House Agriculture Committee last week held the line on the $5.5 billion assumption in the budget for additional farm assistance this year.

  Representatives John Boehner (R-OH), Saxby Chambliss (R-GA) and Charley Stenholm (D-TX) 6and most of the Democrats on the Committee deserve credit for that action. Chairman Combest opposed them, but he supported the Committee bill on the floor and it passed the House on suspension. We only hope that the Senate will follow their lead.

The Senate could bet to the supplemental and the President could sign it before June 28th when we are due to deliver this testimony. But as we write, the tax cut is the only policy assumed in the resolution that actually has been enacted.

The budget resolution assumes new spending policies that total more than $530 billion. The Budget Committee Chairman has wide discretion to release money for various policies assumed in the resolution—

- $300 billion for prescription drugs;
- $28 billion for health insurance for the uninsured;
- $8 billion for Family Opportunity Act;
- $14 billion for home health; and
- $66 billion for agriculture.

Release of these amounts by the Chairman will impact greatly the fiscal path pursuant to the budget resolution. It may impact even more on the longer-term outlook. Thus, the Budget Committee Chairman has considerable latitude to influence final budget outcomes this year.

The table at attachment 1 shows three different budget surplus calculations—

- Total (or consolidated or unified) surplus;
- On-budget (non-Social Security) and off-budget (almost entirely Social Security) surplus; and
- On-budget surplus less the HI surplus.

From an economic perspective, the total surplus is the only really meaningful number. The actual unified budget surplus will determine the amount by which we reduce debt held by the public. It measures the impact of the Federal government on the entire economy.

The off-budget (shorthand for non-Social Security) surplus has proven to be very useful. Aaron Wildavsky used to write a lot about the norm of budget balance. Given very large and growing actual and projected surpluses, the norm of budget balance does little to restrain fiscal policy choice or impose budget discipline.

But the proposition that we should "save Social Security surpluses", i.e., use those amounts to retire debt held by the public, has very broad and deep political appeal. Congress and the President have all but adopted blood oaths to the effect that you will save Social Security surpluses for Social Security. That has proven a very useful firewall from the perspective of those of us who support debt retirement. As noted above, "saving Social Security surpluses" would reduce debt by amounts larger than the total budget of any State in the nation and the GDP of many large countries. Devoting all Social Security Trust Fund surpluses to that purpose would allow the Treasury to buy back all the debt that available to retire before the end of the decade. There may be no specific economic import to the number, but the policy outcome certainly is a welcome one.

The HI surplus is the new kid on the block. The need to "save Medicare surpluses" is floated by some as a proxy for the argument to reduce debt more and faster than would be the case if we used only Social Security surpluses for that purpose.

Reducing debt more may indeed be a better policy—but we do not expect it to happen. We believe—when all is said and done—Congress and the President will compromise on policies to commit the entire non-Social Security Trust Fund surplus. We fear for the political party that first argues that something else is more important than saving Social Security, but we doubt that the HI surplus prohibition will prove to have the same staying power.

The budget resolution made it very clear that Congress cannot pass policies that would dip into the HI Trust Fund surplus unless you make an explicit decision to do so.

It seems clear to us that the budget resolution allows you to use Medicare surpluses to pay for Medicare reform. Indeed, you may want to do so. Anything Congress does in the short term that helps to narrow the long-term gap between dedicated receipts and benefit commitments in Medicare would be a solid investment in future fiscal sanity.

It seems to us that there is more than enough money to pay for the policies assumed in the resolution (certainly in the budget year) without diminishing the HI surplus. And the Chairman has extraordinary power help ensure that outcome.

On the other hand, a prescription drug benefit in the absence of Medicare reform is a bad idea—not because it may use up part of the HI surplus in the short term. Adding prescription drugs to the current Medicare program would only make an already unsustainable program more expensive. And the Medicare dilemma already is more difficult than the Social Security problem.

Our organization believes that universality; transparency and accountability define responsible budgeting. There is no objectively right level of Federal spending and revenues. We believe that Congress should abide by the budget or act constructively to change it. You should not cut taxes below, nor increase spending above the budget without first amending the resolution.

We are concerned that Congress and the President have not acted to write into law appropriations caps for the balance of this Congress. WE understand that some Members hate the thought of voting for a cap one cent higher than the $661 included in the budget for FY 2002. We also understand that some Members want to know more about the President's request before agreeing to new appropriations caps. And we understand that some think $661 is too little, period.

For those committed to fiscal discipline and the integrity of the budget process, we have this advice. The sooner you write caps into law the less you will spend in the aggregate and the more discipline you will bring to the appropriations process.

We understand the reluctance to add caps to the supplemental due to the 60-vote majority that would be required. But who is kidding whom? If you cannot muster 60 votes for the new caps in the Senate, you probably cannot enforce them in any case. We urge the Chairman and the Ranking Member to get together with one another—with your House counterparts and whomever else you think it is necessary to strike a deal you can enforce—and move legislation to enact new caps for the balance of this Congress at the earliest possible moment.

This could be a critical step toward restoring faith in the budget process even as it could test the commitment of the Congress and the President to fiscal restraint.

In closing, we don't really think that the pending debate is about saving money. We are convinced the debate is about how to spend. We think and hope that you can hold the line and actually use Social Security Trust Fund surpluses to retire debt. We will be very surprised (albeit pleasantly) if actual debt retirement exceeds those amounts. So the sooner you force a debate and vote on how much is too much to spend for appropriations, the sooner the Chairman will have a clear idea how much is left for everything else. And he has an extraordinary degree of latitude to keep spending within the amounts available in the budget this year.

Thank you again for the opportunity to testify today. I am happy to take any questions that you may have.

Attachment 1

Budget Status Report—June 1, 2001

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-06	2002-11
Surplus													
CBO March	275	304	353	400	437	508	578	641	718	806	883	2002	5629
Baseline													
Off-Budget	156	172	187	202	221	238	256	275	293	311	330	1020	2487
On-Budget	119	132	166	197	215	270	322	366	425	495	553	980	3142
HI	28	38	41	43	42	45	43	42	40	36	28	209	397
On-Budget-HI	92	95	125	155	173	225	279	324	385	459	525	773	2745
Tax Cut													
JTC Estimates	-74	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130	-479	-1275
Debt Service*	2	5	8	14	21	29	38	49	61	74	87	77	385
Surplus effect	-76	-43	-99	-122	-128	-164	-190	-209	-229	-261	-217	-556	-1660
Remaining Surplus													
Total	200	261	255	278	309	345	388	432	489	545	666	1448	3968
On-Budget	44	**90**	**67**	**75**	**87**	**106**	132	157	196	234	336	425	1481
On-Budget-HI	16	**52**	**26**	**33**	**45**	**62**	89	115	156	198	308	218	1085

*Based on CBO Estimates
Prepared by the Committee for a Responsible Federal Budget—June 2001

Attachment 2

Selected Countries with GDP less than US Social Security Trust Fund Surpluses

Chile
Columbia
Egypt
Finland
Greece
Hong Kong
Indonesia
Iran
Ireland
Israel
Malaysia
New Zealand
Pakistan
Peru
Philippines
Poland
Portugal
Saudi Arabia
Singapore
South Africa
Thailand
Venezuela

Chairman CONRAD. Thank you very much.

We are going to turn to Members who are here, first Senator Stabenow and recognize her for 8 minutes for a statement, questions, and however she chooses to use her time.

Senator STABENOW. Thank you, Mr. Chairman. Once again, let me thank you for holding this important hearing for us as we move forward, as numbers continue to adjust.

As we all know, the estimates on the tax cut that was passed have been changed in terms of full cost, and as we look at the changes that have been coming forward in terms of the revenues, I think it is our responsibility on the Budget Committee to keep Members focused on the realities of what we have to deal with.

I know, Mr. Chairman, that you are strongly committed, as we all are, to fiscal responsibility as we move forward on this budget.

I did want to ask, first of all—well, first of all, make a note that yesterday we heard from our Goldman Sachs representative that half-a-percent change in labor productivity would be a loss of about a trillion dollars to us. When I look at the Concord Coalition surplus excluding Social Security and Medicare Part A after the tax cut, basically a half-a-percent difference in labor productivity, it wipes out the surplus that you have projected here.

Mr. GREENSTEIN. Sure.

Senator STABENOW. So I think that is important for us to note as we move forward, and we certainly want to have labor productivity continue. It has really been the back bone of our economy and at the growth that we have experienced, but I think it is important to note what just a small deviation can do.

Also, Mr. Bixby, I think it is important to reemphasize something you said in your testimony. When we look at the tax cut and the budget resolution, it all adds up on paper, but only if today's long-range economic projections are accurate, only if a number of questionable assumptions are made that tend to underestimate likely expenses and overestimate likely revenues. Certainly, that is the position that we find ourselves in at this moment.

I would like to ask any of you to respond to one of the issues in the tax bill, and that is the alternative minimum tax provisions which are set to expire in 2004 and also the higher education tax deduction which expires in 2005. The higher education deduction is, of course, critical to labor productivity and being able to encourage people to go on to receive the skills that they need to be able to be productive citizens in the new economy, and also, with the AMT expiring, essentially that is a tax increase for citizens.

Do any of you doubt that these sunset of tax cuts will be renewed by Congress or have any comments as to how you believe these various tax cuts will be acted upon by the Congress and any likelihood that, in fact, we would truly eliminate the AMT provision in 2004?

Mr. Greenstein.

Mr. GREENSTEIN. We are clearly not going to eliminate the AMT provision in 2004. About 1.4 million taxpayers will be under the AMT this year.

Under the tax bill, by 2010, it is 35 million.

The Joint Tax Committee estimate of the cost of limiting the increase in the number of taxpayers under the AMT to 20 million by

2010 or so—17 million, I think, by 2010, 20 million in 2011, rather than 35 million, which is the level it would have gone to under the law prior to passage of this tax cut, that alone is 200- to $300 billion over 10 years.

So I think the question is not will Congress address it. You clearly will, but where is the money going to come from? That is where the tax bill as currently passed is a setup, and I think you have to respond appropriately.

It was done as a setup saying that we really want a 1.7-, 1.8-, $2-trillion tax cut, so we will make it look on paper like it is 1.35 and we will set up these clips of which the biggest is the AMT, much bigger than the education one in terms of cost, and we will put the gun to the head of Senators like yourselves that if you do not extend the AMT relief in the bill, you will get attacked for raising taxes on a lot of people.

The numbers that we have gone through here today, and the chairman's numbers indicate, there is not any money around unless you want to dip into the trust fund surpluses to deal with that. So the conclusion—the conclusion my testimony comes to—the conclusion is, yes, you are going to have to deal with the AMT and the other sunsets, but they have to be paid for within the revenue side, and the logical way to pay for them is by scaling back some of the excesses in that tax bill that have not taken effect yet.

Most of the AMT effect will be on people over $100,000 a year. Some will be below. Most of the cost is above. We should not be lowering their tax rates and making other changes by more than we can afford and then recapturing part of that through the AMT. We fix the AMT, and it probably means you cannot lower the rates quite as much. You do not completely eliminate the itemized deduction phase-out, which is a huge tax cut that neither the House or Senate bill out of conference, having not been in either bill, a huge additional tax cut for people that make millions of dollars a year. That does not even start to take effect until about 6 or 7 years from now.

So there are adjustments that can be made within the bill to pay for the AMT issue, but the Congress voted on the budget resolution to limit the tax cuts to $1.35 trillion, and your only hope of getting through the next number of years, even if the productivity estimate does not go down—the only hope of getting through without dipping into the trust fund surpluses is that you have to fix the sunset problems in the tax cut bill on the revenue side, redo the tax bill right.

I think $1.35 trillion is still too high, but at a minimum, you have got to make the ultimate cost fit within 1.35.

Mr. BIXBY. Let me just add to underscore something that Bob said, which is that even without the tax cut, forget about the tax cut, there was still an AMT problem brewing, so that the tax cut exacerbated the problem somewhat and as the Joint Committee has estimated, it takes about $200 billion over the rest of the tax cut to fix that, but that fixes only part of the problem. It gets you back to square on. Still, even with that, the number of taxpayers subject to the AMT over the next 10 years is going to go from $1.4 trillion to 20—excuse me—million—I get my trillions, billions, and millions, but in this case, it is only millions—taxpayers to 20 mil-

lion taxpayers, and it is likely that Congress would hear about it from your constituents. So you would probably do something about that. Anyway, so it may cost more than that.

The education extending that one costs about $20 billion, I think, according to the Joint Tax Committee over the remainder of the tax cut provision, but that is one of the unrealistic assumptions that is bandied about right now is that nothing will happen with that.

Ms. WAIT. If I may, harking back to my comment at the beginning of all of this, I am not nearly as good a prognosticator, I guess, but I can suggest to you, one, that it is likely that when the time comes, something will be done to extend the AMT and the education deduction. I do not know exactly what.

If we have far larger surpluses than you all think we are going to have right now, we will probably behave one way. If we have a lot less money, we will probably behave another way.

I think that sitting here today and trying to forecast exactly what is going to happen, 2, 3, or 4 years from now, I just do not know, but I have seen how the Congress behaves in situations where you would be, for instance, thrown into using the Social Security Trust Fund surplus to offset the cost of AMT if you did not do something else. You will do something else if that is the situation, but since I do not know what the overall economic and surplus situation is going to be, I cannot forecast exactly what you are going to do.

Senator STABENOW. Mr. Chairman, in conclusion—I see the red light—let me just say that one of the reasons that Senator Evan Bayh and Senator Olympia Snowe and I put forward the idea of a budget trigger was to make sure that if revenues did not materialize that actions on phase-in of tax cuts or spending would not proceed until the dollars were there, and I am going to continue to vigilantly support the chairman's position of taking actions that protect Medicare and Social Security as we go forward with these items and the unsurety of the budget.

Thank you.

Chairman CONRAD. Senator Clinton.

Senator CLINTON. Thank you very much.

First, I would like to thank our chairman for holding this second of two extremely important hearings that are beginning to highlight the predicament that we find ourselves in following the passage of the tax bill, and I thank each of our witnesses for their insightful and helpful presentations.

I think the message is quite clear. It is one that many of us tried to make on the Senate floor and back in our States that there is a right balance between debt reduction and tax relief and the investments we need, and we do not think that the tax bill that was passed and signed into law struck that balance, but we are obliged now to figure out how to deal with the situation that we have found ourselves in.

Given what we have heard this morning, I have a couple of questions, and one is what Senator Stabenow raised about the AMT. The other, though, is about the concern we have about our national savings rate. I think it was Mr. Bixby, if I am not mistaken, in your testimony, your written testimony, who highlighted that in addition to improved productivity, we have to put the idea of in-

creasing national savings in the center of our thinking. I believe you made the point, Mr. Bixby, that increasing national and personal savings is the single most effective policy the Government can pursue to promote long-term economic growth and retirement security.

I think we have squandered the opportunity to keep our national savings in the right balance, and certainly our personal savings figures are quite distressing.

So I would like to push each of you on this point. What kind of reforms do each of you favor that you believe would help to boost our national and personal savings rate and, therefore, our economic growth potential? I would like to throw in the point that Bob made which had not really struck me, Mr. Chairman, until I heard him make it, and that is that we passed a budget resolution that set a very specific figure for the tax cut, which we know has been exceeded. Part of our challenge will be, it seems to me, in this budget process is not just to set caps and not just to decrease deeply needed non-defense discretionary programs, but to come up with a strategy to enforce the budget resolution. That will be quite a challenge, but we certainly have a clear signal.

As we gain information from various sources about what the true cost of this tax cut is, it violates the budget resolution. So part of what we will have to be considering is how to get our Congress to abide by the budget resolution which it passed.

Any thoughts you might have on that, I am also obviously very interested in, but let me first ask about this whole question of savings. It is something that I know each of you have addressed from different perspectives, and I would love to hear any thoughts you got.

Mr. BIXBY. I can start, and I am glad you picked up on the savings comment in the prepared testimony because to the Concord Coalition, that really is the key issue here with the surpluses.

We do not see any particular point in the Government running big surpluses just to run up bigger expenditures in the future.

The economic case for saving surplus is that, for one thing, the only way you can pay down debt is for the Government to run a surplus. After 30 years of deficits, it is perfectly appropriate to be running a surplus, particularly in strong economic times as we have in the last couple of years, to pay down some of the debt. That is, as I think Carol mentioned, really the only way the Government can save, despite trust funds and lockboxes and all that. The only way you can translate that into real savings for the future is to be paying down debt with it. So that is the economic case for setting the bar, so to speak, at the trust fund surpluses and trying to pay down debt to do that.

Another policy that the Concord Coalition has favored is a system of mandatory individual retirement accounts, and the justification for running surpluses and using it for that is it would help individuals save, even if it was through a mandatory program.

The key question there is do you do it in the context of Social Security reform, do you do it outside of Social Security reform. For the record, the Concord Coalition thinks it ought to be done within the context of Social Security reform. That may be one thing that Bob Greenstein and I may disagree upon, but I would rather be

having that discussion. I think that discussion of how to use the surplus in the context of entitlement reform, savings for the future—because we know we have these demographic challenges ahead. We know the personal savings rate is low. I think our time would have been more productively spent earlier this year having a knock-down, drag-out fight over Social Security reform rather than a knock-down, drag-out fight over whether the tax cut should be 1.6- or $1.3 trillion.

Senator CLINTON. You get no argument from——

Mr. BIXBY. So you asked for ideas of savings, and that is really the discussion that we are looking forward to having.

Senator CLINTON. Ms. Wait?

Ms. WAIT. As with Bob, I think that the value of buying down debt held by the public is that we are increasing national saving and that there is—I think if there is one thing about which there is no dispute in the economics community, it is that increasing saving now will increase growth in productivity and put us in a better position to deal with our long-term problems.

I have to say, however, as I note in our testimony, I only wish that the argument today were about whether to save money. It really is not. We are going to save the Social Security Trust Fund surpluses. I remain fairly confident of that.

I am much less confident that anything above that amount is going to be saved, whether it had gone for tax cuts, whether it is going to go for spending programs. My sense down here is that everything else is on the table, and it is going to wind up out the door somehow. If I truly believed there were a strategy that would result in the Government retiring more debt, I would say let's do it. I just do not know how we get from here to there.

Senator CLINTON. Bob.

Mr. GREENSTEIN. I very much agree with your statement, the other witness', Bob Bixby, statement. We need to promote national saving on the public, that we really have control primarily on the public side, lots of things Congress does on the tax side, but it says our saving incentives simply end up with people shifting money from investment A that is not tax-favored to investment B that has become tax-favored, without doing that much to increase saving. The one sure thing Government can do to increase saving is to pay down more debt.

We know that when the boomers retire in large numbers, we have big fiscal problems. Paying down debt gives us a double benefit in dealing with that. To the degree that it promotes some faster economic growth, we have a larger economy to help enable us to afford dealing better with those problems when they arise, and to the degree that we are not paying $200 billion a year in interest payments on the national debt, we have more room in the budget to deal with those problems when they arise.

On your other question on enforcing the budget resolution, one thing that adds some complexity here is that the levels of discretionary spending, both defense and non-defense in the budget resolution are not realistic and cannot be really enforced. They cannot be met.

We have already this big request, just a first installment, $18 billion more in defense. As I said in the testimony, we expect that ul-

timately translates into 200- to $400 billion over the 10-year period.

In a provision, the likes of which I have never seen before, and I frankly have to say I find pretty outrageous, the budget resolution gives now-Chairman Conrad the authority to raise the ceiling for defense discretionary without giving him the authority to raise the ceiling for non-defense discretionary, but the non-defense discretionary level both for 2002 and for the next 10 years is neither realistic nor, frankly, probably good policy.

I will give you one little example. As we sit here today, the House is passing the 2002 ag appropriations bill that in a time of budget surplus will require 200,000 low-income, pregnant women, infants, and young children to be turned away from the single program that probably has the most successful track record in the Federal Government, the WIC program.

There is an editorial on this, this morning, in The Washington Post. We have room for massive tax cuts for the top 1 percent, but we are going to turn—at the end of the day, Congress is not going to do that. I hope it will get fixed in the Senate. I think it will ultimately get addressed, but things like this are not going to be addressed within the unrealistic levels that are in the resolution.

So I have always favored caps on discretionary spending, realistic caps. The fact of the matter is in order to have realistic caps, you probably are going to need to make some adjustments on the tax side, and much as I do favor new caps, I think they have got to be part of a negotiated bipartisan agreement that looks at the whole budget again, including the tax side, which probably is not going to happen this year, but maybe it could happen in the next year's budget resolution.

In the interim, I am not worried about a spending spree because you have got this political discipline that neither party wants to go into the Medicare or Social Security surplus, and having that discipline, I think there is not a lot to be concerned in the short term, but, in the long run, we will need new caps, but as part of a resolution that looks at priorities across the budget.

I would find it very troublesome to say that we are going to go at all these tax cuts for the top 1 percent that have not even yet started to take effect yet, take effect and use that as an excuse to put in caps that start throwing poor children off effective program. I do not think that is the right mix.

Ms. WAIT. Senator Conrad——

Chairman CONRAD. We have got to abide by our time limits here, and Senator Nelson has the next——

Senator NELSON. Well, I would certainly defer to the Senator from New York if she would like to followup.

Senator CLINTON. I think Ms. Wait wanted to——

Ms. WAIT. I just wanted to remind you all that—I mean, I do not need to remind you that Senator Conrad almost certainly is not going to increase the defense cap by goo-gobs of money without doing anything on the domestic side, but beyond that, you are going to have to do something about caps and the pay-go scorecard before you recess at the end of this year or you are going to have massive sequesters, the like of which you have never seen.

It is not that you aren't going to have an opportunity to deal with those issues. You are going to be forced to deal with them. My only argument is the sooner you do so, the better off everybody is going to be.

Mr. GREENSTEIN. You are not forced to set new 5-year caps this year. You are only forced to do the same thing you have done each of the last several years, which is to waive the unrealistic caps set in 1997, which ultimately should be replaced with new ones, but I think, again, as part of a larger look at the whole budget.

Ms. WAIT. Excuse me, Bob, but we did set a new cap last year for 1 year, and even if you do that, it is better than nothing at all.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Mr. Chairman, 22 years ago, I found myself happily as a freshman Member of the Budget Committee. It was 22 years later that I find myself happily as a freshman Member of the Budget Committee, and from that former experience, 22 years ago, I learned some painful lessons.

First of all, I learned that I had made a mistake when I voted for the 1981 tax bill, and we saw the consequence of that; that while I was in the Congress, all the way through the decade of the 1980's, not only did we have to undo it, we had to undo it three times, and a fourth time after I had left the Congress in 1993. Thus, you well would have expected that I have voted the way that I have voted this year, which I think what has been adopted is a highly irresponsible fiscal position to put us in, in a fiscal straightjacket of which we now have some very uncomfortable decisions that we have to make.

So my question that I would direct to you all is given the fact of my history and given the fact that because I had some inkling of these matters in the course of the campaign and discussed them very openly with the people of Florida—and the people of Florida instructed me very clearly, they wanted a substantial tax cut, but they wanted to pay down the national debt, and they wanted substantial investments in education, in defense, in the environment, in a prescription drug benefit to modernize Medicare, and they did not want to raid the Social Security and Medicare Trust Funds.

Now, what has been enacted in this Congress thus far signed by the President violates those principles. So what would you recommend to us in order for me to keep faith with the promises that I made to the people of Florida and, thus, how I have voted to this point of now how to get out of this fiscal straightjacket that is facing us?

Mr. BIXBY. Senator, sometimes constituents ask for a lot, and there are not necessarily consistent desires.

There is so much money on the table. This is the sort of thing that the Concord Coalition has nightmares about. There is so much on the table when you look at a 10-year projection, $5.6 trillion, that it appears that almost anything is possible.

The tax cut. Our view on the tax cut was that it should have been something that you could phase in over the next couple of years. Those provisions, in facta, in 2004 and beyond just shouldn't be there because who knows what the fiscal situation is going to be. There is going to be congressional elections and another Presidential election before a lot of this tax cut goes into effect, and we

still could have had a sizable tax cut, but the tax cut is in place. I think for purposes of looking ahead to see how much money is on the table, you have to assume that it is going to be there, and there is no point in going back and redoing the tax cut again this year.

I think now that spending is on the table, I think that there is an obligation to hold the line as much as possible, particularly on the appropriations bills, and looking to a prescription drug benefit. That is going to be a very expensive proposition, no matter how we do it. So I think there needs to be important—I mean, I do not think we should go whole hog into that, and I agree with what Carol said. That probably ought to be done in the context of a broader Medicare reform because that is the other big-ticket item that is out there.

We have something that we do with our field staff at Concord, and I know Carol has got similar things, where you have constituents come together and sort of look at all the options and how much they cost and what the revenue consequences are and debt service cost to all these things and tell them you are the budget committee and here are your choices. So I would tell your constituents, "You figure it out. We will get the Concord Coalition to come in and do one of these exercises, or the Committee for a Responsible Federal Budget," and so people can see the tradeoffs because, quite clearly, despite these big surpluses, there are tradeoffs that have to be made between tax cuts, debt reduction, and new spending, and we cannot go into this situation thinking that we could do it all because, as you heard yesterday, the economics could take away alone without any hard choices being made a big part of the projected surplus.

There is no magic answer, and you probably need to convey that message.

Senator NELSON. Would you agree that had we cut the tax cut in the range of about $900 billion over 10 years that we could have accommodated most of what the people of Florida instructed me that they wanted?

Mr. BIXBY. Possibly, but you would still have the same problem. You would still have tradeoff problems with a big tax cut and a prescription drug benefit. In either case, as you know, you have a big fiscal problem coming out beyond the 10-year budget window, and so you really have to be careful not to make—whether it is 900- or $1.3 trillion. It would still add up paper, and it would add up better on paper. There is no doubt about that.

Senator NELSON. Well, the problem is it is not $1.3 trillion.

Mr. BIXBY. No. It is close to $2 trillion.

Senator NELSON. It is about $1.8 trillion, minimum.

Mr. BIXBY. Right.

Mr. GREENSTEIN. Senator, if I could jump in here.

Senator NELSON. Yes, Mr. Greenstein.

Mr. GREENSTEIN. What I was about to say was actually the question you just asked, that while Bob is absolutely right that there are still difficult tradeoffs no matter what you do and that any budget resolution that was passed this year, including one with a $900-million tax cut, it does not take away the fact that we still have problems down the road when the boomers retire.

Having said that while voters often ask for a combination of things that are unrealistic, what your constituents asked for really was not that unrealistic.

Senator NELSON. I agree.

Mr. GREENSTEIN. It all could have been accommodated with a smaller tax cut.

What do we do about it now that we are where we are? I think there are two steps. Step No. 1, that I mentioned earlier this morning, is the budget resolution says $1.35 trillion for the tax cut. That is the official cost of the tax cut. The first step is it has got to stay within $1.35 trillion, not 1.7, not 1.8, not 1.9, which means that any additional tax cuts that Congress takes up and dealing with the sunsets which is what adds that extra 4- or $500 billion, AMT, the whole bill, they have got to be paid for on the revenue side within the bill.

Fortunately, the one fortunate thing here is since so many of the tax cuts that are not the broad middle-class tax cuts, but the very high-income tax cuts do not start to take effect for a few years and then phase in over many years. You have the possibility of getting the money to deal with the sunsets and the other revenue problems that if not financed in this way, take the whole cost to 1.7 or 1.8 or 1.9, to deal with them within the tax bill, so the total stays at 1.35.

But even if you do that, it is still very difficult, unless the surpluses continue to grow, which they might not. It is still very difficult, even at 1.35, a real 1.35, to meet the various wishes of your constituents.

If the surplus does not grow, I think ultimately—you are not going to do it this year, but, ultimately, that is going to require some scaling back of the tax cut below the 1.35. While at the current time that looks politically impossible and is right now, if you looked a month after the 1981 tax cut passed and said what are the prospects that in the next 3 years with Ronald Reagan still as President that 30 percent of the 1981 tax cut will be taken back by Congress, anyone would have said that is crazy, it will never happen, but when the fiscal tradeoffs had to be made, it did happen.

Senator NELSON. That is right, and Reagan had to lead the charge——

Mr. GREENSTEIN. That is right.

Senator NELSON [continuing]. Because the country was going into economic cardiac arrest.

Mr. GREENSTEIN. It will be tougher now, because you do not face deficits, to face total budget deficits, but, ultimately, the question is that the first step, do not let that tax cut get any larger. The second step is, ultimately, you all and your colleagues on the other party will need to go back to the public, and they will need to be asked what do you want, do you want less for education, do you not want as much of a drug benefit, whatever it may be, in return for letting all the tax cuts take effect, do you want us to scale back some of the tax cuts and invest more in education or environment, and the voters, if the issue is squarely put to them, I do not know exactly what they will decide, but they need to be a part of it. That is part of what we have elections for.

Ms. WAIT. Mr. Chairman, may I make a very brief statement?

Senator NELSON. Yes.

Chairman CONRAD. Certainly, please.

Ms. WAIT. First off, I think that Bob would be the first to concede that I am not going to sit by quietly and watch people do bad things to poor women and children. I think that the Senate will certainly step in and keep that from happening in whatever we do. We have to protect the most vulnerable populations in this society.

Second, I would say to you, Senator, you have to concede that the straightjacket you are in today is vastly preferable to the one you were in 22 years ago.

Senator NELSON. Oh, indeed.

Ms. WAIT. I mean, we are in so much better shape than we were——

Senator NELSON. Dealing with a surplus is much better than a deficit.

Ms. WAIT. And much more difficult in some respects, but a much better situation for the country, for the budget, for the economy.

Finally, I would say to you, you begin by enforcing the budget. We began by congratulating the chairman for his commitment to doing that. I have deviated slightly from that myself saying you need quickly to put in place realistic caps, and caps, you can enforce. Everybody who knows me knows that I think the Government could probably get by on $661 billion in new budget authority next year, but, then, I probably have the lowest spending number in down and what I would do does not matter. I do not have an election certificate on the wall, and what really matters is what you can get, 60 votes in the Senate, and at least 218 votes in the House and a Presidential signature for. You need to come to an understanding about that and do something about it sooner rather than later.

Enforcing the budget is the only place you have to start right now unless you think you have the votes to go back and re-litigate it and start all over again. Going forward, if we knew more about what you were going to be facing, we would give you better advice. We do not.

One concern I have not articulated here and I do want to do before it is over is that Bob keeps talking about the longer-term problems that we face. To the extent that we grow the size of Government between now and the time the baby-boom generation retires, that gap gets more difficult to close. That mitigates somewhat the positions that we have expressed over the last year saying that on balance, if you were going to spend the money, anyway, tax cuts or not as damaging as you would have described them to be, we would have preferred a smaller tax cut. We would have preferred retiring more debt, but on balance at this juncture, growing the size of Government, unless you have a commitment to a higher tax level only makes the problem more difficult when you get to that point when the baby-boom generation retires.

Senator NELSON. Mr. Chairman, thank you, and thanks for holding this hearing because this is something we really need to keep locking in, like a laser on.

Chairman CONRAD. I thank the Senator from Florida.

I would say to the Senator from Florida, I would answer his question saying the Senator from Florida has kept full faith with the voters of Florida because you supported a budget resolution that protected the Social Security and Medicare Trust Funds in each and every year. You supported a budget resolution that had a $900-billion tax cut, substantial tax cut. You supported a budget resolution that reserved resources for improving education, providing a prescription drug benefit, strengthening national defense, and you supported a budget resolution that, in addition to that, set aside $900 billion to strengthen Social Security for the long term. It was the only option before us that did something about the long-term problem facing us, which is we all know the retirement of the baby-boom generation. So I would say the Senator has kept full faith with the pledges that he made in supporting a budget resolution that did everything single thing that he talked about.

I would just like to end where I began as reality time. This is not projections. This is not what is maybe going to happen. This is what has already happened. If we start with the most recent forecast of CBO, we take out the tax bill, we take out the budget that has passed, and we take out what the President is proposing on defense, we are already invading the trust funds of Medicare in 2003, 2004, 2005, 2006, and 2007. So we are not talking about things that might happen or prognostications. We are talking about what has already happened in a tax cut, in a budget resolution, and in a defense request from the President of the United States.

Beyond that, we can make some informed judgments about where we are likely to go in just a few areas because that first chart has nothing with respect to fixing the alternative minimum tax which costs over $200 billion to do. It has nothing to do with the extenders, which we all know is going to happen, the extension of popular tax provisions, like the research and development tax credit, that aren't included in the budget resolution. It does not include any money for natural disasters, and natural disasters have already occurred. We already had the head of FEMA call up yesterday and tell the Appropriations Committee, he needs an additional billion dollars just to get through September. There is none of that in this budget. There is no new money for education in this budget, even though the Congress has passed—or the Senate has passed and education bill that authorizes over $350 billion, and there is no change in the economic forecast in that first chart.

We know the economic forecast is going to change because economic growth is not meeting what is in the projection. If we just on two of those items make a reasonable assumption with respect to education funding and a revision in the forecast, we can see the results, and the results are clear for anybody to see who has the courage to look. The result is deep raids in the Medicare Trust Fund and even raiding the Social Security Trust Fund, something the vast majority of Congress has voted not to do on both counts.

We are in trouble. It is just as clear as it can be. We are in trouble. We are in trouble already, and the prospects are the trouble is going to get worse, and it is because we have put in place an unrealistic budget, one that is based on a forecast that is overly optimistic in my judgment, No. 1; No. 2, that we have passed too large a tax cut; No. 3, that the budget did not include items that

are clearly going to happen, including the President's request for increases in national defense, including new money for education, including the necessity to fix the alternative minimum tax which is otherwise going to at the end of this period affect 35 million taxpayers in this country when today it affects less than 2 million.

We also know there are going to be natural disasters in this country. We have already experienced them. We know, I think beyond a shadow of a doubt, the forecast in the short term is going to go down. Economic growth was forecast to be 2.4 percent this year. The consensus forecast now is 1.8 percent. That means we are going to get less Federal revenue. How much less is an item of discussion.

We had a very distinguished panel here yesterday, two Democratic witnesses, a Republican witness, who agreed that revenue is going to be down from what is forecast 50- to $75 billion just next year. We are in trouble, and that is a message that has to be clearly delivered to our fellow Members of Congress and to the country because it is going to have to guide us in every decision we make. It is why I believe the budget resolution must be enforced, but that is not enough. That is not good enough. We are also going to have to say to our colleagues, no new spending that is not in the budget that is not paid for, no additional tax cuts that are not paid for. That is a message we need to clearly deliver to our colleagues and to the country.

All those who are out there who think there is this big honey pot, the honey pot is gone. The honey pot has been fully committed. In fact, it has been overcommitted, and we are into the trust funds of Medicare already, and you can see with even reasonable, very reasonable and modest and conservative assumptions that we are going to be into the Social Security Trust Fund.

So it is time to face reality, and that is a message that has to be delivered over and over and over to colleagues, as unwelcome a message as it is and as unwelcome a message as it is to people in the country.

That still is an optimistic outlook for the economic future. That is still assuming we have economic recovery next year, good economic recovery, and that we do not have further slow-down this year. That is assuming very strong productivity growth, 50-percent higher than we saw in the 21 years from 1973 to 1994. Those are very, very optimistic outlooks for the economy. We hope they all come true, but we also recognize reality, and that is going to require us to make tough decisions. And the sooner we face up to it, the better off we will be.

I want to thank this panel. We appreciate very much your time and your taking the opportunity to come here and give us the wisdom of your experience.

Thank you very much.

[Whereupon, at 11:47 a.m., the committee was adjourned.]

ECONOMIC AND BUDGET UPDATE

THURSDAY, JULY 12, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Hollings, Stabenow, Clinton, Corzine, Domenici, Nickles, Gramm, Bond, Gregg, and Hagel.

Staff present: Mary Ann Naylor, Staff Director; and G. William Hoagland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Good morning. We will bring the hearing to order.

We want to welcome OMB Director, Mr. Daniels. Thank you very much for being here.

Mr. DANIELS. Thank you, Mr. Chairman.

Chairman CONRAD. As we discussed, we wanted to reciprocate for your kind gift to me last time you were here. You will remember the Director at the hearing on the budget brought me a wonderful pie, and he had it divided as to how we might use the surplus. And it was a terrific pie. It was an apple pie, my favorite, and it went over very well with my staff. And we thought we should reciprocate this morning.

So we have a pie. It is somewhat smaller. [Laughter.]

Chairman CONRAD. And it represents the "Shrinking Surplus." So, Mr. Director, I am going to send this pie down to you. I am told it is actually rather good pie.

Senator GREGG. Is there another pie that represents the tax cuts?

Chairman CONRAD. You know, that is part of the shrinking surplus. That is part of the reason of the shrinking surplus.

So, anyway, I hope your staff enjoy it, and I hope it is taken in the good humor that it is intended.

Mr. DANIELS. Absolutely.

Chairman CONRAD. We are grateful that you took time out of your busy schedule to be here today. We wanted to get your views on the current budget situation because, as you know, obviously we are faced with changing circumstances, and we are faced with a series of decisions that still must be made this year. And so the best information that is possible is important for us.

For example, we have got a request from the administration for a substantial increase in defense spending. The question arises: How do we pay for that? And we already see warning signs that the budget is in some difficulty.

Let me just put up that first chart. This looks at the year 2001. It starts with the surplus, takes out the trust funds of Social Security and Medicare, takes out the tax cut, takes out the budget resolution policies, and the interest associated with that. And we show a $6 billion margin for 2001 before any reduction in revenue as a result of the economic slowdown.

Medicare Raid in FY 2001 Assuming Bush Tax Cuts, Budget Resolution Policies and Lindsey Revenue Estimate
(in billions of dollars)

CBO May baseline total surplus	**275**
Social Security trust funds surplus	- 156
Medicare HI trust fund surplus	- 28
CBO May baseline non-Social Security, non-Medicare surplus	**92**
Cost of tax bill	- 74
Cost of other budget resolution policies	- 10
Interest	- 2
Available surplus	**6**
Reduction based on Lindsey estimate	- 23
Raid on Medicare	**-17**

Mr. Lindsey, the chief economic adviser to the President, indicated in a kind of back-of-the-envelope calculation that we could see as much as a $56 billion reduction this year from an earlier baseline. When we adjust that for the more recent baseline, that would mean about a $23 billion reduction, somewhere in that range, which would mean we would be in deficit this year not using the trust fund of Medicare.

Even more serious, I think, is looking ahead to next year. Next year we can see, based on testimony that was provided this committee by three eminent economists, their anticipation of reduced revenue for next year because of the economic slowdown this year, that we could be using all of the Medicare Trust Fund next year and even possibly going into the Social Security Trust Fund by a small margin. So it strikes me that we have questions to ask and to answer.

And I want to emphasize that these numbers are based on just three factors: spending in the budget resolution that has passed, the tax cut, and reduced revenue as a result of the economic downturn. This is not a problem caused by increased spending because no appropriation bill has yet been passed and signed into law.

Now, the figures I am using assume only the spending that is provided for in the budget resolution that was written and passed by our Republican colleagues, by and large, and includes the effects of the tax cut and includes reduced revenues as a result of the economic slowdown.

Now, some have suggested that by reporting these shortfalls, I must be advocating a tax increase this year. That is not the case. I do not think that would be wise policy. That is not my record. I supported a substantial fiscal stimulus this year of $60 billion. I did not support shifting $33 billion of corporate revenues by 2 weeks to make 2002 look better. And that is part of the reason we have got a problem in 2001, that shift of corporate revenues by 2

weeks to try to make 2002 look better. So the issue is not advocating tax increases at a time of economic slowdown.

But looking ahead to 2002 and beyond, I believe the clear question: Do we use trust fund money from Social Security and Medicare to fund other programs of the Federal Government? Remember, for 2002 and beyond, the administration is forecasting strong economic growth. You are not forecasting an economic slowdown next year—and you are not alone in this, the Congressional Budget Office is not forecasting economic slowdown next year. The blue chip forecasters are not. All are projecting fairly strong economic growth.

But we still see deficits in each of the next 4 years if we are not using trust fund money from Social Security and Medicare.

Short- and Long-Term Surplus Outlook

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May total surplus	**275**	**304**	**353**	**400**	**437**	**508**	**576**	**641**	**718**	**806**	**883**	**5,629**
Social Security trust fund surplus	199	172	187	202	221	238	256	275	293	311	330	2,487
Medicare HI trust fund surplus	28	38	41	43	42	45	43	42	40	36	28	397
Available surplus (without trust funds)	**92**	**95**	**125**	**155**	**173**	**225**	**279**	**324**	**385**	**459**	**525**	**2,745**
Cost of tax bill	74	38	90	107	107	135	151	160	167	187	129	1,272
Cost of other budget resolution policies	10	27	29	32	38	42	56	60	64	69	72	488
Possible economic revisions 1/	23	67	---	---	---	---	---	---	---	---	---	67
Interest	2	6	11	19	27	38	50	65	81	99	118	514
Available surplus (short term)	**-17**	**-42**	**-5**	**-4**	**1**	**11**	**21**	**39**	**72**	**104**	**206**	**404**
Bush defense request 2/	-1	12	16	18	20	21	23	24	26	28	33	220
Education spending	0	3	7	10	13	15	18	20	21	22	23	154
Natural disasters 3/	0	2	4	5	6	6	8	6	6	7	7	55
Tax extenders 4/	0	1	4	5	9	14	17	20	22	25	27	145
AMT fix 5/	0	-0	-1	-1	2	12	22	30	39	48	54	206
Possible economic revisions 1/	0	0	22	22	19	16	15	13	12	14	13	145
Interest	-0	0	2	4	6	10	14	20	27	36	45	164
Available surplus (long term)	**-17**	**-61**	**-58**	**-66**	**-74**	**-84**	**-94**	**-94**	**-83**	**-74**	**4**	**-685**
Raid on Medicare	**-17**	**-38**	**-41**	**-43**	**-42**	**-45**	**-43**	**-42**	**-40**	**-36**	**0**	**-369**
Raid on Social Security	**0**	**-24**	**-17**	**-24**	**-32**	**-39**	**-51**	**-53**	**-43**	**-38**	**0**	**-316**

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1/ Economic adjusted in 2001 and 2002 based on estimates by Larry Lindsey and by Goldman Sachs respectively; other years estimated by SBC.
2/ Assumes $18.4 add-alone Bush April budget in 2002 adjusted for inflation in all subsequent years.
3/ Outlays resulting from subtracts of historical average of $3.6 billion per year of emergencies beginning in 2002, adjusted for inflation thereafter.
4/ Includes R&D tax credit, Internet tax moratorium, Roth IRA, Coverdell ESA, and other provisions in the Senate-passed version of H.R. 1836.
5/ Includes "AMT Relief" provision in JCT document JCT-1-'00 R, excluding the treatment of nonrefundable personal credits which is counted with the tax extenders, above.

Perhaps even more serious is that we see these shortfalls before the administration's request for substantial increases in defense spending, before money for natural disasters—and we have just had a rather serious natural disaster in West Virginia—before new money for education, and the Senate has passed almost unanimously an authorization bill for substantial increases for education. And this is before the extension of popular expiring tax provisions, for example, the research and development tax credit. And it is before a fix to the alternative minimum tax, when we all know that the number of American taxpayers subject to the AMT is going to increase dramatically.

So, I repeat, I think this raises the serious question of how we finance the Federal Government going forward. Do we use Social Security and Medicare Trust Funds to fund other programs, especially at a time of economic growth? I think that is especially important given the fact the baby-boom generation begins retiring in 11 years. And we all know at that time—this is from the Social Security Administration—that the surpluses that we now enjoy in the trust funds of Social Security and Medicare turn to significant deficits in the next decade.

Now, I want to conclude by saying some now say that the Medicare Trust Fund surplus does not exist. I would refer them to legislation that every Republican Senator voted for just 4 months ago. Just 4 months ago, every single Republican Senator voted for a measure that had this statement of findings, and the findings were as follows:

"The Balanced Budget Act of 1997 and strong economic growth have ended decades of deficit spending."

No. 2, "The Government is able to meet its current obligations without using the Social Security and Medicare surpluses."

No. 3, "Fiscal pressures will mount as an aging population increases the Government's obligations to provide retirement income and health services."

Four, "Social Security and Medicare Hospital Insurance surpluses should be used to reduce the debt held by the public until legislation is enacted that reforms Social Security and Medicare."

Five, "Preserving the Social Security and Medicare Hospital Insurance surpluses would restore confidence in the long-term financial integrity of Social Security and Medicare."

And, six, "Strengthening the Government's fiscal position through debt reduction would increase national savings, promote economic growth, and reduce interest payments."

I agree with all of those assertions, and I am a little surprised people in 4 short months have changed their position and now say there are no surpluses. I just direct them to the study.

Let's go to those next charts, if we could. I would just direct them—well, we hear repeatedly that there are no Medicare surpluses. I just had a debate on the floor, and the assertion was made again that there are no Medicare surpluses. OMB's own reports show that Medicare Part A is in significant surplus and Medicare Part B is in rough balance. The CBO reports demonstrate the same thing. So I hope we are not debating whether or not there are Medicare Trust Fund surpluses or not.[4]

Let me now turn to my very able colleague, the former chairman of this committee, Senator Domenici, for his statement, and I will just conclude as I began. I think the real question before us and the one we have got to grapple with together is: What is the appropriate means of financing Federal programs going forward? Do we want to be using trust fund moneys at a time of economic growth? I think that is the fundamental question before us.

Senator Domenici, welcome. It is always good to have you here.

Senator DOMENICI. Thank you. I was going to ask, Senator, Mr. Chairman, could we on this occasion, if we have a few members here, before we start with the Director, could we give them 5 minutes?

Chairman CONRAD. Well, our intention was that we would do as we normally do, that we both make opening statements, and then we would go to Mr. Daniels, and then give people a chance during their questioning round to make statements and then ask questions.

Senator DOMENICI. OK. I was asking it as a special favor, but I will not ask anymore.

Well, let me say, Mr. Chairman, I am pleased that you called this meeting. I think it is important that we lay before the American people where we are and what has happened. The first thing I want to say is we did one thing very, very right, and, actually, we had some Democrats helping us, and that was to provide for the tax cut that is currently taking place with about $72 billion being returned to the American taxpayers through the remainder of this year and about 30-some next year.

Now, frankly, I would challenge anyone to propose to the Congress of the United States, this committee, or the American people

[4] CHART NOT AVAILABLE AT PRESS TIME.

that, because the surplus has gotten smaller because of economic shortfalls, we ought to increase taxes now, in the middle of this event. And I know the chairman has just said that he is not for that, and I listened carefully. He said "this year" he is not for raising taxes.

Frankly, I want to go back a little bit in history and share with you what has happened in the past when we raised taxes when the economy was in either in recession or in a downward trend. Let me give you a few examples of this.

First, I think we all remember what happened when Mr. Hoover was in charge of economics in the country. We had a recession, a deficit, recession, a deficit. We don't have any deficit. Whatever implication was that there is no surplus, it is wrong. We have the second largest surplus in the history of America right now. Already that number is there, and it is the second largest surplus.

But when Mr. Hoover decided let's raise taxes to help with the deficit, in the midst of an economic downturn, guess what happened to America? We had the biggest, worst depression in the history of American capitalism.

Now, it is not Keynesian economics, it is not supply economics, if you are talking about raising taxes to fill any kind of gaps that might exist in this budget. It is pure Herbert Hoover economics.

I know the chairman is not talking about that, but there are rumors around that it is the tax cut that got us into this problem. And let me state unequivocally and as simply as I can: The tax cut did not get us in this situation. The budget of the United States is in solid shape. It is the economy that is not in such very good shape. And the economy is not part of the numbers in this budget except for estimates that are either right or not right with reference to what is happening to the economy.

So my second point I would like to say to you personally, Mr. Chairman, while you are saying you are not for increasing taxes and while you have not today said that we are using Social Security or Medicare Trust Funds to pay for Government, you are coming perilously close. And I want to tell you and tell everybody here, as of right now there is no raid on Social Security or Medicare. There are no official estimates that tell us we are going to do that.

The chairman's chart has a very large number of assumptions as to what we will spend that are not necessarily so, and the economics are developed off of one statement made by an economic adviser to the President on the back of a napkin. And from that we are pursuing the notion that the budget is what caused this surplus to go down somewhat in size.

Now, let me repeat: The budget is in great shape. The economy is not in good shape. And the question is: What do we do under those circumstances?

Now, Mr. Chairman, if you think there is something that your side of the aisle could do that is better, I tell you, you have the authority to call a meeting of the Budget Committee. We will be here. We will be here and not delay 1 minute. And you can propose a budget because that is what the law says. You can do a supplementary budget. I would like to know, if you did that, what you would change. It would be very interesting.

Would you, in fact, pick up some surplus by increasing taxes? If so, when? Would you really cut programs beyond the amount that we put in this base budget? I don't think so. And that is one point for you.

And the second one is, if we are raising Medicare or going to touch Medicare and/or Social Security, then I would like to stand up here—and I hope you all can hear me. I would like to say—I will talk very loud. I would like to say, Mr. Chairman, you have the solution to the problem. You have raised the problem, and you singularly have a solution. This is the budget resolution language. This is it. And let me read for you what it says down here, after first mentioning the following: There are reserve funds in this budget. Reserve funds are an invention of the last 7 or 8 years. So I was part of bringing them into birth and seeing that we used them. But each time we said the chairman can release funds, and we put conditions on it. And let me read the conditions on these, which amount to $450 billion—$450 billion not yet spent, not in the budget, subject to being released by our chairman if he deems it appropriate.

But it says, "Legislation described may not, when taken together with all other previously enacted legislation, except legislation enacted pursuant to section 211, reduce the on-budget surplus"—and these are the operative words—"below the level of Medicare Hospital Insurance Trust Fund surplus in any fiscal year."

So if releasing these is going to cause us to touch Medicare, the chairman has the prerogative of saying I will not release them. And, therefore, the problem that is being discussed by the chairman can be eliminated by a stroke of his own hand in just saying we are not going to spend this.

Now, let me also comment about what is happening. What is happening is we have an economy that did not come back as quickly as desired and, in fact, stayed down as compared with the assumptions of the previous administration. They had it higher, higher growth. This administration reduced that and had it at a lower rate. And then CBO had it at even a lower rate of growth. What happened is it stayed under that, and plain and simple, the receipts from corporate America left, because you read every day corporate America is not making money. When they do not make money, they do not have profits. When they do not have profits, they do not pay corporate taxes. And I do not think we will ever change that. I would hope so. It would be confiscatory if we did.

So I close by saying I think the budget is in good shape. I think the economy is not in such good shape. And I think it is very, very important that we do the right thing and send the right signals while this economy is still having difficulty. And the worst thing we could do is to imply that we are not doing well in terms of paying off the debt, that we are not doing well in terms of our surplus. The truth of the matter is this surplus is the second largest surplus we have ever had, and we will be paying down the debt more than we have ever done in history. And that is pretty good, pretty good economics, pretty good message. So I hope we truly are engaged, Mr. Chairman, in an objective discussion of what we might do together in changing things, if changes need to take place.

I for one do not know where we would make major changes in the budget. If I had some, I would recommend them and we could do them together. I just think we ought to be steady on line, stay on the same path we are on, and hope the economy will recover and start growing. If that happens, senior citizens, whether it is Social Security or Medicare, it is the very best thing that could happen to you, for you and your family.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. I will just take a moment to respond, and then we will go to you, Director.

First of all, the surpluses that we have now are trust fund surpluses. It is money from Social Security and Medicare. And that is the issue I am raising. Should we be using Social Security and Medicare Trust Fund money to fund other operations of Government? Because that is what we are poised to do this year and next year and years beyond.

The ranking member, our distinguished former chairman, is exactly right. It would be wrong to raise taxes in an economic downturn. And I apply that to this year or next year if we face economic downturn next year. But the administration and everybody else is not forecasting economic downturn next year. They are forecasting strong economic growth. But the numbers show that even in that context, we are going to be using trust fund money to finance the other programs of Government, and I do not think that is the direction we want to go.

The ranking member's suggestion that the tax cut has nothing to do with our facing a deficit this year, I just do not think that is accurate.

Put up that first chart, if we can, on this year, on 2001. We started with a $275 billion surplus projected. You take out Medicare and Social Security, and you are down to $92 billion. The tax cut costs $74 billion. To suggest that has no role here just is not factually accurate; $74 billion came out of the surplus because of the tax cut.

Medicare Raid in FY 2001 Assuming Bush Tax Cuts, Budget Resolution Policies and Lindsey Revenue Estimate
(in billions of dollars)

CBO May baseline total surplus	**275**
Social Security trust funds surplus	- 156
Medicare HI trust fund surplus	- 28
CBO May baseline non-Social Security, non-Medicare surplus	**92**
Cost of tax bill	- 74
Cost of other budget resolution policies	- 10
Interest	- 2
Available surplus	**6**
Reduction based on Lindsey estimate	- 23
Raid on Medicare	**-17**

And I would remind those who are listening, that was not all fiscal stimulus; $40 billion of it is fiscal stimulus by way of a tax cut that went into the pockets of the American people. But $33 billion was a paper shuffle, a shift by 2 weeks of corporate revenue from this fiscal year to the next fiscal year, because they knew they had a problem of dipping into the Medicare Trust Fund in 2002 without that shift. I do not think anybody can seriously argue that provided

lift to the economy by shifting corporate receipts 2 weeks to mask a problem that they had in 2002.

Finally, the former chairman says to me I can have a markup in the committee on a budget. Well, when he was chairman of the committee, we had no markup. Now he is saying, OK, we are in deficit without counting the trust funds, you have a markup. It is a little late, I would say to my dear friend. It is a little late. We are well into the appropriations process to try to go back and redo what has already been done for this year.

Finally, on the question of the reserve funds, two-thirds of the money is in the prescription drug reserve fund. Is the Senator suggesting that the tax cut was so large that it now crowds out the money for prescription drugs? Is he suggesting that we should not go forward with providing prescription drugs because the tax cut was so big that it crowds out the money that was provided for in the budget for prescription drugs? I do not think so.

It is very clear—and I think it goes back to the question of whether there is a Medicare Trust Fund surplus and whether it is worth preserving, because seven of the eight reserve funds say I cannot release them if the enacted legislation puts us into the Medicare Trust Fund. Somebody who wrote that resolution thought it mattered that you not invade the Medicare Trust Fund. I still think it matters.

With that——

Senator DOMENICI. Mr. Chairman, could I have a minute?

Chairman CONRAD. Certainly.

Senator DOMENICI. I promise I will not use as much time as you did in rebuttal.

Let me first of all say to the members, we had no majority on this committee. There were 10 Democrats, 10 Republicans, very hard to get anything done. You have a majority now, and that is why I alluded to the fact that you could do what you would like. If you would like to change things, you can just use your 11 Senators and go ahead and do it. And I would urge, if you have a solution to a problem—which I do not think exists. But if you have one, then I think you ought to seriously consider making recommendations to the U.S. Senate and to the people for what you would change.

Now, having said that, I want to make one last observation. From my standpoint, this Senator's standpoint, the tax cut has nothing to do with the reduction of the surplus. What had all to do with it is economics, and I will lay before you, for somebody to work up on a piece of paper and give it to us, what if the economic assumptions that are in that budget resolution for these 2 years—I am not talking about in 10 years, these 2 years, this one and next year—were right? The tax cut would have no impact on the surplus because we were expecting the revenue to come in that did not come in.

And I repeat, it is the best time to give people tax cuts. It is the best time for the Government to say let you have it back, let you spend it, let's hope it is part of whatever else is going on in the country that jolts the economy into recovery. And then we will see that most of the problems that my friend, the chairman, assumes are going to happen—we will see that they will all disappear.

Mr. Corzine, I note you there at the end, and I welcome you as a ranking member to the committee. I look forward to discussing issues with you.

Senator CORZINE. Thank you.

Chairman CONRAD. Yes, Senator Corzine has joined us, and he is a new member of the committee, and we are delighted to have him as a member. He has a very distinguished career in finance, perhaps one of the most successful Americans in the world of finance. And so I think he can make a tremendous contribution to this committee.

Senator NICKLES. If he would just make a contribution to the shortfall, we would be done. [Laughter.]

Chairman CONRAD. He will ask you to make, you know, a matching contribution, Senator.

Senator DOMENICI. Just said in jest, Senator. [Laughter.]

Chairman CONRAD. Let me say I think one of the most important things we can do this year is do no further harm. That is my motto for the rest of this year: Do no further harm.

When the Senator asked me what would I have done differently, I presented a budget plan to this committee and to my colleagues that would have avoided this problem. We would not be in this position if the budget plan that I had presented had been adopted. And I think that was a sound budget plan.

Let me just say, I think we should now go to the Director. I again want to welcome you, Director Daniels, and as I indicated in our conversation yesterday, there are some who have suggested we are going to have a show trial here. That is not the way we operate in this committee. Our distinguished ranking member, when he was chairman, did not operate the committee that way, and I am certainly not going to operate the committee that way.

We invite you here to talk about serious issues, ones that we have a joint responsibility to grapple with at this point. And so I welcome you here with respect.

STATEMENT OF HON. MITCHELL E. DANIELS, JR., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DANIELS. Mr. Chairman, thank you, and thank you for convening this hearing. Thank you for your commitment to our common objective of finding that mix of policies that will lead to the real end goal, which is prosperity in America and responsibility in our stewardship of the public's and the taxpayers' funds.

Let me begin this morning by noting the persistence of two, at least to me, striking phenomena that distinguish today's environment from any we have seen: first, a tremendously positive national fiscal condition, despite a nearly stagnant economy; second, a strong bipartisan agreement to preserve very large surpluses as a threshold condition of public finance.

In response to your invitation, I am glad to report that, in stark contrast to past economic turndowns, the Nation's finances are in remarkably strong shape. Even in the midst of a year-long slowdown in the economy, we continue to accumulate enormous surpluses and to use the extra receipts to steadily reduce the Nation's outstanding public debt.

This is a phenomenon without precedent. The almost invariable pattern is for countries to run deficits, often very large ones, during economic difficulty. In all modern U.S. slowdowns, the Nation has run in the red, often by very large amounts.

But in the last few years, a unique bipartisan consensus has arisen in our country, in large part due to the work of this committee. An agreement has been forged to run very large surpluses as a matter of course, in strong economic times or in weak. Both parties and both the legislation and executive branches, in this administration and the previous one, have concurred in maintaining a surplus at least the size of the Social Security surplus.

Many would like to set the minimum surplus level even higher, using as a target the artificial overage in the Medicare Part A Trust Fund. This is a relatively modest difference, amounting to whether the minimum surplus should be more like 8 percent or more like 9 percent of revenues. Now, between these two figures lie some hard disagreements, but that should not obscure the radically different nature of our current situation and the new consensus.

It is fascinating to me to note how far this consensus departs from traditional economic thought. Only yesterday, slowdowns were said to call for deficit finance, for governments to take in less in all taxes than they spent. The Nation conducted a decades-long, spirited debate about the wisdom of a balanced budget amendment to the Constitution. Now, suddenly, we find ourselves in strong and, I would say, healthy agreement on maintaining a fiscal position vastly stronger than the mere balance such an amendment would have required.

Whatever differences may prove to separate us this morning, I hope we can all agree that the matter of most urgency must be the resuscitation of economic growth in our country. We are absorbed in arcane matters, abstractions about surpluses and what counts and what does not. I think for most Americans the question has to do with jobs and income and future economic prospects.

The President and a bipartisan congressional majority agreed to utilize a portion of our surpluses to try to stimulate the economy through tax relief, and that action came just in time. I am submitting for the record the comments of a host of economists forecasting a boost to growth stemming from the tax cut ranging from 3/4 percent to 1–1/4 percent in the second half of this year. Just this week, the Blue Chip Consensus of the Nation's top 50 analysts expressed this view, writing, I quote: "The tax cut effects could not have come at a better time..."

Mr. Chairman, you asked for an update on our fiscal expectations. I can report that we see continued large surpluses at least at the size of the Social Security surplus for all years in the budget horizon. The President is determined to preserve surpluses at this level and to continue using these funds for the steady reduction of outstanding national debt, a cause of which you, Mr. Chairman, are a leading champion.

In the 2001 fiscal year now winding down, let us note that we are dealing with the budget agreed to by the last Congress and the last President. That budget, passed last December, contained the largest 1-year spending increase in history. Obviously, a smaller

surge in spending would have ensured a larger surplus today. But the major reason for a surplus that is merely immense, rather than gigantic, is, of course, a shaky economy.

Due to the dramatic economic slowdown, starting about a year ago but not fully measured until the last few months, revenues for the current fiscal year will grow more slowly than previously forecast—I stress "grow" but more slowly—on the order of plus 3 percent or a little more rather than the expected plus 5 percent or a little more.

On the other side, because our agency was overly cautious in estimating outlay spending rates, 2001 spending looks to be somewhat lower than expected also, so the net change in the surplus will be somewhat less than the drop in revenue. And we simply do not know by how much.

I would also add, parenthetically, we are not sure what the size of the Social Security surplus will be. It may also prove to have been affected by the economic slowdown.

The Social Security surplus makes a good target, we say, for several reasons. The best reason for choosing this surplus target versus any other arbitrary goal is that, as we apply these amounts to debt reduction, which is, of course, what we do with any surplus, we achieve with some room to spare the maximum amount of such reduction possible. Over the next 10 years, Social Security will take in excess funds of some $2.5 trillion, whereas maximum debt retirable, without unjustifiable premium expenses, is about $2.2 trillion. This year, we will eliminate over $100 billion of existing debt, marking the fourth year in a row of such reductions, and further shrinkage is scheduled for each succeeding year. This is an important accomplishment for which both political parties, both branches of Government, and both the last two administrations all deserve credit.

The Nation's finances are in extremely sound condition. Only persistent, long-term economic weakness can threaten this condition, so promoting a return to vigorous growth must be our common objective. The best course forward is clear: first, pass this year's appropriations at the level of the 2002 budget resolution; second, work together to continue restraining total spending in the next few years. Businesses, States, cities, and families have no hesitation to limit their spending when revenues subside. The 50 State governments recently report that collectively they are lowering spending growth from nearly 8 percent last year to around 3 percent in fiscal year 2002. Spending in the Federal domestic agencies exploded during the last 3 years, including growth of 45 percent at HHS and 27 percent at DOT. These Departments can benefit from a period of digestion without great growth beyond these expanded levels.

Restraint does not mean paralysis. We can make room for new initiatives and for reasonable spending growth in good programs by finally becoming serious about the review of antiquated, duplicative, and non-performing programs. Somehow, we must reverse the bizarre presumption, which operates nowhere else in life, that the burden of proof rests with those who challenge any penny of current spending. As in any business or family, the burden must be placed on those accountable to justify the ongoing value of what-

ever money is being spent today. Any healthy organization constantly searches for ways to redeploy money from less efficient to more efficient purposes; we must weed the garden if new plants are to sprout and flourish.

Finally, we must be prepared to collaborate on additional moves to strengthen the economy. The chairman has suggested we should do no further harm. I think, on the contrary, we should be in pursuit of doing further good. This might involve approaches unrelated to fiscal policy; trade liberalization and the alleviation of paperwork or other regulatory burdens come to mind.

Mr. Chairman, I commend your concern in calling this hearing and your vigilance in seeking to make sure that today's hard-earned fiscal vitality is preserved. I am pleased to be able to report the strength of our position, but also to associate with your determination to take nothing for granted and to see that progress continues in both the near and the long terms.

Chairman CONRAD. Thank you very much for your statement, Director Daniels.

Under the previous procedures of the committee, the ranking member and I will each take 10 minutes for questioning, and then we will go to the members, 7 minutes each, according to the precedents that have been previously established here.

First, if we can put up the chart on 2001 again, maybe if we can just briefly talk about 2001 and 2002 and see if there is some rough agreement or where there might be disagreement. I think at the top there really is not—I mean, those are just factual matters in terms of where we started with the surplus in Social Security and Medicare.

Medicare Raid in FY 2001 Assuming Bush Tax Cuts, Budget Resolution Policies and Lindsey Revenue Estimate
(in billions of dollars)

CBO May baseline total surplus	**275**
Social Security trust funds surplus	- 156
Medicare HI trust fund surplus	- 28
CBO May baseline non-Social Security, non-Medicare surplus	**92**
Cost of tax bill	- 74
Cost of other budget resolution policies	- 10
Interest	- 2
Available surplus	**6**
Reduction based on Lindsey estimate	- 23
Raid on Medicare	**-17**

The thing I want to focus on is the question of what kind of an adjustment to the revenue forecast you are anticipating at this point. I understand you had some ideas yesterday that you shared with people. Do you have a disagreement with the conclusion here with respect to a reduction in the revenue forecast this year because of the slowdown in the economy?

Mr. DANIELS. Mr. Chairman, I cannot disagree because we do not have a forecast I think we can rely on yet. I think I can tell you it will be modest. Remember, we are dealing with over a $2 trillion revenue base, so the reduction up there is about 1 percent. It might be 1 percent or 2 percent, I am not sure. It is important, I think, for everybody in keeping our heads here to recognize how small a miss that is.

I have looked back, by the way, at past forecasts, and this year's forecast is going to be much closer than most previous ones. But the base of our affairs is so large now that it does produce changes on this order.

I am constrained to say that we do have differences at the top, however. You know, the idea, first of all, of arbitrarily dismissing the Social Security and Medicare Trust Funds has never been one that I understood. It is like saying Tiger Woods had a very mediocre season if you do not count the Master's, the two Opens, and the PGA. These are massive surpluses.

And, further, let me point out that we have got to be careful about our language. Just as it is, I think, utterly inaccurate to even use the word "deficit" when we are running surpluses on the order of $200 billion, or that neighborhood, I think it is highly inaccurate to use phrases like "go into," "touch," and "use" these funds when we have done that always. The only purpose when you talk about using them for other programs, the other program these funds have been used for and are today is debt reduction. This is a goal we all share. We are only disagreeing about how much debt reduction should occur.

But as we have sometimes said, this money does not go into a vault somewhere. There is not a hole in Paul O'Neill's backyard. There is no mattress in the world big enough. These funds always and still today, when we are in surplus, are used to reduce our debt. A very good thing to do—but not at the expense of a strong economy, and that is why we assert that it was a very essential and very timely act to balance our policy by returning some of the surplus to the taxpayers who sent it in, in order that we might have a return to growth and that we might have surpluses next year and the next year and as far as possible.

So that is my response, and I thank you for that opportunity.

Chairman CONRAD. I am happy to provide that opportunity. I would just say to you it is not that we are not counting the trust funds. We are counting them. But there has been a bipartisan agreement that you alluded to in your statement that it is not appropriate to use Social Security Trust Fund money for other purposes, other than paying down debt. That is a consensus. That is something, as you have mentioned, I have strongly advocated. I think it is also important to provide the same treatment to the Medicare Trust Fund surpluses.

And so if you set those aside, use them for debt reduction, do not use them to fund other programs, that makes sense to me.

Mr. DANIELS. Well, here, too—excuse me, but——

Chairman CONRAD. If I could just finish.

Mr. DANIELS. I am sorry.

Chairman CONRAD. As we look to 2001, I do not think you are differing with the numbers here. The numbers lead us to the conclusion that I think is quite clear, that we are poised to run a non-trust fund deficit; that is, if we are not using trust funds for other purposes, which is a policy goal that I have, and you have at least in part with respect to the Social Security Trust Fund, you can see where we wind up. With the economic slowdown and the size of the tax cut, we show we are running a deficit in 2001 of $17 billion.

Medicare Raid in FY 2001 Assuming Bush Tax Cuts, Budget Resolution Policies and Lindsey Revenue Estimate
(in billions of dollars)

CBO May baseline total surplus	**275**
Social Security trust funds surplus	- 156
Medicare HI trust fund surplus	- 28
CBO May baseline non-Social Security, non-Medicare surplus	**92**
Cost of tax bill	- 74
Cost of other budget resolution policies	- 10
Interest	- 2
Available surplus	**6**
Reduction based on Lindsey estimate	- 23
Raid on Medicare	**-17**

Let's go to the 2002 chart, because economic slowdown I think is one set of circumstances. What most concerns me is we are looking to a period in which we are forecasting strong economic growth. You are forecasting at this point strong economic growth next year. I saw Mr. O'Neill saying that he believed we would see robust return to growth next year. And yet when we do the analysis, just based on the budget resolution that has passed, the tax cut that has passed, and some estimate of economic downturn in 2002 we are using all of the Medicare Trust Fund, and even dipping into Social Security by a little bit.

Social Security and Medicare Raid in Fiscal Year 2002 Assuming Bush Tax Cuts, Budget Resolution Policies and Goldman Sachs Revenue Estimate
(in billions of dollars)

CBO May baseline total surplus	**304**
Social Security trust funds surplus	- 172
Medicare HI trust fund surplus	- 38
CBO May baseline non-Social Security, non-Medicare surplus	**95**
Cost of tax bill	- 38
Cost of other budget resolution policies	- 27
Interest	- 6
Available surplus	**25**
Reduction based on Goldman Sachs estimate	- 67
Raid on Medicare	**-38**
Raid on Social Security	**-4**

Let me turn to the fundamental question, and that is the third chart that shows the multiple years. And you referenced it in your—it really goes to the question that we have to face most immediately, which is the administration's request for $18 billion for fiscal year 2002 that is not in the budget. That means we would go further into the trust funds if we were to pass the administration's request without some offset.

Short- and Long-Term Surplus Outlook

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May total surplus	**275**	**304**	**353**	**400**	**437**	**508**	**576**	**641**	**718**	**806**	**883**	**5,629**
Social Security trust fund surplus	156	172	167	202	221	238	256	275	293	311	330	2,487
Medicare HI trust fund surplus	28	38	41	43	42	45	43	42	40	36	28	397
Available surplus (without trust funds)	**92**	**95**	**125**	**155**	**173**	**225**	**279**	**324**	**385**	**459**	**525**	**2,745**
Cost of tax bill	74	38	90	107	107	135	151	160	167	187	129	1,272
Cost of other budget resolution policie	10	27	29	32	38	42	56	60	64	69	72	488
Possible economic revisions1/	23	67	—	—	—	—	—	—	—	—	—	67
Interest	2	6	11	19	27	38	50	65	81	99	118	514
Available surplus (short term)	**-17**	**-42**	**-5**	**-4**	**1**	**11**	**21**	**39**	**72**	**104**	**206**	**464**
Bush defense request 2/	-1	12	16	18	20	21	23	24	26	28	33	220
Education spending	0	3	7	10	13	15	18	20	21	22	23	154
Natural disasters 3/	0	2	4	5	6	6	6	6	6	7	7	55
Tax extenders 4/	0	1	4	5	9	14	17	20	22	25	27	145
AMT fix 5/	0	-0	-1	-1	2	12	22	30	39	48	54	206
Possible economic revisions 1/	0	0	22	22	19	16	15	13	12	14	13	145
Interest	-0	0	2	4	6	10	14	20	27	36	45	164
Available surplus (long term)	**-17**	**-51**	**-58**	**-66**	**-74**	**-94**	**-94**	**-94**	**-83**	**-74**	**4**	**-685**
Raid on Medicare	-17	-38	-41	-43	-42	-45	-43	-42	-40	-36	0	-369
Raid on Social Security	0	-24	-17	-24	-32	-39	-51	-53	-43	-38	0	-319

1/ Economic adjustment in 2001 and 2002 based on estimates by Larry Lindsey and by Goldman Sachs respectively; other years estimated by BSC. 19-Jul
2/ Bush defense request for 2002 and 2003 from Bush campaign; other years estimated by BSC.
3/ Outlays resulting from extension of historical average of $5.6 billion per year of emergencies beginning in 2002, adjusted for inflation thereafter.
4/ Includes "Permanent Extension of Certain Expiring Provisions" in JCT document JEG-1-144 N, plus extension of higher education deduction in H.R. 1836.
5/ Includes "AMT Relief" provision in JCT document JEG-1-144 N, excluding the treatment of nonrefundable personal credits which is counted with the tax extenders, above.

And the question I would have for you—this is the larger chart, 2002. If we look at the President's defense request, how do you be-

lieve that should be financed? Should we go further into trust fund money or should we offset it by spending cuts in other areas or by new revenue? What would be the approach you would advocate?

Mr. DANIELS. Thank you, Mr. Chairman. I will answer each of the questions, I hope, in the order they were asked.

First, I need to return to the subject—and we have discussed it before—of Medicare and whether it is surplus or not. It is not. This year, Medicare will, as every year, cost substantially more, in this year over $50 billion more than it takes in. Every penny of Medicare benefits will, of course, be delivered. Medicare spending will rise by tens of billions of dollars this year to deliver on those commitments. There is no problem doing that. The President's commitment to doing that is ironclad. This very moment, he is announcing principles for Medicare reform that would strengthen this program and ensure it delivers better health care to older Americans in the future.

Second, I had hoped by now that the whole idea that these funds were being used in any other way had been dispelled, and I will submit for the record, I think, the quite excellent and decisive column of Robert Samuelson in this week's Newsweek and Washington Post in which he speaks very bluntly to this subject.

I would also like to—I believe you talked about calendar year 2001. Let me just observe in passing that if President Bush had been in office last December, I doubt that the Congress would have passed a $57 billion increase, a 1-year increase in spending. If that had not occurred, we might not be having this conversation today. Today's surpluses would be larger by some very large amount.

The defense increase, the amendment to this year's budget, which the administration said from the very outset would be provided as soon as a good accounting of the underfund in defense, of the shortfall, particularly in those aspects which most touch our young men and women in uniform—we are talking about pay, housing, and health care, which makes up the largest portion of that amendment. That amendment can be funded while protecting the Social Security funds for debt reduction, every penny. This, of course, requires that the Congress not breach the other spending limits in the resolution, which we will work to see that does not occur.

Chairman CONRAD. Well, honestly, I do not see that. I do not know how one can come to that conclusion. Our numbers show, just based on the budget resolution that has passed, the tax cut and with some acknowledgment of the economic downturn that has occurred this year, that you are into the trust funds of Medicare and Social Security next year before the President's request for $18 billion more for defense. And so the only conclusion one could come to is that means you intend to finance that out of taking more money from the trust funds.

Is that your intention?

Mr. DANIELS. Clearly not. Our intention is—the President had made repeatedly clear—to start by ensuring a surplus at least at the size of Social Security, retiring debt with that amount.

Your charts assume certain things not in evidence, specifically, additional spending in a variety of areas for which room is made in the budget resolution. But there is nothing more changeable or

discretionary than spending the public's money. And I would be happy to point out both as to 2001 and 2002 that the President submitted billions of dollars in recommended reductions, which so far the Congress has not shown a willingness to support. If we want to further strengthen the surplus as we move into 2002, a great place to start is by dusting off some of those which have so far not met the approval of congressional committees.

Chairman CONRAD. Well, I would just say to you that the only spending assumptions that are in my numbers are the spending directed by the passage of budget resolutions that were written and passed by your Republican colleagues here in the House and the Senate. And that is what leads us, that combined with the tax cut and the economic downturn, to our conclusion that we will be into the trust funds next year of both Medicare and Social Security, and that your defense request just puts us further into those funds. And I think that is a serious question before us. I do not think that is the right way to fund increases in defense—increases, by the way, which I support.

I turn now to our——

Mr. DANIELS. May I add just one more response? I would like to say that I think one of the most welcome statements made this morning, Mr. Chairman, was yours, the comment you made that this is no time to be thinking of tax increases that might further weaken a struggling economy. I think this is extraordinarily important, and I commend you and I know the President would want to commend you for that statement.

This leads, then, to the implication that to protect ourselves and to make sure that next year's huge surplus is as huge as we would all like it to be, we have got to work harder on the spending side of the budget. And we stand ready and I have a number of ideas that we will be sharing with you this fall, and, of course, as the next budget is put together.

Chairman CONRAD. All right. Senator Domenici?

Senator DOMENICI. Mr. Chairman, I am going to let some of our members go next, and Senator Nickles was next. Actually, Judd Gregg was here, but he is gone. I yield to let you go next, and then let's let the next Senator on our side go, and we have three of ours and then I will come back.

Senator NICKLES. Senator Domenici, thank you very much, and, Director Daniels, thank you for your testimony. I would just make a couple of comments.

It is interesting. I remember Bill Clinton campaigning on "It's the economy, Stupid," and I look at the economy, which is the reason why we are really having this meeting today. And I notice that the economy in the second quarter of 2000 was growing at 5.6 percent, and in the third quarter of last year at 2.2 percent, the fourth quarter at 1 percent, the first quarter of this year at 1.2 percent, and still pretty flat. And that is the difference. That is the difference. Except for Director Daniels also mentioned something in responding to your question on defense. He said, well, last year, we had a spending spurt. We did not have a budget last year. We ignored the budget last year. There was a spending spree, and it was not in defense.

Defense spending—correct me if I am wrong—grew at 3 percent, nondefense spending grew at 12 percent. And so there was a spending surge last year, but it was not in defense. It was in other areas, and I think in a way that was irresponsible.

I will just mention a couple other things. So the economy is flat. I happen to agree with the statement Congress did right by passing the tax cut to help give some lift to the economy. We still have enormous combined surpluses. Senator Domenici mentioned we are still running surpluses over $200 billion, or in that neighborhood. That is a lot of surplus, with tax rates at an all-time high.

And so we made some changes, I think pretty small changes. Maybe we should do some more. If we really want to stimulate the economy, if we want to help lift the economy, let's make a capital gains reduction. Let's make the tax cut permanent so people can count on it and have, I think, a positive impact.

So I would just say thank goodness that we did the tax cut. I agree with Senator Domenici. It was timely, it was important, it was probably too timid. So let's make it permanent and let's do something on capital gains, let's do something on depreciation schedules to allow people to depreciate property over the real lives. And I think that would help the economy.

Now I will make just a couple comments. I do not worship at this shrine of Medicare surplus. That is a facade that is—I do not know what it is, a political phony argument. There is not a surplus in Medicare. Medicare is spending right now—total Medicare funds last year, Part A raised to 150 in taxes, that is your 2.9 percent payroll tax, 1.45 on individuals and doubled by employers, Part B premiums, 24, for a total of $174 billion. Total Medicare spending was $262 billion. That is a cash deficit of $88 billion. So there is not a surplus.

You might say, well, I keep hearing about this HI surplus. Well, that was in Congress, President Clinton's proposal, let's take home health and move it out of Part A and put it into Part B because that is subsidized. That is paid for mostly by direct funds.

Well, if you want to keep the surplus in HI, let's just say we are not going to pay for hospitals. Let's put that over in general revenues, and then we keep the HI surplus. Or let's say all the hospitals west of the Mississippi. It made about as much sense as we did on home health. It is just a paper accounting gimmick.

Medicare is paid for by a payroll tax, and it is a big payroll tax. It is an enormous payroll tax because of the tax increase passed by Bill Clinton and the Democrats in 1993 to make it 2.9 percent on all income. It used to be based on Social Security base, and now it is on all income.

You mentioned Tiger Woods. He pays a lot of Medicare.

Somebody just signed a contract with the Capitals. He is going to make $21 million. That is $10 million a year, $10 million a year, they are paying $290,000 in Medicare tax. That is a lot of tax.

So Medicare taxes have gone up, and actually, in spite of the fact that Medicare taxes have gone up, the total Medicare payments exceed the taxes coming in. So I do not think it makes a lot of sense. We can rewrite the language and say, well, this does not go into the—this is not paid for by the trust fund, certain items, and, therefore, the trust fund is made solvent. That is what President

Clinton did. It makes no sense. That is a paper accounting and maybe if it makes politicians feel good, I think so be it. But it does not really work.

I could go on a little bit. I just think "It is the economy, Stupid." The economy's growth went down to 1 percent, and it was forecast by the Clinton administration, it was forecast by others to be at 3 or 4 percent. And it is our responsibility to do what we can to see if we cannot get it back up. And let's try to do that. And can we do it? And I happen to think some changes in policy like capital gains reduction, permanent tax cuts, maybe some realistic depreciation schedules would help us do that. I would like to see us do that. But I think worshipping at this, trying to protect the $28 billion trust fund that some people are talking about is just a paper accounting gimmick that is not real budgeting. So I would just make that comment.

Mr. DANIELS. If I may respond just briefly, Senator, I do not tend to associate with that view. To me, there are some very mystifying things about the way that Washington has looked at this question—and maybe it helps to be a man from Mars who did not live here over these last years.

For instance, we start with the fact that Medicare is not in surplus, but moving beyond that, I ask myself why this particular surplus achieves sacred status. What about the military retirement surplus, the trust fund? What about the Civil Service retirement Trust Fund? We have 114 that I can count trust funds in the Federal Government; why are those less important? The answer is they are not. We are equally devoted to our civil servants' security, to our military retirees' security, but we have not arbitrarily said that we would add that to every year's surplus. And if we did, what would be the effect? The same as happens now—we would take that amount and send it—to whom—to bondholders.

The implication of some sides to this debate is that instead of sharing some of the surplus with the taxpayers at-large in order that we might have surpluses in the future, we should have sent it to bondholders instead. Who are these people, incidentally? It is interesting to me. Thirty-six percent are foreign banks and foreign holders. Of the Americans who own these bonds, the famous top 1 percent own 43 percent. The top 10 percent by income own 86 percent.

Why it would be better policy to send the amount of Medicare Part A to those bondholders here and abroad as opposed to leaving that money with the taxpayers who paid it in the interest of a stronger economy is, to say the least, unclear.

Senator NICKLES. I appreciate that.

I was going to make just one other comment, because I know my time is almost up, and that deals with Social Security. I think it is a little regressive to say we are going to take the surplus in Social Security and use it just for debt retirement. I would much prefer taking that surplus in Social Security and putting in personal savings accounts where individuals own it and control it and invest it than to have a regressive tax used as our primary vehicle for debt reduction.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator, maybe I could just show you a statement made by Senator Domenici 3 years ago on the question of Medicare surpluses——

Senator GRAMM. Mr. Chairman, how many times are you going to get to speak before anybody else gets to speak?

Chairman CONRAD. Everybody is getting a chance to speak, Senator.

Senator GRAMM. Well, this is the fifth time you have spoken. I have not spoken.

Chairman CONRAD. You will get your chance just as everybody does. As you know, the chairman has a right to answer questions that are raised as we go forward, and just as Senator Domenici did when he was chairman, I will exercise that same prerogative.

This is what Senator Domenici said 3 years ago: "For every dollar you divert to some other program, you are hastening the day when Medicare falls into bankruptcy, and you are making it more and more difficult to solve the Medicare problem in a permanent manner into the next millennium."

Senator Domenici was right then and was right to have made that point. The idea that there are no surpluses in Medicare is contradicted by the reports of the Office of Management and Budget, or contradicted by the reports of the Congressional Budget Office. They report clearly that we have a surplus in Part A, we have rough balance in Part B, and that in fact——

Senator NICKLES. Mr. Chairman——

Chairman CONRAD [continuing]. Let me conclude—Part A is financed by payroll taxes. That is in surplus. Part B, by Congressional action, is financed by 25 percent coming from those who pay premiums, 75 percent from the general fund.

And if we follow the logical argument of our colleagues on the other side who are saying there is too little money in Medicare, the obvious conclusion is that you would need to save more, not save less; and yet what they are suggesting is to save less, which makes no earthly sense that I can see.

Senator HOLLINGS.

Senator HOLLINGS. Mr. Daniels, let me first establish some bona fides with respect to truth-in-budgeting. Senator Gramm and I back in 1985 established just that, a budget process whereby the amount appropriated had to conform to the amount of the budget resolution. Otherwise, we said it is a request to cut right straight across the board. And it was sold on the idea of truth-in-budgeting, and very, very, importantly, it was bipartisan.

I worked the Democratic side because the Democratic majority leader, the Democratic whip, and the Democratic chairman of this Budget Committee opposed that initiative. Yet we got the majority of Democrats up and down on 14 successive votes.

So we had truth-in-budgeting. And now I am here this morning listening to these statements. First, I did not think you would have the gall to use the word "surplus"—you did not use it in your statement, but in the newspaper here just on Monday, along with your picture, it says "The surplus has declined from being gigantic to mainly immense."

Then, I heard you say "enormous surplus" and "preserve the surplus" and the "remarkably strong shape" that we are in. And then,

I see where you say "I can report that we see continued large surpluses for all the years in the budget horizon"; and then, "massive surpluses": and then, to the extreme, you say "It is dangerous to use the word 'deficit'."

Well, let us go to your report. Here is your budget, given just a couple of months ago, on page 241, and you show that the total gross Federal debt goes from $5.6 trillion to $7.1 trillion, or up $1.5 trillion. That is page 241 of your document, showing the debt increasing.

You use the expression, too, that the surpluses are used "to reduce the debt." No. Not under Director Daniels' document. All of the so-called off-budget surpluses, Social Security, Medicare, military retirees, and so on, are computed, and still the gross Federal debt goes up. The debt has not been going down in the last few months; it has been going up. We had it going down for 8 years, and they say they got it in shape. We fought for those votes, and we could not get a single Republican vote.

And yes, we raised taxes. We taxed Social Security; we taxed gasoline; we cut the size of Government over 300,000 slots, and we cut spending over $380 billion. And we had a good 8-year slide—do not run back around when they started this tax cut nonsense, to have the audacity to cut $74 billion out of revenues and say it has no effect. Well, look at the effect it is already having.

Now, here we go. "The Debt to the Penny." I want you to look this up on your computer. You ought to get in step with the Treasurer of the United States. Under law, he publishes this regularly, and it is put on the internet. The debt to the penny has gone up since the beginning of the fiscal year $36 billion.

You say it is dangerous to use the word "deficit"; I am saying it is dangerous to use the word "surplus". I cannot find any surplus. I cannot find any in the actual fact, in the actual document.

Now there is a game played, and I understand that game, because I have watched it over here on both sides and in the Congress. It says the debt held by the public has gone down $136 billion, but the debt held by the Government has gone up $173 someodd billion, so it comes out to a $36 billion increase in the debt.

So that counting all the so-called surpluses that we have had a yin-yang about up here, whether it is there or it is not there or whatever it is, I can tell you the Treasury has spent every bit of it and still comes up with an increase in the debt.

Specifically with respect to Social Security, I am worried about your credibility. We had a knock-down, drag-out a little over 10 years ago, and this committee voted 19-to–1 to put Social Security off-budget. We said that under law. It was later signed into law on November 5, 1990 by George Walker Herbert Bush. Section 13.301 said that you could not use—that is you, the executive, the President could not—and the Congress could not use Social Security in citing their budgets.

And you have already seen by this particular figure here that if it is $173 billion, the Government debt has gone up, and you have already gotten into Social Security as of the 11th of July or whatever today is. And we are talking about what may happen next year and what may happen later this year and so on. And has the director of the budget come forward to say it is dangerous to use

the word "deficit" when I cannot see any surplus—of course, like with two credit cards, you can use your Master Card to pay off your VISA, but you still have the same debt. You can play games with the American public over this on TV, because they do not understand it, and they have already turned off this program and gone to something else, hopefully.

But in any event, that is a good one to make a record and keep talking about the word "surplus," but all of these surpluses have been expended. That is what the Greenspan Commission said on Social Security, for example. It is section 21. Look at it back in 1983—put Social Security off-budget. It was my amendment, and I had to fight from 1983 to 1990; it was a 7-year fight, but we finally got it into law, and now we have the director of the budget coming up here, talking surpluses.

And let us talk about taxes——

Chairman CONRAD. Senator, could I just remind the Senator——

Senator HOLLINGS. Let me use some of your time as a former chairman, Mr. Chairman. [Laughter.]

Chairman CONRAD. Let me just say——

Senator HOLLINGS. Let me just complete the thought, and I can complete it very quickly and have the gentleman comment.

With respect to taxes, I was here when we balanced the budget last. We paid our way. That is all that I am worried about. We are not paying for the Government we spend for, and we are not paying. I was there under President Johnson when the interest cost was only $16 billion; it is now $366 billion. That is $350 billion interest taxes. For a sales tax, I get a school; for gas tax, I get a highway; for interest taxes, I get absolutely nothing. And you are talking about this budget being in good shape, when we find that we have already gone into the red?

I would appreciate your comment.

Mr. DANIELS. I appreciate your question, Senator, and we all recall well your leadership over the years, from the eighties on, in pursuit of greater fiscal discipline.

Once again this morning, you have directed our attention to the difference between outstanding debt and the so-called total debt. The total debt, which by every other budget convention is not viewed as the operative measure of surplus or deficit, as opposed to our annual intakes and outflows, but it has a very important purpose, and it is important that you frequently bring our attention back to it. That purpose is that it reminds us of the currently unfunded promises that the Nation has made, principally in the area of Social Security and Medicare, and it is why, for instance, this very morning, the President is at the White House urging fundamental Medicare reform. Later, he will be urging fundamental Social Security reform.

We cannot tax our way to those promises. It will be impossible. We need reform to do it, and we need to act quickly so that that reform can be timely and moderate in its form.

And when I say, as I have on some occasions, that to talk in a different context of a Medicare surplus as "dangerous," my principal reason is that I believe that deluding ourselves that Medicare runs a surplus when it plainly does not is an invitation to pro-

crastination. It is an invitation to put off for years the reforms which are fundamentally needed now.

I will put up just once more for the record a chart that documents more or less what Senator Nickles brought to our attention earlier. This is the 10-year outlook for Medicare. Medicare was always designed to draw on the general revenues. This should come as no surprise to anybody, but I think it does——[5]

Senator HOLLINGS. Mr. Chairman, I know my time is up, but I never asked you about Medicare. I asked you about the overall debt. Is it up or down? Is it in surplus or in deficit?

Mr. DANIELS. The national debt, on which we pay interest—and incidentally, thank you for pointing out the burden of interest taxes—that is coming down, and that interest cost that you talked about is dropping very quickly. It is one of the things that will help us to keep a surplus in years ahead.

The total debt, which measures our actual outstanding debt plus our unfunded promises, remains very high and has even crept up. That is not an argument to further punish a struggling economy with taxes. Quite the contrary—it is an argument to strengthen that economy any way we can and to reform the programs that need to stand behind those promises.

Chairman CONRAD. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Senator DOMENICI. Senator Gramm, would you give me just 1 minute?

Senator GRAMM. Sure. It is your time.

Senator DOMENICI. I do not know how much longer we will have the Senators who are here, but since my chairman used a second time through to respond, I want to just take a minute to say that if you asked me to summarize why we are here and what we ought to be doing, we are here because the economy of the United States needs to recover more rapidly and stronger—or, putting it another way, we are here because the American economy is faltering. There are a lot of reasons—no growth in the world—there are plenty of reasons. But the truth of the matter is we ought to be using our talent to figure out what we can do to help the recovery grow and to do the most for its acceleration and for prosperity.

I believe the most important issue going is to keep the tax cuts in place and maybe to even look at some other tax cut that might generate growth. We could have put a chart up here that assumed the economics from the budget resolution and those that may be occurring now, and all the difference that we are talking about here is the difference in those two numbers—growth predicted and growth actual. There would be nothing else different in them.

So what are we going to do? Are we going to increase taxes to do it? Frankly, I think that that is what we should be looking at, and I urge that the committee look at it seriously.

Chairman CONRAD. Senator Gramm.

Senator GRAMM. Mr. Chairman, thank you.

First of all, let me congratulate you. You are the only living Democrat who has ever presided over the Budget Committee when the Congress did not spend every penny of the Social Security sur-

[5] CHART NOT AVAILABLE AT PRESS TIME.

plus and every penny of the Medicare surplus as you define it. That is quite a distinction, and I congratulate you.

My concern, however, in listening to you is that that is all about to change; that every word that you have spoken since you have become chairman has been that this is all about change, and we are about to spend these things.

I took the chart that you used the other day on the floor and tried to figure out why all this is happening. First of all, you assume a recession and an economic downturn, and we may be in one. We will know when we collect the data, and the distinguished head of the OMB will tell us his estimate, and the CBO director will tell us his. But first, you assume a downturn. We do not have a firm fix on it yet.

Second, you make the extraordinary decision that when we are in the midst of providing prescription drugs for seniors, we can use any funding source in the world except Medicare; that we have got to use every penny of Medicare to pay bondholders, and we cannot use any Medicare funding to fund Medicare benefits.

Now, you will have a hard time explaining to my 88-year-old mother why some rich bondholder in Zurich deserves her Medicare funds more than she deserves them in prescription drugs.

But the most startling thing you assume is one of the most massive spending sprees in American history. When you come down here to your other assumptions—and notice this says "possible long-term" scenarios by Senator Conrad—you then have a list that adds up to the whopping total of $1.089 trillion of new uses of money that are not in the budget that Senator Domenici presided over.

So that obviously, if you assume a downturn, and you assume a new use of $1.089 trillion, you can create one hell of a deficit problem no matter how big the current surplus is.

I would say that first of all, I urge the chairman to use his unilateral power to just say no. The chairman controls unilaterally about $450 billion plus, and by simply saying no, he can stop it from being used. And I urge him, if he really believes that, given the state of the American economy, paying down more debt is more important, I urge him to use that unilateral power.

Second, if we are really concerned about the level of debt reduction, I cannot understand why we would conduct a policy that would use another $1.089 trillion of it. I am afraid that what I keep hearing underneath all of this good rhetoric about trust funds is that we need smaller tax cuts, and we need more spending.

It seems to me that in the end, that is the policy that is being proposed, and it is an intellectually honest proposal—I just do not think people support it in America—but it is something that we are going to get to debate.

Finally, before I run out of time, let me make a point about these so-called trust funds. It is the cruelest hoax ever perpetrated to say that somehow, we are protecting Social Security money for Social Security. Everybody knows it is not true. Not one penny of this surplus has gone to help Social Security—not one penny. Not one penny of it has gone to any use that will help us pay benefits in the future.

In fact, I have a quote here from Bill Clinton explaining why these phony IOUs in West Virginia do not pay benefits, and he sums up by saying that, basically, these IOUs "do not have any impact on the Government's ability to pay benefits."

The cruel hoax is that we are stealing every penny of Social Security surplus, and if you believe there is a Medicare surplus, every penny of Medicare surplus to pay down debt, but not the debt of Social Security and not the debt of Medicare—the debt of the Federal Government. Is that not pilfery? I say it is.

What should we be doing? We should be taking that surplus and investing it in the name of the people who pay into these programs so that we have assets to pay benefits in the future. But it is a cruel hoax to claim that by just paying down debt, we somehow have the ability to pay claims in the future.

Let me ask in my final moments here, Director Daniels, the following question. First of all, I assume you believe that, given the knowledge we had when we wrote the budget, our decision to follow Senator Hollings' proposal initially to move the tax cut into the present was a good decision economically.

Mr. DANIELS. Oh, yes, sir.

Senator GRAMM. In fact I would be willing to say—I do not know whether you would be—that if I believed—and I may very well believe; the chairman may be right—that we are facing a slowdown where we are going to have a bigger revenue shortfall than we anticipated, I would think had I known that that I would have cut taxes more, not less.

Would you have followed that same approach?

Mr. DANIELS. One can certainly say that the risk that should most concern us all and, really, the only risk to our long-term positive surplus, positive fiscal picture, is a prolonged economic downturn. So all measures that might combat that ought to be considered, and in my testimony, I suggest that that is really what should absorb us here today.

Senator Hollings is probably right—anyone so bereft of something better to do than to watch this hearing on television may have switched it off by now.

Senator GRAMM. I hope not.

Mr. DANIELS. If they did, it might be because we have spent an awful lot of time talking about abstractions like surpluses and so forth and not enough time talking about jobs and income and the economic growth that I think Americans are looking to us all to foster. And that economic growth and that alone gives us a chance to enjoy these surpluses in the future and debate how to use them.

Senator GRAMM. Well, Mr. Chairman, let me say that I intend to support you in your effort to control spending. When you raise points of order against things that bust the budget—and I assume you will do it if people propose to spend more than $300 billion in Medicare—count on my support. But I think that when we tell people that we are going to protect all these surpluses, we had better be ready to do it, and I think the obvious next question is what are we going to do to fix these problems. And I am eager to work with you.

Chairman CONRAD. I thank the Senator.

I would ask the Senator from Michigan for a minute of her time.

Senator STABENOW. I would be happy to yield.

Chairman CONRAD. The Senator from Texas holds up one of my charts but misrepresents it. This chart shows that we are already into the trust funds in the next 4 years only based on the spending in the budget resolution written and passed by our colleagues on that side of the aisle and with the tax cut and with modest assumptions about the effect of the economic downturn. That is before any additional spending, before any appropriations bills have passed; just based on the assumptions of the spending that our Republican colleagues voted for.

Short- and Long-Term Surplus Outlook

($ billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-yr
CBO May total surplus	**275**	**304**	**353**	**400**	**437**	**508**	**578**	**641**	**710**	**806**	**883**	**5,629**
Social Security trust fund surplus	156	172	187	202	221	238	256	275	293	311	330	2,487
Medicare HI trust fund surplus	28	38	41	43	42	45	43	42	40	36	28	397
Available surplus (without trust funds)	**92**	**95**	**125**	**155**	**173**	**225**	**279**	**324**	**385**	**459**	**525**	**2,745**
Cost of tax bill	74	38	90	107	107	135	151	160	167	187	129	1,272
Cost of other budget resolution policie-	10	27	29	32	38	42	56	60	64	69	72	498
Possibla economic revisiona1/	23	87	---	---	---	---	---	---	---	---	---	67
Interest	2	6	11	19	27	38	50	65	81	99	118	514
Available surplus (short term)	**-17**	**-42**	**-5**	**-4**	**1**	**11**	**21**	**39**	**72**	**104**	**206**	**404**
Bush defense request 2/	-1	12	16	18	20	21	23	24	26	28	33	220
Education spending	0	3	7	10	13	15	18	20	21	22	23	154
Natural disasters 3/	0	2	4	5	6	6	6	6	6	7	7	55
Tax extenders 4/	0	1	4	5	9	14	17	20	22	25	27	145
AMT fix 5/	0	-0	-1	-1	2	12	22	30	39	48	54	206
Possibla economic revisiona 1/	0	0	22	22	19	16	15	13	12	14	13	145
Interest	-0	0	2	4	6	10	14	20	27	36	45	164
Available surplus (long term)	**-17**	**-61**	**-58**	**-66**	**-74**	**-84**	**-94**	**-94**	**-83**	**-74**	**4**	**-685**
Raid on Medicare	**-17**	**-38**	**-41**	**-43**	**-42**	**-45**	**-43**	**-42**	**-40**	**-36**	**0**	**-369**
Raid on Social Security	**0**	**-24**	**-17**	**-24**	**-32**	**-39**	**-51**	**-53**	**-43**	**-38**	**0**	**-319**

1/ Economic adjustment in 2001 and 2002 based on estimates by Larry Lindsey and by Goldman Sachs respectively; other years estimated by SBC. '00-Jul
2/ Assumes $18.2 will alone Bush April budget in 2002 adjusted for inflation in all subsequent years.
3/ Assumes $5.5 billion in emergency spending in 2002 adjusted for inflation in all subsequent years; beginning in 2002, adjusted for inflation thereafter.
4/ Includes "Permanent Extension of Certain Expiring Provisions" in JCT document #51-1-144-R, plus extension of higher education deduction in H.R. 1836.
5/ Includes "AMT Relief" provision in JCT document #51-1-144-R, excluding the treatment of nonrefundable personal credits which is counted with the tax extenders, above.

Senator GRAMM. What about——

Chairman CONRAD. Let me complete. I did not interrupt the Senator.

Senator GRAMM. All right. You are right.

Chairman CONRAD. Then, the Senator adds up a number of other items and talks about the trillion dollars of spending and says that that is the Senator from North Dakota's proposal, the Budget Committee chairman's proposal. This is not my proposal.

The first item is the Bush defense request. They have asked for $18 billion in 2002 that is not in the budget that would come out of the trust funds. That is the question that is being raised here. Does that make sense? Is that the way we ought to pay for additional funding for defense?

The second item is education spending. It is not in the budget, but we passed on the Senate floor by an almost unanimous vote an authorization for more than $300 billion of new money. It is not in the budget. How should it be funded? Should that come out of the trust funds? I do not think so.

The third item is natural disasters. It is not provided for in the budget, but typically, we fund $5 to $6 billion a year for natural disasters. Should that come out of the trust funds? I do not think so. But that is what we are poised to do.

The fourth item is the extension of popular expiring tax provisions. Those are tax cuts. It is not a spending item. It is a tax cut. It is not in the budget. If we do that, where is the money going to come from? Is it going to come out of the trust funds? I do not think it should.

The next item is fixing the alternative minimum tax. That is not a spending program. That is to keep people from paying more in taxes who are about to find they are in for a big surprise. They are going to have their taxes increase. We are going to go to 35 million people in this country caught up in the alternative minimum tax, and it will cost $200 billion to fix it.

Finally, economic revisions. That is not spending. That is a reduction in revenue because of a weakening economy.

The fact is that if you put it all together and add it up, you see that you are deeply into the Medicare Trust Fund—in fact, you eliminate it—and you are deeply into the Social Security Trust Fund. And the result of doing that is that you hasten the insolvency of those funds. They go broke sooner.

Now, some apparently do not care about that, but I do. I think it really matters to real people. That is the question. The question is are we going to do something looking ahead, not in a time of economic slowdown, but at a time when the administration forecasts and projects strong economic growth. Are we going to fund other programs of the Federal Government out of the trust funds? I do not favor it.

The Senator from Michigan.

Senator STABENOW. Thank you, Mr. Chairman.

First, Director Daniels, we appreciate your coming before the committee again.

Mr. DANIELS. Thank you, Senator.

Senator STABENOW. I appreciate your service, and——

Senator DOMENICI. Would the Senator from Michigan yield for 30 seconds?

Senator STABENOW. I would be pleased to do so.

Senator DOMENICI. I want to say, Mr. Chairman, that Senator Bond obviously is next on our side—he is the only one left—and I am going to turn the meeting over to him at this point, and he will sit here until he is finished and for perhaps as long as you all are going to take.

I thank you for the hearing. I wish we could go through an alternative set of projections, but we will do that the next time you have a meeting and show the public why we are where we are. There is just no question that the economy is not growing, and anybody who says it is anything else is just deceiving the American people.

With that, I thank you very, very much.

Chairman CONRAD. Thank you. I do not think anybody is trying to deceive anyone. The fact is the weakening economy is absolutely a part of it.

There are three parts. There is the budget resolution that was passed, the spending that is contained in that. That was written and passed by our friends on the other side of the aisle.

There is the tax cut that was primarily supported by those on the other side of the aisle, and there is the weakening economy.

Those are the reasons. It is the three of them working together that we have a difficulty.

The Senator FROM MICHIGAN.

Senator STABENOW. Thank you, Mr. Chairman.

Obviously, Director Daniels, this is a very important topic for all of us. We all feel very strongly about how we proceed for the country. We appreciate your service. I have a different perspective than you do, but I think we all care very deeply about making the right choices.

I have a couple of questions for you this morning. First, to followup on the chairman. He listed items not included in the budget resolution but ones that we assume will be reported by the admin-

istration, in fact, some put forward by the administration. I would ask if you would respond to the chairman's list, if there are items that you disagree with—the President's defense request, education spending, natural disasters, the extensions like the R and D tax credit, fixing the AMT, possible economic revisions or interest. Are there areas where you would disagree with what the chairman has indicated will be additions to the budget?

Mr. DANIELS. Not in large part, Senator, but I think this illuminates a very important point. There is a reason why those items are there; the Congress voted to project these possible increases into the future, and that is because most of them represent new needs of the country.

I think the single biggest quarrel I would have with the approach that the chairman laid out, the single biggest dubious assumption—or, to me, challengeable assumption—is that the starting point is sacrosanct—almost $2 trillion of spending that it will trundle on and in fact grow with inflation, unchallenged, uncorrected, and no redeployment to these new purposes.

This is something that we must all work on very hard together. Again, I salute the chairman's repeated point that it would be folly to raise taxes at a time when our biggest problem is a sputtering economy. And if we turn our attention, then, to the spending side, our common goal ought to be to make room for these items, as many of them as can be accommodated, by working harder on the embedded base of spending, much of which is encrusted with obsolete, nonperforming, duplicative programs.

I am sorry, just one last point which I hope is responsive. Nothing is more discretionary in the hands of the Congress and this committee than spending the taxpayer's dollar. As I pointed our earlier, if anyone here had been so prescient just 7 months ago to be worried about these subjects, there was a remedy at hand. Congress did not have to increase spending by the biggest amount in national history—$57 billion. If that growth had only been—pick a number—half that size, we would not have this concern this morning.

So we always have it in our power to make choices that enable us to do those new things the Nation needs and still preserve economic growth and fiscal integrity.

Senator STABENOW. We certainly understand and agree that we have choices. I was proud to be here in 1997 when we balanced the budget for the first time in many, many years—many decades, actually—and actually have reduced spending as well as taxes overall. I think that that has been very positive and has, frankly, been the basis for the economic growth, paying down the debt, and bringing interest rates down.

I will look forward to your offsets. If you are assuming that the items the chairman has listed will have offsets in terms of cuts in other parts of the budget, we certainly will look forward to your recommendations equalling these areas in terms of cuts.

I have two other points. First, with all due respect, I could not disagree more with the notion now of changing what is an over 30-year policy of designating a Medicare Trust Fund. As we all know, Medicare was put in place in 1965. Since that time, at least on a yearly basis, there have been reports that have been reported every

year to the Congress about the solvency of the Medicare Trust Fund.

I was quite interested that my good friend from Texas now calls what is an over 30-year policy of Medicare Trust Fund Part A a "cruel hoax." It is interesting to have changed that policy. We have had many Presidents; they all talked about the Medicare Part A Trust Fund over that 30-year period, and I do not believe any of them, Republican or Democrat, believed that they were perpetrating a "hoax" on the American people.

But now, we find a difference. Rather than putting forward what we would like to see, which is protecting Medicare and Social Security and using it only for debt reduction, which strengthens the economy and guarantees we then have the capacity in a stronger way to be able to meet those obligations, we have seen since the beginning of this year the President's budget come forward and talk about Social Security but not Medicare. And I have been deeply concerned that when we looked at the initial budget, it showed Medicare basically being transferred into a contingency fund and spent on other things—not on debt reduction but on things other than Medicare.

I would also suggest that the Medicare Trust Fund—we certainly have many trust funds in the Federal Government, but I am not sure there is any that will see such an explosion of costs or people coming into it and obligations being incurred in 2011, just 10 years away, when we know that those of us baby boomers and other will be retiring. We have major commitments and a promise that was made to the American people regarding Medicare and the funds being available. So we will have great pressure. And if anything, with all due respect, your chart shows the deficit if you add Part A and Part B. I would suggest that if that is the case and we believe in Medicare and having those services available, the approach should be to add to Medicare, not to take away from Medicare. When you have a deficit, you do not further create a deficit, which is what is happening. Under all the numbers that I have seen, we see a dramatic, dramatic moving up of that insolvency date of Part A under the plans that we have talked about.

So I could not disagree more with this approach, and I would just ask my question now, which is this. Given all of this debate, how at this point would you react to a notion that Senator Evan Bayh and Olympia Snowe and myself and others put forward on the Senate floor of an economic trigger that guarantees we do not dip into Medicare and Social Security, that we maintain our deficit reduction targets as we proceed with tax reductions or spending.

It seems to me that an idea that got 49 votes on the Senate floor, Mr. Chairman, for some kind of economic trigger and protection should be resurrected at this point given the threats to Social Security and Medicare. So I would like to know if the director would support us revisiting that issue.

Mr. DANIELS. Thank you, Senator.

Let me get to that question by touching on a couple of the other points you made.

I think our starting point here is one of I suppose unanimous agreement that Medicare is a sacred trust; that again this year and every year that President Bush is here, every penny of Medicare

benefits will be delivered, every penny collected for Medicare will be spent on Medicare, and of course, in this year, $54 billion more from the general taxpayer. So that there, we have total agreement. And in fact, this morning, the President is proposing long-term Medicare reform which would lead to greater solvency and to better health care, most importantly, for today's and tomorrow's beneficiaries.

I think that where we part company is on the notion which sooner or later, I guess I am going to have to read from Rob Samuelson's column where he called this "Orwellian" and talked about the image of raids on the trust funds is false, stated bluntly for the record that Medicare spending now exceeds Medicare taxes, the trust fund covers only 57 percent of Medicare's total. I really think this ought to end this rather curious argument that has gone on.

So the point—and I know it is sincerely held—about fencing off this arbitrary amount of Medicare Part A—as I pointed out, why not make the same argument for military retirement, civil service retirement, any of a number of other important trust funds—those funds, of course, we all know do not go into a bank account somewhere. When we choose to fence them off, we send them to bondholders, and we pay down a little bit more debt than we would have otherwise.

And here, I would simply plead for a common search for balance in our policies. The President has strongly committed himself to steady debt reduction, and as I mentioned in my testimony, we are really here talking about the difference this year—shall we devote about 8 percent or about 9 percent of $2 trillion of revenue to this year's debt reduction—but debt reduction at all costs as a priority above and beyond all others can be very self-defeating. If it prevents economic recovery, we will have shortfalls in future surpluses that you will never be able to tax your way out of.

Senator STABENOW. Let me just correct—no one is suggesting debt reduction at all costs.

Mr. DANIELS. All right, but the notion that we would withdraw even more money from the economy at a time when it is in a very slow growth mode I think may be well-intentioned but would be economic folly. I have characterized this as "medieval medicine" where, if the patient was not doing well, we bled him a little more. So——

Senator STABENOW. Let me just add one other thing. When Chairman Greenspan sat in that chair, he disagreed with the amount of debt reduction that you believe can be made quite substantially. His numbers were much more in line with what we are talking about in terms of Medicare and Social Security. So there is a real difference; there is an honest difference. This is not "medieval"—well, you can talk to the chairman about that—but the fact is that we heard several different numbers on debt reduction, including——

Mr. DANIELS. Actually, Senator, to correct the record, the numbers are all quite close. Now they are closer than before between OMB and CBO. And Secretary Greenspan submitted a further letter documenting that he was not talking about the complete amount that was, as we would say, unredeemable. But I would be

happy to supply that for the record. The estimates are all really quite close and leave totally intact the notion that we can do as much as is practical—which I think we all agree we should try to do—and still have ample funds in search of a purpose. There is where we will debate. You might want to spend them; we might want to invest them on behalf of a stronger Social Security system or perhaps leave them with taxpayers. There is where our honest differences will lie.

Chairman CONRAD. Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

Welcome, Director Daniels.

Mr. Chairman, it is a true pleasure to be here in this exciting hearing. We only hope that the American public have not turned off their television sets now, because there are some very important issues being debated here.

Director Daniels, I recall when Chairman Greenspan was here earlier this year, he said that it was very unusual for him that it was time for tax reduction along with debt reduction, and I believe he made that point very clearly.

Frankly, it is just in time that we had tax reduction. The economic slowdown that began last fall, the fall of 2000, has gotten worse. The markets forecasted in March of 2000; the economy started last fall to turn down; and the real bright spot is consumer spending. The tax relief that is going out this month is perhaps the best measure or the best stimulus to keep the economy growing, and I hope that it can help consumers jump-start the rest of the economy as well.

For the first time in recent memory, or that I can recall, we have a tax cut which is appropriately timed to serve as fiscal stimulus. I have been very leery of saying that we can use tax cuts as counter-cyclical, but lo and behold, due to perhaps great foresight—and I would commend the distinguished former chairman of the committee, the Senator from South Carolina, who was very, very insistent over the past few months when we passed the budget to say we need to give money back to the American people. He was saying that, I believe, in February, and it turns out he was right. For the rest of us, it may have just been dumb luck. But we have in place rebate checks that are going back to people who need them now, who can invest them or spend them to reduce debt.

I think the very worst thing we could do would be to raise taxes now. You are talking about a trigger that would raise taxes when we go into an economic downturn—probably the worst idea since the significant revenue increases of 1932 that helped take an economic downturn or recession into a Great Depression.

So to say that we should trigger tax increases because the economy is slowing down even under Keynesian terms makes no sense. And fortunately, a strong bipartisan majority of the Senate agrees. On Tuesday, we had a very enlightening vote on the amendment by the Senator from South Carolina to do away with tax rebates, and I am very pleased to have been one of the 94 Senators, along with our chairman and ranking member, who said do not stick it to the consumers, do not give them the jolt this year. And the Senate has spoken loudly and forcefully on the need for the stimulus provided by the tax package.

Now, it is true the stimulus has not worked yet. The economy is still sputtering, and in the meantime, some back-of-the-envelope calculations are getting members worried about the budget picture. There is no formal re-estimate yet, no formal midyear review, but people scribbling on the backs of envelopes. No one has actually thought through all the pluses and minuses that would figure into budget baseline, but these back-of-the-envelope scribblings really should be taken with a grain of salt—or perhaps I might say a dose of salt—until a proper re-estimate has been done taking account of all the relevant factors.

Most important, we should not panic when we have not seen the results of the tax stimulus. We knew when we passed the tax bill that there would be a lag time before the provisions were implemented, the new tax withholding tables were calculated, rebate checks are just being mailed out, and, as 94 Senators said, we ought to stay the course, because the main threat—the main threat—to our ability to meet our commitments to Medicare and to Social Security in the future is the sagging economy right now.

I will not go back and rehearse the economic lesson given to us by the Senator from Texas; I would commend it to my colleagues to read it and learn from it. But I would like to do something different in this Q and A session and ask you a couple of questions, Mr. Director.

Mr. DANIELS. I can adapt to that.

Senator BOND. Have you made a formal re-estimate of the surplus? Are there any official new figures on the OMB numbers for the current year?

Mr. DANIELS. No, I am sorry, there are not. We are working on them, and later this summer, probably in the next month, we should be able to do that.

Senator BOND. So that basically,w e are looking at numbers scribbled on the backs of envelopes. Mr. Lindsay scribbled some numbers on the back of an envelope. We have two envelopes or more with numbers scribbled on them, and we have had a committee hearing on this. Is it fair to call this the hearing on the two envelopes?

Mr. DANIELS. I will let you characterize our purpose here today, but I for one appreciate the chairman getting us together, as we probably should occasionally, to review what is always going to be a shifting picture.

Senator BOND. I always look forward to getting together with our distinguished chairman and you, Mr. Director.

Let us talk about reserve funds. I understand that reserve funds are not really money in the bank ready to spend. These are reserve funds—and I would like your comment—that the chairman has the right to release. All of these deficits assume that all these funds, some $442 billion, could be released. But as I see the Budget Act, it says "The chairman of the committee may revise committee allocations to the committee," and under Part B, it says "Legislation described in subsection A may not, when taken together with all other previously enacted legislation, reduce the on-budget surplus below the level of the Medicare hospital insurance trust fund surplus in any fiscal year covered by this resolution."

Therefore, am I correct in my assumption that if my good friend, the tremendous deficit hawk, the chairman of the Budget Committee, wants to keep us out of budget deficits with trust funds, all that he has to do is refuse to release these funds? Do you understand that that is how it works?

Mr. DANIELS. Well, I understand the chairman to be a powerful person for many reasons, and I guess that is one. Let me just say, however, that I hope—and I think we ought to all work together to ensure that, to whatever degree the Congress may decide, the chairman, with a clear conscience, fiscal conscience, can release funds from those reserves in the future and on schedule so that we can address Medicare improvements and enhancements like prescription drugs, for instance.

I would just like to go back to a thought that occurred when I was conversing with the Senator from Michigan. We have got to do a much better job, it seems to me, of preventing inertia from being the enemy of the new. In my years in business, we fought this all the time, but it is a much worse phenomenon here. What I mean by that is the failure or the inability to rigorously reexamine old spending, to treat it as taken for granted, and thereby to penalize the opportunities to act on new needs and to constrain them by whatever limit we determine is appropriate in terms of future surpluses.

So again, I hope that especially as we approach the next budget year, we can all come to that discussion with a much more open mind and much more of a determination to challenge the installed base of $1.863 trillion, more or less, of spending and decide what of that has served its purpose and can give way to the new needs that, for instance, these reserve funds reflect.

Chairman CONRAD. Senator Corzine, would you yield a minute to me?

Senator CORZINE. Of course.

Chairman CONRAD. Can I just try to set the record straight, and I will use the Senator from Missouri's chart, because the power of the chairman is, unfortunately, badly overstated here.[7]

The language that the Senator refers to applies to seven of the eight reserve funds. It does not apply to the biggest one. The $300 billion that is in the prescription drug reserve fund does not have the limitation on the Medicare Trust Fund.

So the fact is that that limitation only applies to seven of the eight reserve funds, and the biggest one, it does not apply to at all.

The other point that I want to make is that I hope our colleagues on the other side are not concluding that because the tax cut was so large, it prevents us from going forward with the prescription drug program that passed the Congress. I do not think that that would be the correct result.

The other point that I think is important to understand is that 60 votes can overcome whatever the chairman of the Budget Committee determines with respect to any of these reserve funds, and that is appropriately so. Frankly, I thought too much power was given to the Budget Committee chairman, especially with respect to defense; to have one person in this body determine what the

[7] CHART NOT AVAILABLE AT PRESS TIME.

number is for defense I think is too great a grant of power to any individual.

We are left with this question. Since our numbers show, given the budget resolution, given the tax cut, given the economic slowdown, that we are already into the trust funds, and the administration comes with a request for significant increases in defense spending, should that come out of the trust funds? And we are not talking about at a time of economic slowdown, because next year, the administration is forecasting economic growth, significant economic growth.

Yet we see that we are being asked to fund a defense request out of the Medicare and possibly Social Security Trust Funds. I do not think that that is an appropriate financing mechanism.

I would recognize——

Senator BOND. Mr. Chairman, would the all-powerful chairman cede me just 60 seconds to make a parting farewell and give you a compliment that I know you will use your massive powers very well.

We strongly disagree on your conclusion that you do not have the power to release the $300 billion including Medicare prescription drugs. We believe that that is vitally important, and we hope that you will exercise your power to do so. We think that your power covers all. We recognize there is a 60-vote point of order, and we look forward to your wise usage of the huge powers, the immense powers, that you have. [Laughter.]

Chairman CONRAD. I thank the Senator from Missouri, who is a good friend and who was part of our Deficit Reduction Caucus for many years when we really faced very, very serious challenges.

Senator BOND. You know, nobody paid us any attention then.

Chairman CONRAD. No, they did not.

Senator BOND. And here you are, the chairman.

Chairman CONRAD. I thank the Senator.

I want to make clear that I am not suggesting that the chairman of the Budget Committee does not have a role in releasing the $300 billion in the prescription drug reserve fund. Certainly the Budget Committee chairman does. The point I was trying to make is that that is not tied to avoiding using the Medicare Trust Fund for that purpose. The other seven trust funds are tied to not invading the Medicare Trust Fund.

The Senator from New Jersey, our new member, Senator Corzine.

Senator CORZINE. Mr. Chairman, I am extraordinarily pleased to be here and to be able to work with you on what I think are some of the most important issues that face our Nation. How we approach a number of these issues, as this discussion today brings out, I think is remarkably important for discussion, debate, and conclusion about.

I will move from the true to the sublime here, talking about power. Being number 98 on a food chain of 100, I recognize my role, but I would like to raise some questions with the director that really maybe even call on some of the private sector background that you alluded to.

We talk about trust funds. When one looks out into future years with regard to Social Security and the demographic challenge that

we have in front of us, there seems to me to be a reason to believe that one might want to set aside money for future calls both on Social Security and Medicare, and that we ought to be disciplined about that process as we go forward.

I ask whether there was a defined benefit plan at Eli Lilly or some of the other places where we do set aside money and manage it for a purpose, and I think that was the thought that has to do with the Social Security Trust Fund and Medicare Part A funds. We administer a rate, and there can be a good discussion about whether you set these aside and invest them cooperatively or whether we do it in private accounts, but you accept the idea that we ought to be looking ahead to the demands of our trust fund requirements in future years, and I think we got away from that debate here today while we were talking about the economy.

Second, I would like to ask a few questions about tax cut structure and efficacy. Being an old University of Chicago graduate and believing somewhat in the efficiency of markets, that information usually gets into the financial bloodstream and makes a judgment about things. We just passed a tax cut that I think was signed June 7th, 24 trading days in the world of markets; I think we have had 8 up days and 16 down days, and we have seen a decline of 8 percent in the Dow and 11 percent in the NASDAQ. I wonder whether the world is making some assessment about the efficacy of the tax cut, and particularly the structure. We have talked about whether it should have been larger, but it is whether we frontload it for purposes of stimulus in current events or whether we are talking about backloading it, which is another issue.

Then, I just have to ask you whether you agreed with the Senator from Texas with regard to paydown of debt, because I was troubled when I heard that we are paying off rich bondholders, which lowers interest expense for the Federal Government—I think it is about 11 percent. That is kind of an important issue, and since money is fungible, and we are not borrowing in capital markets, isn't that money often "redeployed," to use your term, into other effective capital market investments which may be stimulative to the economy? So I am concerned about that theory that somehow, when we pay off bondholders, we are transferring money to rich folks as opposed to maybe having a more efficient capital market as we go forward.

Then, you talked about redeployment on spending and the concept that we are going to have $18 billion of increase in military expenditure. You know, part of that $1.9 trillion that you talked about does include expenditures in the military budget. Are there things that we think we can do there that do financing in the same way that, seemingly, we are putting all that pressure into domestic discretionary spending?

I know that was a whole series of issues, but I am concerned about purposes of trust funds, actuarial purity, tax cut structure and efficacy as reflected in current economic data, debt paydown, efficacy.

Mr. DANIELS. Senator, you may be number 98 on the seniority list, but clearly, you are not number 98 in terms of your thoughtfulness about these issues. Those were great questions, and I am going to try to treat each of the four that I caught, if I may.

First of all, I very much liked the formulation you ended with in your first question as opposed to some that I heard at the beginning. At the end, you talked about should we not be looking ahead to the obligations that the trust funds represent. I think that that is just the way to think about it, because in the first place, these are sacred and also massive obligations that at present, we are not on a track to fund without ruinous and really unthinkable tax increases. That is a better way to put it——

Senator CORZINE. I did not question that assumption, but you understand the logic.

Mr. DANIELS. Right. But let me certainly associate with the idea of looking ahead to obligations which are sitting out there. That is the clear-minded way to think about it, as opposed to talking, loosely and inaccurately, about "going into" the trust funds as though there were a pile of money somewhere. There is nothing but a pile of IOUs, as your question really illuminates. And the fact is we always have—and this year again, everyone advocates going into the trust funds—everyone—the question is for what purpose. And some quite sincerely believe we should go into the trust funds more deeply to pay off more debt. This leads to sending those funds to bondholders as opposed to perhaps taxpayers at-large or perhaps through some other program, some actual operational spending program of Government. So let us get away from misleading talk about into the trust funds, as thought it is not exactly what happens every year by their very nature and structure.

So that yes, we should look ahead. The President's recommendation for looking ahead involves fundamental reform of both Medicare and Social Security, and we will have spirited debates about those subjects because he is going to put them on the Nation's agenda, and that is where our differences will come.

But I certainly appreciate your framing the question that way, pointing out that today, the trust funds have only IOUs and commitments which we must meet.

Senator CORZINE. Can I ask a followup question? IOUs, which I think are bonds, if I am not mistaken—we may have different interest rates on them, but they are bonds——

Mr. DANIELS. Right.

Senator CORZINE [continuing]. And they are assets that people do use in pension funds. So to use the word "IOU" I think gets away from a choice of assets that are held as opposed to the fact that—I do not know that we need to make a good or bad judgment. You might have a different asset allocation, which I think a lot of people are suggesting.

Mr. DANIELS. Yes.

Senator CORZINE. But IOUs are just Treasury debt.

Mr. DANIELS. Fair enough, but nothing stands behind that debt except tomorrow's taxpayers—my kids, yours, and everyone else's.

Not to have the Social Security debate here this morning, but the President's proposal will include in some measure a conversion to real assets, real earning assets, owned by the taxpayers who are paying into Social Security. You asked about the company pension funds. They look like that. They do not look like the Social Security structure that we have today.

I think it is too soon for us to know how to read the 18 days of market return, to what extent did markets anticipate the tax cut before its arrival and bake those numbers in; to what extent, if any, while we are speculating, does the distant rumble that maybe future tax cuts be taken away moderate any positive market reaction, I certainly defer to you in terms of reading the entrails of daily market movements.

I am going to submit for the record, however, a raft of comments from market participants and watchers which I find to be virtually unanimous in believing this is a positive effect.

Chairman CONRAD. Mr. Director, if I might, here is our problem. We have a vote on, and we are halfway through the vote, and we still have Senator Clinton with her questioning period.

If you could conclude your answers to Senator Corzine quickly, perhaps we could get Senator Clinton in before the vote.

Mr. DANIELS. I think I can name that tune in 60 seconds.

Chairman CONRAD. Great.

Mr. DANIELS. Your third question dealt with debt and the interest on it and so forth. It gives me a chance to say that what I think we are really here to discuss is a balance among policies. We all agree about debt reduction; the question is how much, the amount of Social Security, the amount of Social Security plus Part A or some different number. I think the President's proposals represent a healthy balance—debt reduction, the second most this year in American history, debt reduction as far and as fast as we can; tax relief, to strengthen the long-term economy, without which we will not have surpluses to debate about; and spending control at reasonable growth levels to protect those first two pillars.

So I believe that that is a fair balance and one that recognizes current economic reality.

Finally, on the redeployment of spending, yes, I think it is very incumbent on the administration and the Congress to search for redeployment of spending in defense. The whole idea of a top-to-bottom review, a strategic rethink that the President commissioned, is that much of our embedded base in defense may no longer meet the moment.

I would point out that Congress has got to help here. We struggle with earmarks in the Federal budget, and the single biggest pile of them is in defense. It is very hard to run a modern, 21st century defense when you are hogtied by a million Lilliputian orders to do this, that, or the other, which maybe does not fit the strategy. I cite the current debate over the B–1 redeployment also as an example that inertia is very tough in this area.

Chairman CONRAD. Senator Clinton.

Senator CLINTON. Thank you, Mr. Chairman.

I would like also, if we could, Mr. Chairman, to ask the director perhaps to provide some additional written answers to Senator Corzine's questions. I would be very interested in seeing those answers in more detail than the director had the opportunity to provide today.

We have had a spirited discussion about a number of issues this morning. The fact is that we are all going to have to wait and see how this plays out. You made a reference earlier to if we had been so prescient 7 months ago, we might have known this or that, but

certainly from the perspective of those of us who are concerned about balance, we think that we are heading in a dangerously imbalanced direction. You respectfully disagree. We will see how that proceeds.

What I am concerned about is that the references that are constantly made to old spending rarely come with any specifics. And again, we do not have the time, but I would like specifics from the OMB as to what you are recommending will be cut and the numbers.

Second, I would like to know whether the administration in part of its defense review process includes requirements that the Department of Defense aim toward a clean audit.

Third, I would like to know with respect to the questions that have been raised about new spending exactly what it is that the administration is going to be requesting over and above what we read about with respect to defense increases. We do not have any specific information, and it makes it quite difficult for us to know what the tradeoffs the administration is requesting might be.

Finally, I would like to know whether the director and the top people at the OMB have read "Triumph of Politics," because you act as though we are in an area of uncharted terrain, when I think that the clearest example of where we are going is where we have been. In 1981, when the Reagan tax cut was passed, the top rate was 70 percent on non-wage income. We did a good job keeping tax rates down. We have just passed a massive and, from my perspective, fiscally irresponsible tax cut that further lowers rates, but the bottom line is that in 1981 going forward, I think you could take testimony from the Reagan budget people and lay it next to what we have been hearing, and you would see a remarkable, startling, and to me troubling, similarity.

I remember witnesses who sat where the director is sitting when we were going through our 16 hearings about the budget, saying in very clear, unambiguous language that the tax cuts would lead to increased surpluses, that we would not risk going back into deficits, and that despite the clear evidence of an economic slowdown, the combination of the large tax cuts and the economic slowdown would not have the result that many of us, based on past experience, were concerned about.

So we will look forward to continuing this dialog, and I think the bottom line is that this is not an economic debate, this is not a fiscal debate—this is a political debate. The administration has a different view of our political goals and our mission than many of the rest of us do as to how we strike the right balance and how we create the right conditions for economic growth.

And in fact, let me just conclude with a question. To me, the greatest missed opportunity of the last 7 months if one could be so prescient is that there is no economic plan. There is a tax cut plan. The administration, first and foremost, for ideological reasons, has proposed and forced through a large, fiscally irresponsible tax cut plan. I have no argument with the political philosophy that drove that decision, but what is the economic plan that accompanies that tax cut? Could you enlighten me, Mr. Director?

Mr. DANIELS. Yes. Let me respond to several things that you said, beginning with the fact that you asked—and I think it is a

perfectly appropriate question—we are all actors in the endeavor—to look for those reductions that could enable greater increases today. And I think it was before you arrived, Senator, but I certainly pointed out that the administration proposed billions of dollars of such cuts which have not yet found favor here, and that is a good starting point——

Senator CLINTON. Mr. Director, I am going to have to run to vote. Would you mind giving us your responses in writing? It would be very helpful—because I do want to hear that.

Mr. DANIELS. Oh, of course, I will. I will be glad to.

Senator CLINTON. Thank you.

Chairman CONRAD. Let me close by thanking the director for being here. Let me say that I am somewhat disappointed because I do not think we really got to the nub of the issue, which is that next year, when you are forecasting economic growth, we believe the administration will be using both Medicare and perhaps even Social Security Trust Fund money to fund other programs of Government, and that is before the very substantial defense request that the administration has made.

And my fundamental question to you—and I would like an answer in writing—is what do you recommend with respect to that request by the administration for $18 billion of additional funding next year. Do you believe that should be funded out of trust funds of Social Security and Medicare? Do you believe it should be paid for by spending cuts? Do you believe it should be paid for by additional revenue—or some combination?

My own belief and what I have told the Secretary of Defense is that I will not support, I will not release the reserve funds without it being paid for, without it being offset. And I welcome the administration's recommendation. I do not think that when you are forecasting strong economic growth, that defense increase the administration has made should be funded out of the trust funds of Medicare and Social Security. I think that that is a profound mistake, especially in light of where we are headed in the next decade.

I would like to put up the CBO chart with respect to Medicare. I must say that I find very troubling this notion that there is no Medicare Trust Fund surplus, because the records of the Congressional Budget Office say very clearly on page 19 of the Budget Outlook, trust fund surplus, Medicare Part A, dramatic, substantial surpluses, nearly $400 billion; Part B in rough balance, in fact slight surplus over the period.[8]

The difference here is that Part B is funded by premiums coming from beneficiaries of 25 percent, and 75 percent is general fund transfer. And to call that general fund transfer a "deficit" I think is misleading. If it is, I wonder if the administration is recommending an increase in premiums on Medicare beneficiaries to offset that deficit. And I would like to know how much premiums would have to be increased to offset that deficit.

And if you are really saying that there is a shortfall in Medicare, that suggests to me that we would need to save more—save more. But your policy prescription as I have heard it here today is that we would save less; we would just forget about Medicare Trust

[8] CHART NOT AVAILABLE AT PRESS TIME.

Fund surplus and allow the Congress and the administration to use that money for other programs. To me, it defies common sense.

I unfortunately now have to go and vote, or I will miss it. Again, thank you very much for your appearance here today.

[The prepared statement of Mr. Daniels follows:]

TESTIMONY OF
MITCHELL E. DANIELS, JR.
DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
BEFORE
SENATE BUDGET COMMITTEE

July 12, 2001

Thank you Mr. Chairman, Senator Domenici and Members of the Committee.

I appreciate the committee's invitation and this chance to discuss the nation's constantly shifting fiscal situation. Permit me to start by noting the persistence of two striking phenomena that distinguish today's environment from any we have seen: first, a tremendously positive national fiscal condition despite a nearly stagnant economy; second, a strong bipartisan agreement to preserve very large surpluses as a threshold condition of public finance.

I am glad to report that, in stark contrast to past economic turndowns, the nation's finances are in remarkably strong shape. Even in the midst of a year-long slowdown in the economy, we continue to accumulate enormous surpluses, and to use the extra receipts to steadily reduce the nation's outstanding public debt.

This is an historical phenomenon without precedent in modern times; the almost invariable pattern is for countries to run deficits, often very large ones, during economic difficulty. In all modern U.S. slowdowns, the nation has run in the red, often by very large amounts. In 1982, the deficit was $128 billion, or 3.4% of GDP. In 1992, the deficit reached $290 billion. By contrast, this year we will enjoy the second largest surplus in American, which is to say, world history.

But in the last few years, a unique bipartisan consensus has arisen in our country, one at variance with preceding economic theory. In large part due to the work of this committee, notably its chairman and ranking member, an agreement has been forged to run very large surpluses as a matter of course, in strong economic times or in weak. Both parties and both the legislative and executive branches, in this administration and the previous one, have concurred in maintaining a surplus at least the size of the Social Security surplus.

Many would like to set the minimum surplus level even higher, using as a target the artificial overage in the Medicare Part A trust fund. This is a relatively modest difference, amounting to whether the minimum surplus should be more like 8% or 9% of revenues, some $160 billion or closer to $190 billion. Between those two figures lie some hard disagreements, to be sure, but that should not obscure the radically different nature of the current situation and the new consensus.

It is fascinating to note how far this consensus departs from traditional economic thought. Only yesterday, slowdowns were said to call for deficit finance, for governments to take in less in taxes than they spent. The nation conducted a decades-long, spirited debate about the wisdom of a balanced budget amendment to the Constitution. Now, suddenly, we find ourselves in strong and healthy agreement on maintaining a fiscal position vastly stronger than the mere balance such an amendment would have required.

Whatever differences may prove to separate us during the course of this morning's hearing, I hope we can all agree that the matter of most urgency must be the resuscitation of economic growth in our country. The President and a bipartisan Congressional majority agreed to utilize a portion of our unified surpluses to try to stimulate the economy through tax relief, and that action came just in time. I am submitting for the record the comments of a host of economists forecasting a boost to growth stemming from the tax cut ranging from 3/4% to 1 1/4% in the second half of this year. Just this week, the Blue Chip Consensus of the nation's top analysts expressed this view, writing "The tax cut effects could not have come at a better time..."

Mr. Chairman, you have asked for an update on our fiscal expectations. I can report that we see continued large surpluses at least at the size of the Social Security surplus for all years in the budget horizon. The President is determined to preserve surpluses at this level, and to continue using these funds for the steady reduction of outstanding national debt, a cause of which you are a leading champion.

In the 2001 fiscal year now winding down, we are of course dealing with the budget agreed to by the last Congress and the last President. That budget, passed last December, contained the largest one-year spending increase in history; obviously, a smaller surge in spending would have ensured a larger surplus today. But the major reason for a surplus that is merely immense, rather than gigantic, is of course a shaky economy.

Due to the dramatic economic slowdown, starting about a year ago but not fully measured until the last few months, revenues for the current fiscal year will grow more slowly than previously forecast, on the order of +3% rather than the expected +5% or more. Because OMB was overly cautious in estimating outlay rates, 2001 spending will also be somewhat lower than expected, and the net change in the surplus will be somewhat less than the drop in revenue.

I would point out that, in missing by 2-3%, this year's revenue forecast was substantially more accurate than its recent predecessors. Also, please note that all OMB projections of economic growth and revenue growth have been completely in line with those of the Congressional Budget Office, the Blue Chip private consensus, and other private estimates. When we produce our Midsession Review later this summer, once again we will use future estimates that match closely the most credible third party predictions available. Such forecasts are always destined to miss by some margin, but we take it as our duty to work with well-founded assumptions and to strive for accuracy as far as is humanly possible.

The Social Security surplus makes a good target for several reasons. First, unlike Medicare, or Military Retirement, or Civil Service Retirement, or many other of the government's 100-plus other trust funds, Social Security is in true surplus for the moment, taking in more than the program costs. Secondly, there is some symbolic value in reaffirming the special commitment we all share to protecting older Americans. Third, the President and a majority of Americans hope for reform that converts a portion of Social Security receipts from a mere IOU to real assets, owned by the worker who paid those taxes. At that point, the notion of a "lockbox" will take on real, literal meaning.

But the best reason for choosing this surplus target versus any other arbitrary goal is that, as we apply these amounts to debt reduction, we achieve with some room to spare the maximum amount of such reduction possible. Over the next ten years, Social Security will take in excess funds of some $2.5 trillion, whereas maximum debt retireable without incurring unjustifiable premium expenses is about $2.2 trillion. This year, we will eliminate over $100 billion of existing debt, marking the fourth year in a row of such reductions, and further such shrinkage is scheduled for each succeeding year. This is an important accomplishment for which both political parties, both branches of government, and both the last two administrations all deserve credit.

So the nation's finances are in extremely sound condition. Only persistent, long-term economic weakness can threaten this position, so promoting a return to vigorous growth must be our common objective. The best course forward is clear: first, pass this year's appropriations at the level of the 2002 Budget Resolution, including the defense amendment recently proposed by the President.

Second, work together to continue restraining total spending in the next few years. Businesses, states, cities, and families have no hesitation to limit their spending when revenues subside. The fifty state governments recently reported that collectively they are lowering spending growth from nearly 8% last year to around 3% in FY 2002. Spending in the domestic agencies exploded during the last three years, including growth of 45% at HHS and 27 % at DOT. These departments can benefit from a period of digestion without great growth beyond these expanded levels.

Restraint does not mean paralysis. We can make room for new initiatives, and for reasonable spending growth in good programs by finally becoming serious about the review of antiquated, duplicative, and non-performing programs. We must reverse the bizarre presumption, which operates nowhere else in life, that the burden of proof rests with those who challenge any penny of current spending. As in any business or family, the burden must be placed on those accountable to justify the ongoing value of whatever money is being spent today. Any healthy organization constantly searches for ways to redeploy money from less efficient to more efficient purposes; we must weed the garden if new plants are to sprout and flourish.

Finally, we must be prepared to collaborate on additional moves to strengthen the economy. This might involve approaches unrelated to fiscal policy; trade liberalization, and the alleviation of paperwork or other regulatory burdens come to mind.

Mr. Chairman, I commend your concern in calling this hearing, and your vigilance in seeking to make sure that today's hard-earned fiscal vitality is preserved. I am pleased to be able to report the strength of our position, but also to associate with your determination to take nothing for granted and to see that progress continues in both the near and long terms.

[Whereupon, at 12:21 p.m., the committee was adjourned.]

FISCAL YEAR 2002 DEFENSE BUDGET

WEDNESDAY, JULY 18, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Feingold, Nelson, Stabenow, Clinton, Corzine, Domenici, Nickles, and Snowe.

Staff present: Mary Ann Naylor, Staff Director; and G. William Hoagland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Why don't we begin and welcome Secretary Wolfowitz to the committee and Dr. Zakheim as well. Welcome. Am I pronouncing that correctly?

Mr. ZAKHEIM. Yes. Good enough for Government work, sir. [Laughter.]

Chairman CONRAD. How do you like to have it pronounced?

Mr. ZAKHEIM. Zakheim. You were very close.

Chairman CONRAD. Very well. Welcome to you both.

This hearing is to consider the President's request for additional funding for national defense. I think it is important to put this request into perspective. The President's defense budget amendment asks for an increase of $18.4 billion over and above the April request, which was already $3.3 billion over the baseline. This represents an increase over the 2001 enacted level of $32.2 billion, or 10.4 percent. This represents the third largest peacetime increase since World War II.

It would also push national defense spending over the cold war average of $331 billion for the first time since 1993, and that is putting all of the budgets in the context of 2001 dollars so that we have a fair comparison.

I am pleased the President has now submitted his 2002 defense budget, but there remain serious questions to be answered by the administration before the Congress can responsibly take action. Several of these issues were raised in my letter to the President of June 26th, and I hope I will receive a response to that inquiry.

First, when does the administration intend to submit a full 6-year Future Years Defense Plan? As I understand it, that is required by law, but we have not received it. In other words, when will we have a realistic estimate of future defense spending levels from the administration?

Second, when will the administration provide an outlay estimate for the budget amendment for 2002 and beyond?

Third, the briefings to Senate staff by Dr. Zakheim have clearly suggested that the defense budget amendment may be further amended later this year as the defense reviews proceed. Is that a correct understanding?

Fourth, and finally, what are the implications in future years of this request for additional funding in 2002? Is there any chance that it would not be carried forward to future years? Will DOD seek another $18 billion increase over this year's $18 billion increase, as Secretary Rumsfeld recently suggested before the Armed Services Committee?

Further, we need to know how the administration intends to pay for this defense increase. In the budget resolution, defense was set for 2002 at the level of the President's April request. As a result of the size of the tax cut and the weakening economy, we face a stark choice: fund the administration's defense request out of the Medicare Trust Funds, or possibly even Social Security Trust Funds in 2002, or find other spending cuts to offset it, or additional revenue. And I am interested: What does the administration propose? What does the administration suggest? Do they believe we ought to use trust fund money to pay for additional defense spending? Or do they have a proposal for spending cuts or new revenue? What is the advice and the guidance that they would provide the Congress with respect to paying for their request?

Mr. Wolfowitz, I hope here this morning you will address this and the other issues that I have highlighted. I want to emphasize that the reserve fund that has received so much attention makes very clear that it cannot be used if it is invading the Medicare Trust Fund. We now believe that would be the case in fiscal year 2002. And so we need to know how you would propose dealing with that problem.

With that, I will turn to my very able colleague, the distinguished former chairman of this committee, for any comments that he would like to make.

Senator DOMENICI. Thank you very much, Mr. Chairman.

Mr. Chairman, I notice that tonight some group has invited us to honor the Budget Committee.

Chairman CONRAD. The Historical Society.

Senator DOMENICI. Does that mean they think we are finished? [Laughter.]

Chairman CONRAD. I don't know.

Senator DOMENICI. Historical Society honoring the Budget Committee. Maybe it is because we lasted 25 years.

Chairman CONRAD. That is pretty good. I guess they actually do this for other committees.

Senator DOMENICI. I understand. First I want to say to the Secretary and to the chairman, this is a very difficult day for me. I happen to have a bill on the floor on energy and water that I am managing, and there is a very important hearing with reference to nuclear power in the future, and I have to try to do both of those sometime this morning and be here. So I intend to give my opening remarks and then with that to say I am very sorry I cannot be

here. If I am needed by you, Mr. Secretary, for any discussions after this hearing, I am available.

I want to first compliment you on taking the job you have taken and, second, I want to thank you for the wonderful work you have done. I really did not believe we would be this late in the cycle and have so few appointees in high positions in the Defense Department. For a long time there were only two of you as appointees, and it is kind of a tribute to your leadership and that of the Secretary that you have proceeded as far as you have. And I commend you.

I like what I hear. I like the approaches you are taking, and I only hope we can be on the same side, getting those approaches funded, so we enter this millennium with a new approach to defending our country and being an important player in the world.

Having said that, also I want to say to the Comptroller, Mr. Zakheim, that we have worked in the past, and it was always a pleasure. I think the Secretary is very fortunate to have you on board.

Mr. ZAKHEIM. Thank you.

Senator DOMENICI. You know what you are talking about and where to find things, and if you don't, you are one of those rare people that knows who to ask around this place, and you get the right answers. I am hoping you will supply that to the President throughout his term.

Mr. ZAKHEIM. Thank you, sir.

Mr. WOLFOWITZ. Thank you for those kind remarks, Senator Domenici.

Senator DOMENICI. You are welcome.

First, let me make it clear: I support the President's amended budget request for the additional $18.4 billion. There is no doubt in my mind that this amount of money is needed. Whether each specific item that has been requested is of the highest priority or whether there has to be some adjustment made can be left for further hearings and later days. I strongly support the objectives that this funding will support, such as restoring military morale with targeted pay raises and, most importantly, that we finally solve the problem of adequately funding military health care. We have always nickled-and-dimed that and put it off, and now we are doing that no longer, and I think that is good and we should continue it through the new year and on into the future.

Second, and perhaps more important than that statement, the budget resolution that governs today makes room for the additional funding. The simple fact is that based on the budget resolution guidelines in effect today, there is no reason why the chairman should not make this money available to the defense authorizing and appropriations committee. In any event, we will have an argument about that at a later date.

Until and only if the budget resolution is changed by Congress, and assuming every policy in that budget resolution is enacted, there is a surplus. A surplus. If we were passing the defense request today, there is a surplus of $38 billion, according to the budget resolution and the numbers that we can accept and must use at this point. So the 18.4 request clearly is within that limit.

I don't know nor does the chairman know what the economy and other factors may or may not portend for the future. But for today, and until the budget resolution, the official legislative scorecard for how we do business around here, until it is change in an official way, we should support the President's defense amendment and act as quickly as possible to make this money available and get on with it.

Obviously, restoring military health programs, providing targeted pay raises, transforming our military for the 21st century and the threats that we have there, and bolstering our readiness, streamlining our DOD facilities and infrastructure, and, last, reforming DOD's financial management systems—these are all exciting, long-overdue goals that ought to be achieved, and I laud the President, the Secretary of Defense, and you, Mr. Secretary, for what you have done.

I will work with the President in whatever way I can to make this possible. Again, I apologize that I cannot be here for the remainder of the hearing.

If, in fact, there is a serious contention that we ought not fund the defense number because it is overspending, then I will seriously recommend that every appropriation bill be put up for reductions. Why should we just hold defense hostage? Let's take every appropriation bill and make it bear its share of the concern that the chairman has, if there is one, and cut everyone so as to accommodate this 18. Maybe that would be a good amendment to offer on the floor and see how the Senators think about defense spending, whether they want to seriously consider not funding the President's request this year because this economy is in a downturn. I don't believe we can do that. I don't believe we should do that. In fact, I believe we ought to find a way to fund it. The fact that we are having a downturn that puts some of the size of the surplus in the next budget resolution and the next one after that in some kind of jeopardy certainly does not justify spending on everything else as usual, fill up their cups, and then say to the defense, you are going to get far less because of this factual situation.

I don't think the U.S. Senate will do that. I say to my good friend, the chairman, I know that you do this in good faith and ponder it in good faith, but I cannot imagine the U.S. Congress saying we are not going to give the President this 18.4, whatever it is, because the United States economy has suffered a downturn.

I thank you very much. Have a good hearing.

Chairman CONRAD. Thank you, Senator Domenici.

We will now turn to our witness, Secretary Wolfowitz. I just want to add my voice of respect for Secretary Wolfowitz. I had an experience with him many years ago when he was our Ambassador to Indonesia. I was extremely impressed at that time with his knowledge and his capacity, and I must say I was very encouraged when I saw that you were given this high-level responsibility in the new administration.

So, welcome, and we will proceed with your testimony, and then it would be the intention of the committee that it will come back to me for a round of questions, and then we will go to each of our members. And they will have a chance for statements and questions as well. Welcome and proceed.

STATEMENT OF PAUL WOLFOWITZ, DEPUTY SECRETARY, UNITED STATES DEPARTMENT OF DEFENSE, ACCOMPANIED BY DOV S. ZAKHEIM, COMPTROLLER

Mr. WOLFOWITZ. Thank you very much, Mr. Chairman. I appreciate this opportunity to talk to this important committee about our priorities for defense for fiscal year 2002 as reflected in the President's amended budget.

The U.S. Armed Forces are unquestionably the world's best trained, best equipped, and most powerful military force in the world. They provide the security and stability that make peace and prosperity possible through most of the globe.

However, we spent much of the 1990's living off the investments of the 1980's. We allowed our military capabilities to be slowly degraded as we overused a shrinking and underfunded force. America's dedicated servicemen and women dutifully did more with less—putting off needed investment in training, infrastructure, maintenance, and procurement in order to keep up with the proliferation of missions.

Many in Congress—and on this committee—worked hard to give them more resources. But notwithstanding those efforts, a policy of overworking and underfunding our troops continued.

When President Bush took office, he asked the Defense Department to undertake a comprehensive review of the condition of America's forces. He asked us to engage our brains before we opened our wallets, and so Secretary Rumsfeld initiated a broad strategy review soon after he took office, and as Senator Domenici pointed out, during a period in which he was essentially home alone with no confirmed appointees. I was the first one, by the way, to arrive, and I didn't arrive until March, and we are still only about a third of the way through our confirmations.

We have completed the first stage of that strategy review, and that forms the basis for the 2002 budget request. We are now starting the second stage, which is being merged with the congressionally mandated Quadrennial Defense Review, and that will form the basis for the 2003 budget and the new FYDP.

From the completion of our initial studies, we have drawn two conclusions: The first, with respect to the threat, is that the security environment America will face in the decades ahead will be much more dangerous than the one that we faced in the decade just past. The other, with respect to the condition of our forces, is that it is unfortunately even worse today than we had expected going into those studies.

These preliminary conclusions have formed the basis of the 2002 budget and a starting point for the second, more formal round in the review process—the congressionally mandated Quadrennial Defense Review.

Over the next several months, that second stage, the QDR, will address a number of questions, most importantly, trying to target the size and character of our future defense force structure. In doing so, Mr. Chairman, we have decided that we need to look beyond the modes of analysis of the past. In the past, we have tended to evaluate force structure and the risks associated with that force structure exclusively on the basis of our ability to execute existing war plans. That leaves out two very important dimensions by

which the capacity of the force needs to be measured. One is that every day we use our forces not to fight wars or to carry out war plans, but we use them around the world in ways many of which are unplanned, unbudgeted, and unaccounted for.

The ongoing operation is Bosnia is a prime example. It was supposed to last 1 year and cost $1 billion, but it is now a significant ongoing feature of the defense budget. It is a significant strain on our defense force structure, and we have in future years to account consciously and specifically for those strains.

At the same time, in addition to look at what the forces do day to day and the war plans that they have to be prepared to execute, we also have to prepare for a future that is hazy and indistinct, a future beyond the war plans, a future into the next decade.

While that is indeed an unpredictable future, we can discern the emergence of new and more formidable threats, threats that we have to begin to prepare for now. And I might emphasize a point that I am sure this committee understands very well, but that is indeed a feature of defense planning that often I think escapes people: A great deal of what we are doing today is to build the forces for 10 years from now. A great deal of what we have in the force today is the legacy of what we had 10 years ago. It is not like turning a speedboat. It is always analogized, and correctly, to turning a supertanker.

I remember during the Gulf War when I had the privilege of serving Secretary of Defense Dick Cheney as his Under Secretary of Defense, at the end of the Gulf War he made a point of publicly thanking his predecessors, including the Democratic Secretary of Defense Harold Brown, for having given us some of the weapons systems, specifically, particularly the Stealth aircraft that were so decisive in that war. And I say this because of necessity you have got to look at this year's budget. Everybody in Washington tends to look at the near term, but I want to emphasize that as we look at this year's budget, we are making decisions that are going to affect not just next year or the year after, but the next decade. And, indeed, if I might say so, I think we are not just talking about our own security, which, frankly, looks reasonably well taken care of, at least at the present, we are talking about the security of our children and our grandchildren.

As we look at that future, and as we look at the strains on the present force, we will be trying to develop a force structure that not only addresses current war plans but, as I said, the risks imposed by our ongoing use of our forces in peacetime and the risks of not being prepared for emerging threats in the future. Our intention is that by the end of the QDR we will give much more precise advice to the President and to the Congress on how to balance those different needs and risks, and to present a defense posture that is better suited for ourselves and for those future generations.

The final results of this strategy review will be incorporated in the fiscal year 2003 budget and the fiscal year 2007 Forward Year Defense Plan. And I think perhaps indeed I might just pause for a moment. I think in answer to a couple of your questions, there is no intention to offer you any further amendments this year. This is this year's budget, and, indeed, it is a budget designed to not offer you amendments to this budget next year. So it will be the

first time in, I believe, 5 or 6 years that we have gotten away from this dysfunctional practice of underbudgeting for defense deliberately, or at least consciously, in anticipation of a supplemental appropriation. What you are getting now is our full, best, honest estimate of what we need for fiscal year 2002.

What may have confused the picture is reports, correct reports, as I just indicated, that we are undertaking additional fundamental review that will be reflected in the 2003 budget and in the FYDP 2003–07, but not further revisions to this year.

While the first stage of our review has focused on the nature of threats and the condition of the existing forces that we have, the QDR will help us decide the kinds of forces we need to build. But it is sufficiently clear that we must urgently begin to repair the damage inflicted by the coasting that we did in the 1990's.

The 2002 amended budget starts us on a path toward transformation by undertaking urgently needed, immediate repairs to our existing force and by investing now in some of the transformational technologies and R&D that we will need for the 21st century force.

Using the 2001 enacted budget of 296.3 as a baseline, the President earlier this year issued a budget blueprint outlining a 2002 baseline of 310.5. That, as you know, included a $4.4 billion real increase to cover certain Presidential initiatives.

The request before you proposes to raise that investment to a total of $328.9 billion, $18.4 billion more than the President's February budget blueprint.

As I explained earlier, the first stage of our strategy review has identified where we are today and outlined in broad terms the direction that we have to go to build a 21st century force. The QDR we hope will tell us precisely how high that mountain is that we need to climb, whether it is 6,000 feet or 12,000 feet or maybe even higher. But one thing we do know for sure, Mr. Chairman, and that is that we are starting in the hole. We have to start climbing now, and that is what the 2002 budget does for us. It begins the work of repairing the present force and building the force of the 21st century.

Consider DOD's aging infrastructure, which the 2002 proposed budget begins to address. One of the phenomena of the last 10 years is trying to do more than the services had resources for. One of the places they would go looking for funds was real property maintenance. Those are the kinds of expenditures which you can easily defer for a year and not notice, and probably defer them for 2 years and not notice too much. When you defer a lot of that for 10 years, you begin to have deteriorating facilities and major repair bills. And I passed out for you some of the charts that have come from the services indicating the kind of disrepair that we encounter in facilities around the country and around the world. And I would emphasize it doesn't mean that all of our facilities are in terrible shape, but overall, there is a great deal of work to do, and this budget increases funding to begin that work.

I might say, though, that to give you a sense of the magnitude of the problem, under the budget levels of previous years we were on a path that would replace our existing infrastructure at a rate of 192 years. That doesn't mean, by the way, that the average age

was 193 years. It means that our rate of replacement and repair was 192. In the commercial sector, the standard for facilities replacement is more like 57 years. We, averaging over our whole infrastructure, have a target of 67 years. That is a lot less than 192, as you can see.

The 2002 budget proposes to increase funding for facilities from $3.9 billion to $5.9 billion. That $2 billion increase will bring us down to 98 years, which is a lot better than 192. It is still not yet down to our 67-year target.

One of the ways we can get closer to 67 years without even further expenditures will be if we can get rid of some of the unneeded infrastructure, some of the cold war facilities that we no longer need, and that is going to require at some point a major effort on the part of the Congress as well as the administration.

Beyond the facilities, in fact, because the importance of the facilities is in large measure because our people are the key to everything that we do, in addition to starting to repair the facilities that they live and work in, this budget will help put us on a path to recovery in key areas of military pay, housing allowances, readiness training, and health care, overall quality-of-life investments that tell our men and women in uniform that we value their service and their sacrifice.

But the 2002 budget, Mr. Chairman, moves beyond simply repairing the present force and takes a major step toward transforming that force and building the force of the 21st century. Reflecting the high priority of transformation, the fiscal year 2002 budget boosts research, development, testing, and engineering by 14 percent in real terms. That is an increase from $41 billion in fiscal year 2001 to $47.4 billion in fiscal year 2002.

Today's strategic environment is far different from that of the cold war. We have an obligation to plan for the changing circumstances that we face—to make sure that we are organized to dissuade rash and reckless aggressors from taking or even threatening action. One of the most disturbing areas of vulnerability, one that is frequently identified as an area where our opponents might seek to exploit so-called asymmetric approaches, asymmetric warfare against us, is the threat from ballistic missiles, not only those armed with weapons of mass destruction but even those armed with conventional warheads. And I would point out that this is not a threat in the future. Indeed, 10 years ago, during the Gulf War, our worst single casualties were inflicted by Iraqi Scud missiles, and Iraqi Scud missiles nearly succeeded in expanding that war and dragging in Israel.

This budget invests heavily in efforts to deter and defend against existing and projected threats and to dissuade potential adversaries from continuing to invest in their dangerous capabilities. The budget advances the President's commitment and the Congress' commitment to build effective missile defenses for our territories, for our allies, and for our deployed forces against threats of all ranges, based on the best available technologies, deployed at the earliest possible date.

But missile defense is not the only area where we are investing heavily in transformation. In addition to that important initiative, the budget includes another $13.3 billion of investments in a wide

range of potentially transformational capabilities. There is supposed to be a chart attached to my testimony. I am not certain you have it, and if you don't, I would like to submit it for the record. It gives some indication of the wide range of transformational programs that we propose to invest in with the $13.3 billion in addition to missile defense that is in this budget.

Chairman CONRAD. Maybe you could submit that. I don't have that in the materials I have received.

Mr. WOLFOWITZ. It is what we call a glitch. It is being copied right now, and you should have it hopefully even before I finish here.

Chairman CONRAD. All right. Very well.

Mr. WOLFOWITZ. I will finish quickly, too.

There are also a number of initiatives in this budget proposal that are addressed at streamlining our operations and saving us money, many of which require congressional support. In the case of Peacekeeper, for example, where we are removing 50 cold war missiles with a total by START counting rules of 500 nuclear warheads, a system that is overdue to be retired, we not only need funding to do the retirement, we will need the support of the Congress to remove the current restrictions that prohibit us from getting rid of a nuclear system that we no longer need.

For many important reforms, whether it is reducing our excess infrastructure, reallocating functions, or giving the Department the ability to manage efficiently, we will need the help of the Congress.

Mr. Chairman, one of Secretary Rumsfeld's top priorities is to transform the Department's system of financial management. We recognize that we must make fundamental changes that will save money and that will assure you, the Members of Congress, and assure the American people that we are allocating and using defense funds properly and wisely.

Finally, and in my view very importantly, this year's budget seeks to apply the principle of honest assessments of what it will take to do the job, or what we call realistic costing. One of the unfortunate consequences of asking the military to do more than they really have the funds for is not only things like deferring real property maintenance, but underestimating the cost of flying hours in the hope that you will get a supplemental, even though the cost of flying hours has risen, by the way, even faster than the cost of fuel, which is a major input, because as planes get older the cost of repairing them goes up.

There has been a tendency to underestimate health care costs that is not unique to the Defense Department. We have tried in this budget, though, to get honest estimates of costs, and a significant part of that $18 billion increase is simply to get us to honest budgeting and a budget that does not require a supplemental in the year 2002. Indeed, we hope with this 2001 supplemental, which I hope is on the verge of being passed, that we will put behind us the kind of supplemental budgeting that became a process that was not based on true anticipated needs.

The increase in the 2002 budget is thus a significant historic increase. It gets us started on the road to rehabilitation and transformation. It is a significant increase, but I am reminded, Mr. Chairman, of another time in our history when there was a chal-

lenge to making the case for increased defense spending. In 1950, General Omar Bradley urged President Truman to ask for $18 billion for defense. The Joint Chiefs had an even higher number, $23 billion, and the services' estimate was still higher at $30 billion. Some things never change. But the President said we couldn't afford that much and $15 billion was the most we could afford. Of course, those were real dollars back in 1950, but—and that was a large chunk of our GNP, by the way. I think $15 billion represented about 5 percent at the time.

Within 6 months, however, we were suddenly in a war in Korea, and just as suddenly, we found we had no choice but to budget some $48 billion, a 300-percent increase. How much better it would have been to have made the investment earlier. If we had done so, Dean Acheson might not have been forced to define Korea as being outside the defense perimeter of the United States on the grounds that we did not have the forces to defend it.

If one looks at historical averages, historically we have spent about 8 percent of GDP on defense. Today we are more in the range of 3 percent of GDP. When thinking about affordability, it seems to me to say that we can't afford an insurance premium of roughly 3.5 percent of GDP today to deter the adversaries of tomorrow, to underpin our prosperity, and by extension, to underpin peace and stability around the globe, doesn't make even basic budgetary sense. When you compare the cost of that premium with the cost in dollars and lives if we fail to do so, it is cheap at that price.

So, in conclusion, Mr. Chairman, while much remains to be done, we know that fixing and transforming our force is a joint responsibility. It is one that will require close partnership between Congress and the executive branch.

We look forward to working with you and your colleagues to rehabilitate today's force and to build the force of the future. We earnestly seek your support in this important and noble mission.

Thank you.

[The prepared statement of Paul Wolfowitz follows:]

Testimony Prepared for Delivery
by Deputy Secretary of Defense Paul Wolfowitz
To the Senate Budget Committee on the FY 2002 Defense Budget
Wednesday, July 18, 2001

Mr. Chairman, members of the Committee, thank you for this opportunity to discuss the President's 2002 amended budget for the Department of Defense.

The U.S. Armed Forces are the world's best-trained, best-equipped, most powerful military force in the world. They provide the security and stability that make peace and prosperity possible across the world. Indeed, no force on earth can do what they do—from the speed with which they can mobilize, to their effectiveness once they are in theater.

The preeminence of our military forces may lead some to ask: in this moment of peace, why do we need such an increase in the U.S. defense budget? The answer is simple: how long that peace lasts will almost certainly depend on our ability to defeat any adversary and maintain the unparalleled capabilities of the U.S. Armed Forces.

However, we spent much of the 1990s living off the investments of the 1980s. We allowed our military capabilities to be slowly degraded as we overused a shrinking and under-funded force. To their enormous credit, America's dedicated servicemen and women dutifully did more with less -- putting off needed investment in training, infrastructure, maintenance, and procurement to keep up with a proliferation of missions.

Many in Congress -- and on this Committee -- worked hard to give them more resources. But notwithstanding those efforts, an imprudent policy of overworking and under-funding our troops continued – a policy that has now, not surprisingly, begun to take its toll. It has harmed the morale of our forces. It has harmed their readiness to meet current threats. And it is undermining our ability to prepare for the threats of the future—because defense decisions and investments can sometimes take 10 to 15 years to reach fruition, especially when it comes to developing and fielding innovative new weapons systems.

With this situation in mind, when President Bush took office, he asked the Defense Department to undertake a comprehensive review of the condition of America's forces. He asked us to engage our brains before we opened our wallets, and so Secretary Rumsfeld initiated a broad strategy review soon after he took office. We have completed the first stage of the strategy review and that forms the basis for the '02 budget request. We are now starting the second stage, the Quadrennial Defense Review, which will form the basis for the '03 budget and the new FYDP. I'd like to briefly explain the process for you before I go into the specifics of the

2002 budget.

In the first months of the Administration, Secretary Rumsfeld tasked a series of studies to look at a variety of issues, touching on subjects from space and missile defense to morale and the quality of life of our troops. While these studies were wide-ranging, they basically covered two broad areas: first, the strategic environment and the challenges our forces will face in the future; and second, the condition of the U.S. military today.

From the completion of those initial studies, we have drawn two conclusions: The first is that the security environment America will face in the decades ahead will be much more dangerous than the one we faced in the decade just past. The other is that the condition of our force today is even worse than we had previously expected.

This exposed a dilemma: To meet emerging dangers, we know we must build a 21st Century force. But we are constrained in our ability to build the 21st Century force we need -- because the 20th Century force we have is in such a serious state of disrepair. It was this urgent need to remedy shortfalls—even before we could contemplate other changes—that accounts for the major portion of both our '01 supplemental and our '02 amended budget.

These preliminary conclusions have formed the basis of the 2002 budget and a starting point for the second, more formal, round in the review process—the Congressionally-mandated Quadrennial Defense Review—which I'd like to address before I get into the budget.

This is only the second time the Defense Department has conducted a QDR under the formal mandate of Congress. However, it is not the first time the Department has taken a broad look at the size and nature of the force needed to meet national defense requirements. Yet the process this time is unprecedented for the amount of time the Secretary of Defense, the senior civilian and military leaders of the Department have spent in carefully establishing the parameters of such a review at the beginning.

Over the past two months the most senior officials in the Department--including Secretary Rumsfeld, the Chairman of the Joint Chiefs, the Vice Chairman, the Service Secretaries, the Under Secretaries and Chiefs and myself have met for close to 35 hours, to discuss a possible new defense strategy for the 21st Century—and to give detailed guidance and parameters to the QDR. These carefully established parameters reflect conclusions drawn from the preliminary strategy reviews as well as the accumulated wisdom and years of experience in defense matters represented by those civilian and military leaders.

The first stage brought to the surface a number of formal questions that will be addressed over the next several months; broadly, they target the size and character of the defense force structure. Of these issues, the most important we've identified is the need to assess the defense force posture on the basis of multiple dimensions of risk.

In the past, we have tended to evaluate risk exclusively on the basis of our ability to execute existing war plans. That focus, we concluded, while important, is much too narrow. Other aspects of the force posture must be taken into account. For example, everyday we use our forces in ways that are unplanned, unbudgeted and unaccounted for—the ongoing operation in Bosnia is a prime example. It was supposed to last one year and cost $1 billion, but is now a significant ongoing feature of the Defense budget and should not continue to be managed with year to year "emergency" supplemental appropriations.

Bosnia vividly illustrates the reality that our forces do more in peacetime than simply prepare to fight the conflict scenarios we anticipate in our war plans. At the same time, and in addition, we must also prepare for a future that is hazy and indistinct. We can be less certain of the specific scenarios we will face in the 21st Century. Nevertheless, we can discern the emergence of new and more formidable threats—threats we must begin to prepare for now. And to do that, we need new capabilities.

These represent two additional dimensions of risk that must be considered along with the more commonly evaluated risks associated with current war plans: 1) the risks imposed by the ongoing use of our forces in peacetime, and 2) the risks of not being prepared for emerging threats in the future. Our intention is that by the end of the QDR, we will give more precise advice to the President and to Congress on how to balance those different needs and risks, and present a new defense posture that is better suited for ourselves and for future generations. Moreover, these final results of our strategy review will be incorporated in the Fiscal Year 2003 budget and FY03-7 FYDP.

While the first stage of our review has focused on the nature of threats and the condition of the existing forces we have, the QDR will help us decide the kinds of forces we need to build. But it is sufficiently clear, however, we urgently must begin to repair the damage inflicted by the complacency of the '90s.

The 2002 amended budget starts us on a path toward transformation by undertaking urgently needed, immediate repairs to our existing force, and by investing now in some of the transformational technologies and R&D that we will need for the 21st Century force. That is what the President has sought to do with the 2002 defense budget.

Getting started quickly is imperative because defense planning is a long-term process. And we have lost precious time. We've been digging ourselves into a hole for a decade, and we can't get out of that hole in a single year, so we need to get started now. Allow me to describe for you some of the key aspects of President Bush's 2002 budget – what it does, and what it does not do.

The President has requested a historic increase to begin dealing with some of the problems I've mentioned. The budget we have proposed is the largest peacetime increase in defense spending since the 1985 Reagan defense budget. Using the 2001 enacted budget of

$296.3 billion as a baseline, the President earlier this year issued a budget blueprint that outlined a 2002 baseline budget of $310.5 billion. This included a $4.4 billion real increase to cover presidential initiatives, including:

- $1.4 billion to increase military pay,
- $400 million to improve military housing, and,
- $2.6 billion for research and development.

The request before you proposes to raise that investment still further to a total of $328.9 billion -- $18.4 billion more than the President's February budget blueprint. Taken together, these increases amount to a $22.8 billion real increase in defense expenditures for the Department in 2002.

As I explained previously, the first stage of the strategy review has defined where we are today and outlined in broad terms the direction we must go in order to build a 21st Century force. The precise specification of where we need to get to will emerge from the second stage of the QDR. The QDR will tell us which mountain we need to climb and how high it stands, whether it is 6,000 feet high, 12,000 feet high—or perhaps even higher. But, one thing is for certain: we know we're starting in a hole. So, no matter how high the peak we must ultimately scale, we know we are below sea level, and we had better start climbing now. And that is what the 2002 budget does for us—it begins the work of repairing the present force and building the force of the 21st Century.

Allow me to give you an example of one way the 2002 proposed budget will begin to arrest some troubling declines. Consider DoD's aging infrastructure, which the 2002 proposed budget begins to address. It increases funding to meet current needs and begins a long-range plan to streamline, restructure, and upgrade DoD facilities.

In the private sector, the standard for overall facility replacement is 57 years. DoD's target is 67 years. Under the 2001 enacted budget, DoD was replacing facilities at an average rate of 192 years. The 2002 budget proposes to increase funding for facilities from $3.9 billion to $5.9 billion. Even this substantial increase only gets us to an average replacement rate of about 98 years—still not yet close to the 67-year target.

However, as Secretary Rumsfeld has said, with a round of base closings and adjustments that might reduce unneeded facilities by, for example, 20-25%, we could focus more funds on those facilities we actually need and get the replacement rate down to 76 years at the 2002 budget level—a substantial improvement.

Our people are the key to everything we do—they are the foundation on which today's force is built, and they will be the foundation on which we will build the force of the future. Smart weapons require smart soldiers, sailors, airmen and Marines. And unless we can attract and retain the best people, no amount of technology can assure our safety and security in the new

century.

To ensure we are taking care of this most precious resource, this budget will help put us on the path to recovery in some key areas including military pay, housing allowances, readiness training, and health care—overall quality of life investments that tell our men and women in uniform we value their service and sacrifice.

The 2002 budget, for example, begins to address previous shortfalls in the Defense Health Care program. We have anticipated a 12% growth in the costs of medical care and a 15% growth in the cost of pharmacy purchases. And so, by using for the first time realistic budgeting of health care costs, the 2002 amended budget proposes $17.9 billion for defense health to cover these costs, a $5.8 billion increase from $12.1 billion in FY 2001. And it includes $3.9 billion for prescription and medical care benefits for Medicare-eligible military retirees and their families.

The 2002 budget moves beyond simply repairing the present force and takes a major step towards transformation with significant investment in new technologies—it begins to build the military of the 21st Century and it begins to address some of the more urgent threats identified in the first stage of the strategy review.

To advance technologies with the greatest promise for transforming our forces to meet the threats of the 21st Century, the budget assigns appropriate funding for Research, Development, Test, and Evaluation (RDT&E) programs. These include, for example, technologies to protect and enhance our communications and computer capabilities. Reflecting the high priority of transformation, the FY 2002 budget boosts RDT&E by 14 percent in real terms, up to $47.4 billion from 41.0 billion in FY 2001.

Today's strategic environment is far different from that of the Cold War. We have an obligation to plan for the changing circumstances we face today—to make sure that we are arranged to dissuade rash and reckless aggressors from taking or threatening action. One of the most disturbing areas of vulnerability, one frequently identified as an area where our opponents might seek to exploit so-called "asymmetric" approaches against us, is threats from ballistic missiles, armed with both conventional weapons and weapons of mass destruction.

This budget invests heavily in efforts to deter and defend against existing and projected threats and to dissuade potential adversaries from continuing to invest in these dangerous capabilities. The budget advances the President's commitment to build effective missile defenses for our territories, for our allies and deployed forces against threats of all ranges, based on the best available technologies, deployed at the earliest possible date. It includes a total of $7.0 billion for Ballistic Missile Defense Organization (BMDO) programs and $1.3 billion for lower tier systems. And it emphasizes an expanded and flexible RDT&E program that is designed to pursue the most promising developments.

In addition to this important initiative, the budget includes another $13.3 billion dollars of investments in a wide range of potentially transformational capabilities. The chart attached to this testimony gives some indication of the wide-range of programs that we propose to invest in with this budget.

There are also a number of initiatives in this budget proposal that are addressed at streamlining our operations and saving us money, many of which require congressional support. The Peacekeeper deactivation is one such example. As in so many other cases where we'll be looking for savings or cutting unnecessary programs, we have to spend money up front to realize those savings in the out years. In addition, in the case of the Peacekeeper, we will need the support of Congress to remove the current restrictions to get rid of a nuclear system that we no longer need—a system that many intelligent observers have been saying we should have discarded long ago.

We can and we must continue to take other such innovative measures. But doing so will require congressional support. For many important reforms—reducing our excess infrastructure, reallocating functions and giving the department the ability to manage efficiently—we will need your help.

One of Secretary Rumsfeld's top priorities is to transform the Department's system of financial management. We recognize that we need to make fundamental changes that will save money and assure you, the members of Congress, and the American people that we are allocating and using defense funds properly and wisely. The budget includes $100 million to upgrade the Department's financial management systems, a key improvement that will help give Department leaders and Congressional committees needed information more accurately, sooner and cheaper.

So this budget does a great deal. However, if we are to revitalize America's Armed Forces and transform for the 21st Century, it is clear that budget increases alone won't get us to where we need to be. We need to find ways to use the American people's tax dollars more efficiently. We can find savings with the management overhaul that Secretary Rumsfeld has already begun. And, we are committed to operating more efficiently, and thereby saving money, in our daily operations.

Finally and very importantly, this 2002 budget seeks to apply the principle of honest assessments of what it will take to do the job, or what we call realistic costing, to other key areas such as flying hours, transformation and management issues, procurement and base operations. Realistic costing is designed to get us away from the dysfunctional process of deliberately under-budgeting in anticipation of "emergency" supplementals. It is our firm intent that with the '01 supplemental, we will put behind us the kind of supplemental budgeting that became a process that is not based on true unanticipated needs.

The increase in the 2002 budget is thus a significant, historic increase. It begins urgent rehabilitation of the 20th Century force that we have and starts building the force of the 21st Century. This 2002 budget gets us started on the road to rehabilitation and transformation.

I'm reminded of another point in our history when it was a challenge to make a case for increased defense spending. In 1950, General Omar Bradley urged President Truman to spend at least $18 billion on defense. The Joint Chiefs gave an even higher estimate at $23 billion, and the services' estimate was higher still at $30 billion. But the President said we couldn't afford that much - $15 billion was as much as we could afford.

Six months later, we were suddenly in a war in Korea. Just as suddenly we found we had no choice other than to budget some $48 billion—a 300 percent increase. How much better it would have been to have made the investment earlier. If we had done so, Dean Acheson might not have been forced to define Korea as being outside the defense perimeter of the United States—on the grounds that we did not have the forces to defend it.

We have spent an historical average of about 8% of GDP on defense, in part because we have not spent enough in peacetime to prepare for, and deter, war. We can't know who may challenge us in the future, or where, or when. Today, we are more in the range of 3% of GDP. But it is reckless to press our luck or gamble with our children's future. To think we can't afford an insurance policy of roughly 3.5% of GDP today to deter the adversaries of tomorrow and underpin our prosperity, and by extension, peace and stability around the globe, is simply wrong. When compared with the cost in dollars and human lives if we fail to do so, it is cheap at that price.

It's interesting here to consider once again the situation in 1950. President Truman's bottom-line figure of $15 billion represented 32 percent of the federal budget, or just 5 percent of the GDP. The jump in spending to $48 billion the war necessitated represented more than 15 percent of the GDP. If history is our guide, it suggests strongly that we are much wiser to pay the premium now than to pay in blood and treasure later.

Much remains to be done, and we know that fixing and transforming our force is a joint responsibility, one that requires a close partnership between Congress and the Executive Branch. It is a responsibility we have to our nation's service members; it is a responsibility we have to future generations. The force we build today will benefit our successors—and help ensure peace and prosperity for our children and grandchildren.

We look forward to working with you to rehabilitate today's force, and build the force of the future. We earnestly seek your support in this important and noble mission. Thank you.

Chairman CONRAD. Thank you. Thank you for your testimony, and as I said before you began your testimony, we are glad to have you before this committee because these are serious issues and they deserve serious attention.

You made a reference to coasting in the 1990's. I hope you weren't being critical of Secretary Cheney, because when we went back and looked at what Secretary Cheney proposed in his final Future Years Defense Plan with what actually happened—and it is very interesting. Secretary Cheney proposed for fiscal years 1994 through 1999 $1.57 trillion of defense expenditure. And what Congress actually passed and the previous administration supported was $1.56 trillion, less than a 1-percent difference.

So I know you don't come here to be critical of our Vice President, former Secretary of Defense, but what was done in the 1990's is almost precisely what Secretary Cheney proposed.

Let me make——

Mr. WOLFOWITZ. Can I comment on that? Because it is an important point.

Chairman CONRAD. Yes.

Mr. WOLFOWITZ. And in case it is—I think you know, but let me make it absolutely clear. I was his Under Secretary of Defense for Policy, and I had a role in helping to design the drawdown of our cold war force.

By the way, I am a little puzzled at the numbers because I don't remember we ever came up with a 1999 budget estimate back then. But I am not trying to quibble.

I am not trying to criticize anyone in the past. I am trying to describe where we are today and where we have to go. But I think when I use the word "coasting," I would like to explain what I think happened.

We had a big investment in defense in the 1980's. I think it was an investment that has paid off enormously, even in just budgetary terms. The fact that we can bring our defense budget down the way we can is because the cold war ended, and I believe that that build-up had a big contribution to it. And it was entirely reasonable after the Berlin Wall came down to do two things: No. 1, to say we don't need a force that big, we have got to bring it down; and, No. 2, to say we don't have to invest enormous amounts of new equipment, we have an awful lot of things in the inventory that are still pretty good.

And that's why I use the word "coasting." We needed to come down. There was a peace dividend that we were entitled to collect. I think two things happened, though. One is that we didn't—if I can keep the coasting metaphor, we didn't apply the brakes when the speed got a little too high; and, second, we encountered a lot of unanticipated requirements with names like Kosovo and Bosnia and Haiti and a lot of smaller ones that have put a great deal of peacetime pressure on the force, have put Optempo rates very high, have caused us to use aircraft and other equipment at higher-than-expected rates. That means faster deterioration, higher maintenance.

So there were things that weren't anticipated, and as I said, we tended to pay for it by taking money out of those long-term accounts in order to cover short-term accounts.

I am in no way trying to point a finger at anybody. I am trying to describe a phenomenon that has left us now with a force that, while it is still the most powerful in the world, has very real deficiencies. And it is hard sometimes for people to understand that since we are so powerful, we have such a big defense budget, how come they are up here "whining," is the word. And I am trying to tell you that when, you know, there are troops living in barracks with peeling lead paint, that is something we have got to fix.

Chairman CONRAD. And I appreciate that, and I hope that it is not misinterpreted when I say we have got to pay for these things in the context of overall fiscal discipline that is not misinterpreted, because I believe we need more funding for defense. I proposed to my colleagues a $100 billion increase over the baseline.

I do think it is important to point out when our ranking member was here, he said there is nothing to prevent the chairman from releasing the reserve fund for defense today. And that is true. Today there is nothing that would prevent that from occurring. But we are not acting on the defense bill today.

And if you go—and I direct your attention to the conference report on the budget, because the conference report on the budget makes it very, very clear. On page 24, reserve fund for defense, under that article it indicates that the Budget Committee chairman has the ability, once the President has made this additional recommendation, to put that money into the budget. But the next article, Article B, says legislation described in subsection (a) may not, when taken together with all other previously enacted legislation, reduce the on-budget surplus below the level of the Medicare Hospital Insurance Trust Fund surplus in any fiscal year covered by this resolution.

So the Senator was very careful in the language he used. I am being very careful in the language I use. When the defense bill comes up, I am not going to be at liberty to release that reserve fund if, with all previously enacted legislation, it shows that we would be using the Medicare Trust Fund surplus. I am legally bound.

Now, let's look at where we now anticipate we will be in 2002, because I think there is a disconnect going on here about the circumstances we find ourselves in. In 2002, the surplus was estimated at $304 billion for 2002, but $172 billion is Social Security money, $38 billion is Medicare money. That leaves us with $95 billion.

Then we take out the cost of the tax bill, $38 billion; other budget resolution policies, $27 billion; the associated interest costs; and that leaves us with $25 billion of available surplus in 2002. But that is before the next estimate by the Congressional Budget Office in the mid-session review. We now anticipate that because of the slowdown in the economy this year, they will report to us lower estimated revenue next year. And we have had distinguished economists come before this panel and tell us it will be in the range of a $50 to $75 billion reduction because of lower corporate receipts, because of lower corporate profits, because of lower capital gains realizations, because of lower individual income, and that as a result, we face a circumstance in which next year we may be using

all of the Medicare Trust Fund surplus as well as even going into the Social Security Trust Fund.

Now, that is the problem here. And what I am asking you, if this develops, what do you think we should do? Should we use trust fund money? As I say, I am precluded from doing that. I don't think it is the right thing to do, either.

What is your proposal on how we would pay for what you are asking? Do you have specific spending cuts in other areas? Do you have revenue increases? Or do you believe we should just go ahead and use the trust funds of Social Security and Medicare?

Mr. WOLFOWITZ. Mr. Chairman, I will defer most of those questions to Mr. Daniels, who has the responsibility for fitting these things into an overall fiscal policy. But I would emphasize, we are talking about trust funds. We are not talking about—we are talking about the future health of Social Security and Medicare. What we are talking about with the defense budget, I think, is also the future health of American security and the safety of our children and grandchildren. And I think we are weighing very important long-term considerations in all three of those cases. But I would, in fact, urge people in thinking about the importance of these defense requests to realize, as I said earlier, that these are investments in our future. They are not just something to get us by from year to year.

Chairman CONRAD. But that still leaves us with the question, Mr. Secretary. And the administration has got an obligation here to answer this question. How are they going to pay for what they request? There are only three alternatives that I know of: one is to take it out of the trust funds of Social Security and Medicare; a second is raise revenue; a third is cut spending in other areas—or some combination of those three. And I am asking the administration to give us guidance. They say we need the additional funding for defense. I personally believe we do need more money for defense.

But you are leaving us in a situation of not having a recommendation of how to pay for it. And if it is not paid for by additional spending cuts or additional revenue, then it is going to come out of the trust funds of Medicare and perhaps even Social Security, and the administration has made very clear they do not believe it should come out of the Social Security Trust Fund.

So I would repeat the question to you. If you don't have an answer today, can you provide from the administration an answer to this question?

Mr. WOLFOWITZ. Mr. Chairman, it seems to me that it is—economic forecasts have enough uncertainty in them, and you are asking me to comment on a forecast of a forecast. We are working, as you indicated with that chart, with the CBO estimates. If the numbers change—and we know they are going to change because my impression is they change every few weeks. Sometimes they go up, sometimes they go down. They have been going down in the last few months, and that causes problems. At some point it is probably almost certain that they will go up, and my guess, from what I know about economics, is that it will go up before people predict it is going up. It will be wrong again. But I don't know that.

If we face the kind of dilemma that you are suggesting—and it is entirely possible that we do—I would at least urge the Congress to look at some other spending priorities before we immediately say that defense is the one that comes last. According to the numbers that were given to me—and everyone has different numbers, but my understanding is that defense spending, if you look at the growth in 2001 with the supplemental over 2000, it is 5 percent. We are asking for another 8 percent. That would make a 13-percent increase in defense spending over 2 years. Domestic spending in that same period has gone up 18 percent. And that is after a decade in which domestic spending increases substantially and defense spending declined substantially in real terms.

I don't know where those—I mean, I know all that other money is money that serves an important need, and some of it serves crucially important needs. But I really do think there is perhaps no need that is more important than ensuring that our children and grandchildren can be safe from the prospect of a world war or even another cold war. Another cold war will make all of our talk about budget surpluses just vanish overnight.

Chairman CONRAD. Well, we couldn't be in stronger agreement on the question of increased resources for defense. But we are left with the question——

Mr. WOLFOWITZ. We like hearing that.

Chairman CONRAD. We are left with the question of how to pay for it, and it is a very serious question.

I think it would be a serious mistake to pay for it by using trust fund moneys of Medicare and Social Security, and that is what we are poised to do.

On the question of forecasts, the forecasts are going down, and there cannot be any doubt they will erode further because of continuing weakness in the economy. We all know what is in this forecast. They are assuming an economic growth rate that is not happening. There is no question about that. And so that puts us in this perilous position. And I think the administration has got a serious obligation to say to us how they intend to pay for their request.

Let me ask one other question and then go to my colleagues. When does the administration intend to submit a full 6-year Future Years Defense Plan that is required by the law? You have told us 1 year. We can't plan—the reason there is a requirement in the law that you have to give us the future years as well as 1 year is so that we can put into an overall plan. When will you provide that Future Years Defense Plan?

Mr. WOLFOWITZ. Mr. Chairman, it will be part of the fiscal year 2003 budget request. We will have a Forward Year Defense Plan in connection with that request.

I think the situation——

Chairman CONRAD. Can I just say that——

Mr. WOLFOWITZ. The situation that we are in this year is not at all unprecedented. In fact, I think 8 years ago at the start of the last administration they had the same problem of submitting an amended budget, having to work over time, coming in with something at the last minute. You can't at the same time then work all those amendments through into the outyears. We will have something with the 2003 budget.

Chairman CONRAD. Can I just say that that just doesn't work? We need to have from you what the law requires, and the law requires, for a very good reason, that you give us your Future Years Defense Plan when you submit your request. And talking about what happened in some previous circumstance I don't think is acceptable. And I would urge the administration to provide us at the earliest opportunity the Future Years Defense Plan because it has significant implications for doing what you want to accomplish. I am trying to be——

Mr. WOLFOWITZ. Mr. Chairman, I assume that in 1993 the law required the same thing, and I assume the Congress in its wisdom understood that a new administration putting together an amended budget would have difficulty presenting you a realistic estimate of what outyear numbers are.

We could get back to the business of pretending that we are giving you a realistic outyear plan, but, quite honestly, I think the way to get to what you really need, which is realistic estimates of the outyears, is to go through the kind of work that we are doing right now in response to the requirement for the Quadrennial Defense Review. And that will appear in the 2003 budget.

Chairman CONRAD. Is there any chance you would be discontinuing the increase that you have asked for for 2002? Is there any possibility you would be suggesting in real terms cuts in the future years?

Mr. WOLFOWITZ. Certainly from what we have seen now, we are going to need—unless we come up with savings of—let me put it this way: Certainly the needs that we have identified and that we begin to fund in this year's budget are needs that we are going to have to fund in next year's budget and years afterwards. So there is a certain—if the question is is this a one-time get well and then you go back down to a lower level, the answer is no. In terms of what we need to be funding, we think this is at least where we need to be.

As we are finally getting some of our key appointees confirmed—and I would—again, I hope this doesn't sound like whining, but we didn't have service Secretaries until late May, early June, and they are now working with very limited staffs under them. But we have a lot of confidence in the three individuals who have been selected to be—have been confirmed as Secretary of the Air Force, Navy, and Army now, who come with very strong views about ways in which we can manage more efficiently and save money. So it is possible, if we are successful in finding significant savings, that some of what we need can come out of savings. That is also part of what has to go into figuring out our future year defense program.

Chairman CONRAD. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Secretary Wolfowitz. I know we could have an endless debate here this morning about, you know, what we can and cannot afford. But I think that there are certain realities that obviously we have to acknowledge. And as one who has served on the Senate Armed Services for several years, there is no question that you inherit an undercapitalized budget. We know we borrowed from operations and maintenance to pay for multiple contingency

operations abroad, and, you know, we are sort of trying to play catch-up.

I know that we have not made the necessary investments for modernization that we need to make in order to prepare for the future. So obviously we are going to have some challenging moments depending on what those surplus numbers imply with the re-estimates in August. But I have no doubts about the worthiness of the proposals that you are presenting on behalf of the administration with respect to what do we need to do in the future.

I would like to hear from you, given the $18 billion proposed increase over this fiscal year, what would be the consequences of not providing that kind of investment from the standpoint of operations and readiness, Persian Gulf missions, our missions abroad in so many areas where we are dispersed? Could you give the committee an idea of what the impact would be if we could not realize this increase for the next fiscal year?

Mr. WOLFOWITZ. I appreciate the question. I think the consequences would be very serious. I think we would find somewhere around the middle of the year that we wouldn't have the money to keep our airplanes flying and to keep our ships operating. We would probably be coming up here with another request for a supplemental, which we might or might not get, but if we didn't get it, we would be shutting down operations in key parts of the world.

We wouldn't be starting investment in some of the programs that take years to come to fruition, and I know people say, well, if it is going to take 10 years, what does it matter if you delay it a year? Well, my view is if it takes 10 years, you ought to figure out how to try to accelerate it. Ten years after we lost people in the Gulf War to missile attack, we still haven't deployed an effective defense against the most primitive missile in the old Iraqi inventory, the Scud missile. This budget will start us on the road to getting there by fiscal year 2007. In the meantime, we are in very great danger both in the Persian Gulf and Korea from missile attack to our troops.

But I think the most serious thing is if we don't get that increase, we are not going to be able to fund the kinds of pay increases, the health benefits, the things that are servicemen and women feel directly, and overall we will be sending a message to them—and I think it is a very, very dangerous message—that after years of doing more with less, they are still going to have to do more with less. And I think some of them are on the verge of saying if that is the way the country feels about what we are doing, I will find a different line of work. That will be a terrible, terrible consequence that we will spend years trying to get back.

Senator SNOWE. How did the Department come to the number of $18 billion? I mean, how was that assessment made?

Mr. WOLFOWITZ. These are always—a great deal of what we call judgment calls are involved. You try to look at what—first identify what your needs are, and I will be honest. When we identify what our needs are, we could come up with a request that is a lot more than $18 billion. So the question is how do you decide of those needs which are the highest priority. And we had a process of trying to identify those alternative priorities to the Secretary of Defense, and I would say that as he addressed it, I think the highest

priority was to begin those fundamental things that are key to maintaining the morale of our service people, and that includes not just direct things like pay, but it also includes things like fixing up housing. That really accounts for the largest single piece of that $18 billion.

Second, I don't think you have much choice in the way you start from the point that if you are going to do honest budgeting, you have got to start with honest numbers. So you have certain increases for health care that are just unavoidable; $5 billion of that increase is to cover what we think will be the real health care cost instead of continuing to under-budget them.

And then there is a very important piece of additional research and development money that we considered also very important to building that future force.

So it is sort of a decision at the end of the day that the highest priorities are people, but beginning to build that 21st century force is not far behind, and you try to balance those at the margin.

Senator SNOWE. Which has been consistently deferred. I mean, it is no secret around here that the way in which we reinforced the defense budget was through supplementals. I applaud the administration for taking the approach of trying to avoid that in the future by providing an honest and realistic budget with respect to what is necessary to support the Defense Department. We did endless supplementals and doing end-runs around the budget because it was clear that Congress wasn't prepared to accept the realities of the true costs given the contingency operations that we were engaged in abroad.

What percentage of that $18 billion would be for pay and health care spending for our personnel?

Mr. WOLFOWITZ. Do you have that number, Dr. Zakheim?

Senator SNOWE. Because I think that is an important issue. We have fought consistently to improve the benefits and the pay for our military personnel so that we can continue to retain good people. That is one of the big challenges that we faced in the Defense Department and our armed forces, to retain our good people.

Mr. ZAKHEIM. Well, Senator, in the original February announcement that the President made, he talked about an increase of $1.4 billion for pay and related expenditures, and that was incorporated in the amended budget. In fact, the total increase in pay from fiscal year 2001 to fiscal year 2002 is about $7 billion. We are now going to be spending overall on military personnel $82 billion-plus on pay.

In terms of defense health, the increase has gone up from $12.1 billion in 2001 to nearly 18—17.9 in 2002. And I would point out that defense health is essentially an entitlement. We are now by law committed, for instance, to paying out Tricare for Life for everyone over 65, and we had to provide $3.9 billion in funding for that. And, therefore, to deal with your earlier question, whatever else we might have had to cut, we would have had to still pay that money.

Senator SNOWE. I might just add, a couple of years ago, I was in the Persian Gulf on the U.S.S. Enterprise, and if there was one issue that was raised by the crew, it was in the issue of health care. So one of the single greatest issues for military personnel is

the quality of their health care and being able to have a good program, a good solid health care program for themselves and for their families. And these are critical issues because there is a cost benefit involved. We lose good people that we have invested hundreds of thousands of dollars in to train, because we are not providing the kind of benefits that are competitive with the private sector. Ultimately it is going to cost us that much more, and so I do think it is a very critical issue. Thank you.

Chairman CONRAD. Thank you, Senator. And Senator Feingold is next.

Senator FEINGOLD. Thank you, Mr. Chairman, for holding this important hearing, and thank you Secretary Wolfowitz.

I have long believed that prior to assessing the financial commitment that we will be making to defend this country over the next decade that we should first answer the following questions: what are the threats to the United States and what should be the strategy to respond to these threats? And I think that it is only after you have answered those two fundamental questions that you can take the final step of assessing what military forces, equipment and infrastructure that will be needed to respond to those threats, and then, only then, should we assess how much of our scarce budget resources will be needed to implement that strategy.

It appears to me, and I certainly listen to the chairman on this, that the Department of Defense is really putting the cart before the horse by asking to increase its already massive budget request by 18.4 billion, when the long-overdue comprehensive defense strategy review has not been completed. So I fear that once again we are being asked to increase defense spending before we have assessed whether such an increase is appropriate within the context of our overall defense strategy, and of course, before we really assessed our ability to pay for such an increase.

Of course a strong national defense is crucial to the peace and stability of our Nation, but a strong economy is also essential to national security. I do not think we can focus on one to the detriment of the other. Any long-range defense plan should therefore take into account both what our strategies should be and how they will be paid for. And I would add, since you mentioned some of these commitments, which I have opposed over the years, that we should consider our commitments abroad. We should know how much they will cost and also how long an American military presence will be required. I believe that for too long the defense budget has not actually received the same intense scrutiny as other parts of the Federal budget.

I, for one, am prepared to vote for responsible cuts to domestic spending and to support defense spending. In fact, I would like to see some of these things you have on your chart here addressed, but some of these should be addressed within the Defense Department. I do not think the priorities of the Defense Department are always correct. When I have read the information about the Osprey, the Trident, the F–18, Super Hornet, I do not think those weapon systems and planes are getting scrutiny, while these needs, desperate needs, are being ignored.

So I guess what I am saying is I am just not prepared to vote for a blank check for the Pentagon. It is not surprising that the De-

partment of Defense would ask for such a large increase in spending when I feel that many in Congress are ready to rubber stamp the administration's request and pile on billions more in unrequested spending.

I am going to continue to argue—and I know the people in my state are concerned about this—that we cannot recklessly, and almost automatically increase defense spending without thought to priorities within the Defense Department and the cost as well, because in the end, the cost could be our balanced budget and the economic well being of our country.

Let me just ask a couple of questions. I think you have already answered this and said it, but I want to be sure. You did say that you do not plan to be back here next spring asking for another supplemental appropriations bill; is that right?

Mr. WOLFOWITZ. That is correct.

Senator FEINGOLD. What can we expect in terms of the proposed increase at least for fiscal year 2003?

Mr. WOLFOWITZ. Senator, we are working on that, and that is something we hope will have an even closer connection with strategy. I say even closer because I have to take exception to the notion that what we are up here asking for has no relation to a strategic assessment. It has a great deal of relation to it, but you do not start from ground zero. You start with a great deal of commitments. You start with a force that is operating around the world. You start with Operation Northern Watch over Iraq and Operation Southern Watch over Iraq. You have things that you know you have to fund. You have facilities that you know are in very bad condition, and our current budget levels would only be replaced at 192-year replacement rate.

As I indicated in my testimony, we are not basing this budget on a notion that we are going to replace all of those facilities. To the contrary, we are really basing this budget on an assumption that at least 20, 25 percent of those facilities we will determine. And it is going to be a difficult process. It is going to involve something like, dare I say the four-letter word, BRAC, which usually gets me in trouble up here, but there is going to have to be some reduction in that base infrastructure, and we in effect are planning on that in this budget.

And by the way, I do want to emphasize too, it is not a budget that simply increases. We have a number of savings initiatives, not as many as the Secretary and I would like. It is partly the question of still not having the people to implement those. But we are taking four Tridents out of the—you mentioned the Trident. I am not quite sure what problem you have with it. My problem with it is that it is a cold war system with nuclear capability. We are taking four of those nuclear Tridents out of the force and converting two of them to very valuable conventional capability. We are retiring the Peacekeeper missile entirely, and I think would, I assume, applaud that move. It is overdue in my view.

By the way, one of the unfortunate facts about defense budgeting is usually in order to cut something, you have got to spend money the first few years to take it out. It is a terrible disincentive for savings, and I hope, as an aside, that we might find a way, maybe with budget scoring or some other way, to give people something

other than a massive disincentive to take anything out of the force, because it has to increase their top line next year.

Senator FEINGOLD. Let me ask you—I appreciate what you are saying. It is helpful. But let me ask it another way. The chairman and I and others, you know, we want to be able to plan, so can you give me a sense, would you expect next year that the amount you would ask for would be similar to this here, substantially greater, or substantially less? Can we get some sense of where we are heading?

Mr. WOLFOWITZ. I do not mean to be a smart aleck. I am tempted to ask, can you tell me which way these—where these fiscal estimates will be in two or 3 years. I mean, there is a problem. You want a precise defense plan. Frankly, I would like a precise defense plan. I think we will manage our resources much, much better if we have stable defense spending profiles. On the other hand, when it encounters economic estimate that go up and down every month, I sort of leave this to my betters to sort of figure out how that works. I do know that stable spending profiles would be very valuable for the Department. That is why we are working in the QDR with this to try to develop an 1903 budget and an out-year defense plan. It gives you those sort of stable estimates. I cannot sit here now and tell you what they are. As I said to the chairman, I do not think that the process of the QDR is going to say that the needs we have identified so far are not real needs, and may in fact may identify, if anything, more needs. What I hope we will also identify though are more savings. So whether that nets out as a plus or minus, I cannot tell you today. I wish I could.

Senator FEINGOLD. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman. Did Senator Clinton have a chance to go?

Chairman CONRAD. She is next, but we are going back and forth.

Senator NICKLES. Well, thank you.

Secretary Wolfowitz, one, welcome to the Committee. I see that you have a cast on your foot. Is that a service-connected disability that you have taken on in your first few months back?

Mr. WOLFOWITZ. I am afraid it was playing tennis.

Senator NICKLES. That might be. There is probably a lot of people—I will not touch that.

I notice in the request—and somebody will complain, somebody will complain there is not enough, and somebody from the military—we are seeking significantly more, I understand, or at least some people have told me that, and others we have heard said that it is too much. I have tried to put this in context of what we have done over the last year or so. I noticed in defense last year, before we did the supplemental, which we just did, defense spending grew at 3 percent. With the supplemental I guess you could say it grew at 5 percent in BA. I also compare that to what we did in domestic. Last year in domestic, between 2000 and 2001, domestic grew at 14 percent, 14 percent. And so I look at what you are asking for next year as a growth of 8 percent, and domestic is growing again at 4 percent. So if you add the two together, in other words, if you go back to 2000, 2001, 2002, defense is still behind. So I just make those points.

I think there is a lot of catch-up. I think the previous administration and the previous congresses did not adequately fund defense, particularly I would say the last few years, because we were hanging on a BA level, right at $300 billion for years. And so you have some catching up to do. We were wearing out planes. We maintained a lot of those at Tinker Air Force Base, but we were wearing out planes. I want to congratulate the military. I am absolutely amazed at the number of missions, the thousands of missions that flew over Bosnia, that fly today over Iraq, and have been able to do that with such great success, great success in the fact the planes are still flying, great success the planes have not been breaking down, great success in our pilots have done a fantastic job and have not been hit by anti-aircraft fire, which is intensified, I understand, over Iraq and so on. So I just make those comments. There has to be some expenses there. We have a lot of dollars that have been flowing out, and frankly, I do not believe in the last few years we adequately provided for our national defense, and I look at it more or less as you are playing catch-up, for years of neglect both by the previous administration and by congress, because we are the ones who ultimately write the checks and maybe we did not write enough.

Last year we passed the Defense Appropriation Bill. Interestingly enough, we passed it as the first bill. Pretty frugal, about 3 percent increase. But we did not hold to that when we passed the Labor HHS Bill. It grew at a BA level of growth of about 24 percent, because most of the other appropriation bills were pretty much in line with lower levels, but when we got to the last couple of bills, we got a little carried away. So I just look at the total growth of spending, defense and non-defense, and non-defense grew quite a bit over the last few years, and defense did not. You have got a lot of work to do. You have got a lot of maintenance. You have got a lot of operation. You have got a lot of procurement that you are way behind.

And I have not analyzed the entire request that you have made. I think that we have that responsibility. We need to analyze. We need to make sure that the $18 billion that you are proposing to spend is well spent, and scrutinize it, and work with the administration, make sure that it is well spent, make sure that it does get to the right place, to where we get the most bang of defense for a dollar. I will be happy to work with you and others doing it, but I just wanted to put it in context because I have heard some people say, "Oh, there is no way we can afford that. This is invading this trust fund," or something like that, and I am, "Wait a minute, where is the criticism on non-defense, that that base was built up substantially last year, and no one is talking about cutting that and reducing that."

So I make those editorial comments and maybe ask you a question, and it is that, defense/non-defense—you probably reviewed it over the last several years—has the growth in defense kept up with the growth in non-defense over the last few years?

Mr. WOLFOWITZ. I have, over the last decade, and my impression is that in real terms, that non-defense has increased by about 25 percent, and defense has decreased by about 25 percent. That is a 50 percent gap right there. And as you point out, Senator, even in

the last 2 years when we have I think developed a consensus that we have got to start doing some of that repair work, domestic spending is still increasing faster than defense spending. I do not want to make an enemy out of all the other Cabinet departments, Senator Conrad, but I mean if you ask me where to look for money, I would say do not look first at defense.

Senator NICKLES. Well, in some cases non-defense was growing at multiples. If last year defense ended up growing—well, without the supplemental it was 3 percent versus 14 percent. That is 3–1/2 times as much. With the supplemental it is 5 to 14, so it is still almost 3 times the growth rate of defense. That is a pretty significant change, and you are trying to have defense now grow at a somewhat faster rate than non-defense today. I happen to agree with you on that, and we will have to fight out the wars, both in the budget process and in appropriations, and I appreciate your presentation before the Committee today.

Mr. WOLFOWITZ. Well, thank you, Senator. As you say, even if we get this full 8 percent this year, and I certainly hope we will, our growth rate over the last 2 years will be lower than the growth rate of non-defense spending over the last 2 years.

Senator NICKLES. Just kind of glancing at the figures, the BA level that we had in 1988, the BA levels that we had in 1986—no, these are adjusted, those are. I will just stop there. I do not want to confuse people. Thank you very much.

Chairman CONRAD. Thank you, Senator Nickles. And, Senator Clinton.

Senator CLINTON. Thank you very much, Mr. Chairman. And thank you, Secretary Wolfowitz, for your service over many years, and for being willing to come back to the government and take on this responsibility, and I also appreciate Mr. Zakheim being here as well.

I think that you probably are getting a flavor of what I believe is the consensus in the Congress, and that is that on both side of the aisle, the majority of us want to do whatever is necessary and justifiable to provide the appropriate funding levels for defense. I do not think that you will see any opposition to well-thought-out requests that really do provide a basis for our long-term security in meeting both known and perhaps unpredictable threats. The real dilemma for those of us sitting on this side of the table is how we do that. And I have to echo the chairman's questions, that we really need your help in doing that because we are in a situation that will make it very difficult to provide the kind of support that is requested.

You know that I have been honored to visit our troops and facilities literally all over the world, and I have seen our men and women in uniform literally on the front lines, doing the work that they sign up to do, but that we need them to do for all of us. So I am certainly among those who will support the kind of well-thought-out requests that I believe will support our services and put us in a good position for the future.

But I am, as you might guess from the tenor of the questions at least on this side of the table, looking for some help. Now, many of us have heard estimates ranging anywhere from $18 billion to $32 billion from the vice chiefs of staff, to $50 billion from an esti-

mate from former Secretaries of Defense, all the way up to $100 billion from the Center for Strategic and International Studies. That is a very large range, and everyone starts from the same premise, that they are looking at our position, looking at what we need to do to be ready to confront any of our security needs, and we obviously are trying to make sense out of such a broad range of defense funding need projections. And I go back to your comments about projections.

None of us know exactly what will happen in the future, but certainly many of us on the floor voted to increase money for defense in the budget and tax cut debate. We were ready to support Chairman Conrad's alternative that would have provided an additional $100 billion over the 10-year window, which is on the high end of the estimates that have been projected. Many of us also supported other amendments from Senators Landrieu and McCain, that would have reduced the tax cut to provide funding for defense. Unfortunately, we got no help from the administration to try to have a more balanced approach toward cutting taxes and providing for defense. In fact, as you I am sure know, and as I was somewhat surprised to read, even publications like the Weekly Standard have criticized the administration for fiddling with tax cuts while the military burned. And that article goes on to say that the real reason the White House is abandoning the two-war strategy is that under the current budget constraints, they cannot afford it. So when that budget and tax cut was signed into law on June the 7th, I think many of us really were, if not confused, at least concerned, that the administration was speaking out of both sides of its mouth. On the one hand, you and Secretary Rumsfeld and the Chiefs and others were conducting a review that we knew would lead to additional requests for funding. On the other hand, there was no willingness to make the hard political decision that would have provided those dollars in the budget. And in fact, 20 days later the President submitted a defense budget amendment that did increase the budget authority by the 18.4 billion that we are faced with in this hearing.

Now what I am struck by is whether or not the Department of Defense was involved in the overall budget preparation. I know a little bit about how budgets are put together in administrations, and I would like to know whether the White House knew at the time it came forward with its tax cuts and its opposition to those of us who were willing to increase defense spending in the budget, whether the White House knew the extensive budgetary needs that DOD would present, and that were left out of the blueprint and the April budget, or were you just left out of the overall budget planning and we are playing some catch-up right now?

Mr. WOLFOWITZ. I think throughout the process we have been in very close, essentially daily contact, with our colleagues in OMB. You know, as you mentioned in your comments, there are a range of estimates about what defense spending needs are. I think it might be worth pointing out—and I do not know whether—most of the outside estimates you mentioned are in the range of $50 to $100 billion. We are well under them. On the other hand, we are above the levels that were in fact considered during the budget debate up here, whether it is the $10 billion that was Senator

Landrieu's proposal or proposals from the Republicans on the Armed Services Committee. We have tried very hard and to work with OMB to get these numbers down to ones that we can truly fully justified. We have worked hard, and we will continue to work hard—you are asking for help—to help in finding savings. We are going to need some help from the Congress on that score. We came up with a proposal. We have a proposal up here that will get us some of the serious bomber capability that we need, but it requires taking 30 B–1s out of the force and using that money to upgrade the remaining 60. And judging from some of the complaints we have had from individual senators and Congressmen, it suggests that it may be a tough road forward to get those kinds of savings.

Peacekeeper is a different kind of example, where we have to ask for extra money in this year's budget in order to retire Peacekeeper. When we eventually retire Peacekeeper, it will take roughly $150 million a year out of the budget. Mind you, it should have been done quite a few years ago, but we have to ask for money to do it, and we do not—when we are talking about all of these estimates and out-year trust funds and so forth, there is no credit given to the fact that out-years there will be $150 million a year in perpetuity that we have saved. I do not think the way the current system is set up it creates the right kinds of budgeting mechanisms, scoring mechanisms to encourage the kinds of savings that I think you and I and, in fact, every serious observer of the Defense Department would like to see.

Senator CLINTON. So in other words, the administration was well aware of the needs that would be required in defense at the time that they put forth their budget and the tax cut?

Mr. WOLFOWITZ. If you mean the time they submitted the blueprint budget last year, we had only just—in fact, I was not confirmed at the time. We certainly were not—I do not know what well aware means. We were in no position back then to give you the kind of detailed justification of a defense increase of the kind we have done now, and in fact, we were working round the clock through May and June to come up——

Senator CLINTON. But there was no doubt that there was going to be a significant request for increased defense spending, was there, Secretary Wolfowitz?

Mr. WOLFOWITZ. I think that is precisely why they asked in the budget resolution to have this discretion for the chairman to put a new mark in for defense. I do not think anyone expected that mark would be lower. It was expected it would be an increase, and that we would, during the course of this work this spring and early summer, come up with a specification of that increase.

Senator CLINTON. Well, you know, Mr. Secretary, I am hoping that we are going to be able to work out the very difficult decision-making that will be required to do what you are requesting. I would certainly add, on my own behalf, to the chairman's list of three alternatives, the alternative of revisiting the tax cut. You know, as I sit here and hear what are very serious concerns about our defense posture and our security needs, I am just amazed that we would be setting ourselves on a fiscal course that I believe will lead us back into deficits, that will pose the kind of impossible political choices that the chairman outlined with the Medicare and

Social Security Trust Fund on the one hand, necessary discretionary non-defense spending, whatever you set that level at on the other hand, including education and the like, and our defense needs.

And I guess I would just ask you—I know you are a student of defense and of our government—as you look down the next 10 years, what is more in the interest of our country, a huge tax cut that puts us into deficits and undermines our ability to meet our needs, or funding our defense needs?

Mr. WOLFOWITZ. Senator Clinton, I think what is most in our interest looking down the road is a healthy economy, and I think a lot of this argument about tax cuts comes down to judgments about what will produce a healthy economy in the future. I do not think you can have a successful defense program without a healthy economy, and that is why I cannot say defense comes first. I do think they go together, and I do think that there is nothing more important—no more important responsibility we have as custodians of the public trust than to try insure the future peace and safety of—the peace and safety of future generations. But I think part of that involves having an economy that continues to grow. The reason we have the surpluses we enjoy today is because the economy has grown. The reason we have the problem Senator Conrad is pointing out is because our growth is slowing. And I think a major judgment behind that tax cut is the judgment that it will contribute to economic growth.

Senator CLINTON. I could not agree with you more, and I would look forward to talking to you in the next 5 to 10 years about what does and does not work to create a healthy economy. I mean one of the reasons that the prior administration had to make the tough choices it made is because it inherited deficits that were growing at a rate that was unsustainable, that froze out private capital, and I would certainly argue that the fiscal responsibility that the past administration and Congresses engaged in made it difficult to fund everything that was required, put us on the path to a strong economy, and I regret deeply that we have taken what I consider to be an unfortunate detour off that path, which will make the choices that you are asking us to make today ever more difficult.

But, you know, the proof is in the pudding. We will see how it plays out, but we are going to have some very tough decisions because we have squandered the opportunity of the accumulated surpluses to do the kinds of things with defense, with our failing infrastructure in other areas that would make us, as a Nation, richer, safer, smarter and stronger in the future, and that is what I regret deeply. And we will—certainly speaking for myself—do the very best we can to meet the legitimate needs that you have presented to us today, but it is an unfortunate conclusion that I reach that we are faced with this instead of being able to make the kind of planning for the future in defense and other areas that a strong, secure Nation should be able to in a time of increasing threats.

And so I look forward to working with you, but it think we all have our job cut out for us.

Mr. WOLFOWITZ. Senator, I might say that I think economizing on defense is not a way to deal with long-term——

Senator CLINTON. I did not say that. I did not say that. I did not imply it. I would not support it. I am just saying it is unfortunate that at a time when we had surpluses and an opportunity to do the long-term planning, instead we have given it away. And I believe given it away, that leads us back into deficit that will make it even more difficult to meet the balanced kinds of challenges that our Nation faces on both the domestic and the international front. Thank you very much.

Chairman CONRAD. Thank you, Senator Clinton.

I would like to take you, Mr. Secretary, back to where I began. I look at 2002, and we start with what the projected surplus was, we take out the trust funds, we take out the cost of the tax bill, we take out the other budget resolution policies that have passed, and then we make an adjustment for the economic downturn based on the testimony of three expert witnesses before this Committee, all of whom were projecting 50 to $75 billion less in revenue next year than is in the underlying budget assumptions. And what that left us with is using all of the Medicare Trust Fund surplus next year, and even dipping into the Social Security Trust Fund.

Now, let us go to the next chart, which is the longer years, and I have provided to Dr. Zakheim and yourself a hand chart of this one so you can study it more clearly. And I would ask you to take it back and share it with others in the administration, because this goes right to the heart of the problem. 2001 we all know about. That is during a time of economic downturn. 2002, the administration is not projecting economic downturn, the administration is projecting strong economic growth, and yet we see that we are using Medicare and Social Security Trust Fund money to pay for other Government programs. And your defense request only makes that circumstance worse unless the administration comes up with a way to pay for it. In fact, the forecasts we have now would suggest your defense request would have to come out of the Social Security Trust Fund, something this administration has pledged not to do.[9]

Based on your testimony here today, looking at the bow wave effect of your defense request, we see that that is a $200 billion item over 10 years. Now, you have indicated you are not going to be asking for less in succeeding years, and I am sure you would not.

So if we just go through for the period of the 10 years, and we start with the projected surpluses, and we take out the trust funds of Social Security and Medicare, we take out the cost of the tax bill, which is now known. That is passed, that is law. We take out the cost of the other budget resolution policies. We know those. Those have been passed. We take out the effect of just the increase in defense that you are requesting here. We take out possible economic revisions that the Congressional Budget Office has already alerted us to, that they will be making in August because of the economic slowdown. And then we put the associated interest costs into the calculation. What it leaves you with is very clear. It is non-trust fund deficits each and every year out through 2008, non-trust fund deficits. That means we would be using, if we adopt your defense request without offsets, we would be into both Medicare and Social Security Trust Funds in 2002, in 2003, in 2004, and we would be

[9] CHART NOT AVAILABLE AT PRESS TIME.

into the Medicare Trust Fund in a substantial way in 2005, 2006, 2007, and modestly in 2008. That is the problem your request presents us.

This administration has pledged not to use Social Security Trust Fund money for other purposes. Our numbers show not only using Social Security Trust Fund money, using Medicare Trust Fund money in a very substantial way.

Now, I believe the administration has done a disservice to defense because they passed a tax cut of significant proportion before they had in a whole plan that added up. Now we are left with a plan that does not add up. It just does not. This is not your responsibility, but it affects your responsibility because it affects defense. And I do not believe it is wise, when the administration is projecting periods of strong economic growth, which they are in the succeeding years, to be using trust funds of Social Security and Medicare to pay for other programs of the Federal Government. I think that is a profound mistake when we all know the baby boomers start to retire in 11 years.

And so what is the way out of this morass? The only way that I can see is that anything that is above what is in the budget, and that is defense and any other proposal, is going to have to be paid for for some way, either additional cuts somewhere else, or additional revenue, or some combination. And I know that is not the responsibility that you have. That is at a higher level. But I say this to you directly and honestly, I think the administration has done a disservice to defense, I think they have done a disservice to fiscal responsibility, because they have got a package up here that just does not add up. And this is not some forecast or some projection other than acknowledge the economic downturn that has occurred. This economic downturn is happening. I do not think there is anybody that does not understand the economic growth rates that are in the forecast are not going to happen this year, and so the results for revenue for this year and next year are really pretty clear.

So I would hope that you would take this back to the powers that be, and explain to them, we have got a real problem here. I want to be helpful. I believe much of what you say is correct. I believe we need more resources for defense. I put them in my budget. I paid for them. And a failure to pay for them is going to lead, inexorably, I believe, to the administration breaking another of its promises, which was they are not going to use Social Security Trust Fund money. And I must say I do not for the life of me understand the distinction between not using Social Security Trust Fund money and not using Medicare Trust Fund money. I do not think either one of them should be used to fund other Government programs. We need those funds to pay down debt or to prefund a liability if we are to prepare for what is to come.

So I want to conclude by again thanking you for being here, Dr. Zakheim as well. We have high regard for both of you. You are exceptionally able people. Our country is fortunate to have people like you willing to serve. I think I know both of you can be making a lot more money and have a lot easier lives in the private sector, but I have, based on my past experiences with you both, I have great respect for you. But that does not take away from the cir-

cumstance we face. I think the administration has really kind of handed us a live grenade, if you will, and somehow together, we have got to dig out, and the sooner we figure this out, the better. I thank you.

Mr. WOLFOWITZ. Thank you, Mr. Chairman.

Mr. ZAKHEIM. Thank you, Mr. Chairman.

[Whereupon, at 11:14 a.m., the committee was adjourned.]

SOCIAL SECURITY TRANSITION COSTS

THURSDAY, AUGUST 2, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:01 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Murray, Feingold, Nelson, Stabenow, Clinton, Corzine, Grassley, and Gramm.

Staff present: Mary Ann Naylor, Majority Staff Director; and G. William Hoagland, Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. Good morning. I have just talked to Senator Domenici, and he has had a loss in the family and will not be able to be with us this morning. He has to return to New Mexico. And I want to express the condolences of the committee to Senator Domenici and his family. We certainly grieve with them in their loss.

I want to indicate that we will proceed as we normally do here. I will say to the witnesses that your full statements will be made part of the record, and we would ask you to summarize your statements in about 5 minutes. We will not be slavish about that, but we would ask you to do that so that there is plenty of time for questions.

Senator Grassley is here. He will serve on the Republican side this morning——

Senator GRASSLEY. Thank you.

Chairman CONRAD [continuing]. In Senator Domenici's absence.

I want to begin by welcoming our witnesses this morning. Bob Greenstein, who is no stranger to this committee, Dr. Orszag, who has provided very valuable testimony to this committee on a prior occasion, and Dr. Schieber—am I pronouncing it correctly?

Mr. SCHIEBER. Correct, yes.

Chairman CONRAD. Welcome. Good to have you here.

Mr. SCHIEBER. Thank you very much.

Chairman CONRAD. We appreciate very much the willingness of the witnesses to share their collective wisdom with the Budget Committee on what is a very important and somewhat complicated subject.

Earlier this year, the President announced the formation of a Commission on Social Security. The President set out certain guiding principles for that commission: no payroll tax increases, no ben-

efit changes for current retirees, and the creation of voluntary private accounts. Anybody who has paid attention to the public debate over the future of Social Security knows that reforms, particularly reforms that include any type of private account, will require substantial new budgetary resources.

While the President's commission has yet to make specific recommendations, the President's guiding principles lead us to believe that they will propose reforms which include the creation of individual accounts roughly equivalent to 2 percentage points of payroll tax. Social Security experts agree that the 10-year cost of such a proposal is about a trillion dollars. The Social Security question that most concerns the Budget Committee is are there sufficient budgetary resources available to fund the types of reforms envisioned by the President and his commission.

Before the enactment of the tax cut, the answer to that question was clearly yes. And in the wake of the tax cut, I look forward to hearing from our witnesses about the continued affordability of this type of proposal. But before we hear from our witnesses, about the budgetary tradeoffs and the transition costs associated with Social Security reform, I would like to remind my colleagues where we stood in January of this year versus where we stand today with respect to the surplus and with respect to the options open to us in addressing the long-term budgetary needs of our aging society.

In January of 2001, CBO presented us with projections showing a $5.6-trillion surplus over the next 10 years, $3.1 trillion in trust fund surpluses—Social Security and HI Trust Funds—and $2.5 trillion in non-Social Security and HI surpluses.

Do we have a chart that shows that?[10]

As we pondered the options for putting that hard-earned surplus to best use, the Budget Committee heard testimony from Controller Walker warning us the permanent or open-ended tax cuts and/or spending increases would reduce future fiscal flexibility. Mr. Walker also reminded us of our stewardship obligation to future generations, suggesting that today's budget decisions need to be made with the future in mind.

We also heard important testimony earlier this year from one of today's witnesses, Mr. Orszag, who told us that higher national savings offers the most effective available policy response to our aging population. Saving the projected Social Security surplus, the projected Hospital Insurance surplus, and one-third of the projected on-budget surplus between 2002 and 2011, he testified, would raise real gross domestic product by roughly $200 billion in 2012. This illustrate a real cost to foregoing national savings. That was your testimony then, Dr. Orszag, at least in part.

With this thoughtful advice, I offered an alternative budget that set aside all of the Social Security and Medicare Trust Fund surpluses. In addition, my budget resolution set aside $900 billion in a reserve fund to strengthen Social Security for the long term. Those reserve resources could have been used in a variety of ways to strengthen the Social Security program.

Some of my colleagues support creating TSP-type accounts on top of or as part of the Social Security program. TSP refers to the thrift

[10] CHART NOT AVAILABLE AT PRESS TIME.

savings plan that all Federal employees have access to. Other colleagues think those resources should be used to collectively invest in non-Federal securities, something that we see happening in a number of Scandinavian countries.

The bottom line is that Democrats voted earlier this year to set aside the resources necessary to strengthen the Social Security program. Unfortunately, that budget alternative did not pass. Instead, the Senate adopted the Republican budget resolution which set aside zero resources to address the transition costs associated with Social Security reform. Let me repeat, the budget resolution that passed set aside nothing, zero, for strengthening Social Security or to fund transition costs. Dollars that could have been used to ease the transition costs of a Social Security reform plan were instead spent on a significant tax cut that, unfortunately, in my judgment, disproportionately benefits the wealthiest among us.

Where does that leave us? We will hear from our witnesses today that these lost opportunities will limit our options for dealing with Social Security's unfunded liabilities. The Bush commission may now be forced to propose reforms which cause massive on-budget deficits, accelerated trust fund insolvency or drastic benefit costs to the traditional Social Security benefit.

Given recent comments from Speaker Hastert and White House Spokesman Ari Fleischer against Social Security benefit cuts and tax increases, it seems more likely that the Bush commission will be forced to make recommendations which use budget gimmicks to hide the true transition costs associated with private account plans. We, at the Budget Committee, will be watching for those hidden costs and for those gimmicks.

Recently, the Budget Committee put together numbers showing the available surplus. Obviously, that is a chart that is hard to see from a distance, but we have copies available for anyone who is interested. What this chart shows is that after we consider the surplus lost to the tax bill, other budget resolution policies, potential economic revisions, the associated interest costs, the Bush defense request, what we find is that there are no budget surpluses left to fund an individual accounts plan without using the Social Security and Medicare Trust Funds.[11]

This chart demonstrates that an individual account plan equal to 2 percentage points of payroll will cost about $1.3 trillion between fiscal year 2003 and 2011. That cost includes both the 2-percent account and the debt service costs associated with those accounts. Because of our dwindling surpluses, an account plan of this size would constitute a raid on the Medicare Trust Fund of $397 billion and a raid on the Social Security Trust Fund of an additional $900 billion. Interestingly, the 10-year cost of an individual accounts plan is roughly equivalent to the 10-year revenue loss attributable to the tax cut.

Now, some might argue, including some of my Republican colleagues, that the Social Security Trust Funds should be used to fund private accounts, but I would remind them that these Social Security Trust Funds have already been committed to pay benefits that have already been promised. They cannot now be spent a sec-

[11] CHART NOT AVAILABLE AT PRESS TIME.

ond time on individual accounts. At least in the accounting courses I took in getting a master's degree in business, we were alerted to such double counting. That is the kind of thing that leads to real fiscal problems.

Raiding the Social Security Trust Funds to pay for private accounts can mean only one of two things: either they are double counting or they are shortening the solvency of the Social Security Trust Funds. That is a mathematical certainty. That plan, I believe, is irresponsible and will result in huge benefit cuts or massive tax increases or dramatic increases in public debt. It seems to me it is inescapable that that is the result.

In conclusion, I would like to reiterate that by insisting on such a substantial tax cut, the administration already has limited the Social Security Commission's ability to find a workable and financial viable solution. My question to the witnesses will be, and my question to this administration will be, where will you find the money to pay for these private accounts?

With that, I will turn to my colleague, Senator Grassley, the very distinguished ranking member of the Senate Finance Committee, and somebody who has taken a long-term interest in the work of this committee and certainly has made significant contributions on the issues that are before us today.

Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman, and thank you for holding this hearing, and bringing a distinguished group of witnesses together, and being very provocative in discussions of very important issues that are before us.

I was not aware of Senator Domenici's absence. I just recently talked to him, and he asked me if I would come, but he did not tell me about this problem. I told him, at that time, that I was going to have to make a quorum in the Judiciary Committee, so I am going to have to absence myself.

I have had a chance to read Senator Domenici's opening statement. I will let his staff make a decision if that should be put in the record or not.

Mr. GREENSTEIN. I would like to just make some of my own personal comments in regard to the subject before us. Some of them are nothing more than just reminders, Mr. Chairman, that there is another side of the story.

I do not mind hearing you raise questions about whether or not we should have had tax cuts or not. I think it is always good in our system of Government to have a reminder from anybody about the wisdom of what we are doing. Obviously, I think the wisdom to have tax cuts was the right wisdom. I voted for it. That is why I worked so hard for it. I guess my only thought that I would leave with you on that subject before I go on to the issue of Social Security is a couple of points:

No. 1 is, if Congress did keep the rate of expenditures that we had in the last 3 years and kept that up for the next 10 years of the decade, we would not have only spent the $1.3-trillion tax cut we had, we would have spent additionally on another half-a-trillion-dollar tax cut during that same period of time. And at the end, maybe you have a level of expenditure equal to what the income of the Federal Treasury is at an historically high level and not sus-

tain that level of income over that same period of time, but concomitantly not reduce the level of expenditures, and consequently have deficits from high levels of expenditure, as opposed to the possibility of having deficits because of tax reduction.

I would rather, myself, choose to have a lower level of expenditure of gross national product and have a deficit than have a higher level of expenditure of gross national product with somewhat higher taxes, but still a deficit. I think it's better for the economy the more that we run money through the pockets of our taxpayers, to let them decide how to—the marketplace to disseminate and divide the goods and services of our country, as opposed to political decisions.

Those are honest differences of opinion between two political philosophies here in Washington and even at the grassroots.

The second thing I would remind is that, and Senator Domenici touches on this, is we guesstimated, over the long haul, including last year's budget, when we had a Democrat President, that we were going to have 2.5- to 3-percent growth this year. And even under the last President, that growth became flat at 1 to 1.5 percent. It was flat two quarters during the Clinton administration, now two quarters in the Bush administration, and it may be flat for another two quarters. It is still growing, but not as much as we anticipated. But within that growth of the economy, we are still going to end up with the highest budget surpluses that we have ever had.

Second, on the issue of Social—no, not second, on a new subject, Mr. Chairman—on the issue of Social Security, we have to stimulate discussion, we have to do something about this. It reminds me of an older citizen who would come up to me in my State and say, "Just leave my Social Security alone." And I can say to that person, "Yes, I can leave your Social Security alone, and you are going to be able to have certainty of your Social Security as long as you live."

But I ask, "Do you not also think that the younger people of America ought to have as good of a Social Security that you have?" And I obviously get the answer, "Yes." Well, if you just leave Social Security alone, that younger person 30 years old will not have as good of a Social Security system as people have right now.

And so I praise President Bush for bringing this issue for discussion. I think it gives us an opportunity to really pick up the ball where President Clinton left off. Remember, President Clinton, and I praised him at the time, and I still praise him for doing it then in January 1998, State of the Union message, he said, "Save Social Security first," and then he started a process of national dialog to save Social Security first.

He had four town meetings—I praised him for that—to start discussion because he knew that he had to get people to understand what the problem was if you are going to solve that problem. We are in the same place. We have got to get people to understand that problem if we are going to solve it. So the President had it. He asked Members of Congress to have town meetings. Members of Congress had town meetings. I had four in my State, 4- or 500 people come to them, to have this dialog. He even had personal accounts in it. He supported personal accounts and the investment in

the private market. Even people today are supporting investment in the private market through railroad retirement, as an example.

So, you know, that cannot be a system or an idea that is so far-fetched that it is wrong for President Bush to propose it. And we have in this process then President Clinton doing the right thing to have a national dialog. And then all of a sudden the conclusion was reached that this personal accounts was too hot of an item, and that would not be a political issue that could be used during the 2000 election, and it was dropped like a hot potato.

And then what happens? We change Presidents. This President picks up the ball where President Clinton leaves off, starts the national dialog on the issues of should Social Security be just as good for the people that are 30 years old as it is for the people that are 65? And that national dialog is what it is going to take to get it done, and we ought to encourage that sort of national dialog. And that is what the President is doing, nothing more than what President Clinton did.

And so I think that we ought to welcome this opportunity and forget the salvation, that the salvation of Social Security can be, that just the economy grows at 4.5 percent, and you do not have to worry about. That "ain't" going to happen. The other side has got to have a better answer than that the economy is going to grow for the next 75 years at 4.5 percent. It is not going to happen.

So I welcome this hearing. I maybe would have chosen other witnesses, but you are doing a very good thing, and I hope that you will keep it up because I think that the more that we keep Social Security in the front line of public debate, the sooner it is going to get done, and the sooner we do it, the less of a problem it is going to be for Congress to make the tough political decisions that must be done. And remember, there were bipartisan bills introduced as a result of President Clinton's initiatives, and those ideas are still around, and we ought to be pursuing that.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Grassley.

I would just say to you, in terms of budget alternatives, our budget alternative did not increase spending. Our budget alternative would have continued to shrink the role of the Federal Government from 18 percent of gross domestic product to 16.4 percent of gross domestic product, which has been the lowest level since 1951. The fundamental difference was we had about half as big a tax cut, we had more debt pay-down, and we dedicated this $900 billion to strengthening Social Security. So you had resources available to deal with this challenge, and that is the challenge we are going to hear about from these witnesses this morning.

Senator GRASSLEY. Would you please give me 15 seconds? Just 15 seconds.

Chairman CONRAD. I would be happy to, absolutely.

Senator GRASSLEY. Remember that at some time during the debate on the tax bill and on the budget, there were at least 48 Democrats, 48 Democrats that voted for a tax cut of $1.250 trillion. That is only $100 trillion less than what Republicans and 12 Democrats voted for that finally became law. So there cannot be a lot of difference between your party and my party on the level of tax cuts.

Chairman CONRAD. Well, I would just say this to you, Senator, that $1.25 trillion- alternative was in comparison to the larger tax plan that was before us, but the Democratic budget plan was as I described, one that had about half as big a tax cut so that we could have more pay-down of debt, so that we could also have money that was available to deal with this long-term Social Security challenge, and now the resources are gone. Now we are seeing the Treasury is borrowing to pay for the tax cut.

With that, we will go to the witnesses. I think we will just go right down the table, if that is OK, if any order is appropriate.

We will start with Mr. Greenstein. We welcome you here. Please proceed.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. GREENSTEIN. Thank you, Mr. Chairman.

As we all know, Social Security has long-term financing problems. The problems have several dimensions to them:

One, Social Security can pay full benefits only until 2038.

Second, the increase in Social Security and Medicare costs, as the population ages, will place pressure on the rest of the budget before 2038. As a result, restoring long-term solvency to Social Security and ensuring a sustainable long-term fiscal policy for the country are items of major importance. As part of that, we have just completed an analysis looking at the long-term costs of two items: the recently enacted tax cut and the Social Security shortfall.

According to official estimates of the Social Security actuaries and trustees, the estimates everyone uses, the projected long-term deficit in Social Security over 75 years equals 1.86 percent of payroll or $3.2 trillion in present value. Present value is the amount today that, with interest, would exactly cover the future costs. The trustees' report, the current Social Security trustees' report, also shows that measured as a share of the economy, the Social Security shortfall equals seven-tenths of 1 percent of GDP over the next 75 years.

To measure the long-term cost of the tax cut, we simply take the Joint Tax Committee's estimate of the cost of the tax cut in 2011 if all of its provisions are extended and assume these costs remain constant as a share of GDP after 2011. Assuming that the cost of tax cuts will remain constant as a share of GDP, once the tax cuts are fully in effect, is the standard approach that CBO, OMB, and GAO all use in making long-term fiscal projections. And in this case, the estimate is likely to understate the long-term cost of the tax cut because several provisions in the bill, like estate tax repeal and 401(k)'s are certain to grow faster than GDP for a number of years after 2011.

As this chart shows, the results show that the projected cost of the tax cut over 75 years is 1.6 percent of GDP. Let me repeat that that is the Joint Tax Committee's estimate of the cost in 2011—1.6 percent of GDP or $7.7 trillion in present value. Thus, the cost of the tax cut over 75 years is more than twice as large as the long-term deficit in Social Security.

Now, an article in this morning's paper quotes some, although no one I think is particularly named in the administration, as saying

that the Social Security shortfall is closer to 1 percent of GDP than 0.7 and that the long-term cost of the tax cut is 1 percent of GDP rather than 1.6.

Even if those numbers are correct—and they are not—even if those numbers are correct, by those numbers, the long-term cost of the tax cut equals the entire Social Security shortfall over the 75-year period. The reasons those numbers are not correct are twofold. The seven-tenths of 1 percent Social Security shortfall figure, as I have mentioned, is directly out of the trustees' report. The higher figure is reached only by acting as though the income from the trust fund, the interest on the trust fund, and the trust fund bonds do not count. That is not the way the trustees and the actuaries do the estimates. It is not the way Social Security works.

But the more important issue is the tax cut, and this is the only way to get the cost of the tax cut down to the 1-percent of GDP which, according to the Post, is said to be an internal Treasury estimate. You have to do either of two things, and they are both wrong. One percent of GDP is the average cost of the tax cut over the next 10 years. Senator, as you know, it phases in over time. You cannot compare the average cost of the tax cut over the next 10 years to the Social Security shortfall over 75 years. Heck, the Social Security, if we took the next 10 years, it is in surplus. We are comparing 75 years to 75 years, apples to apples.

There is only one other way they could have gotten the cost of the tax cut down to 1.0, on joint taxes it is 1.6, and that would be by assuming that while the provisions expiring in 2010 are extended, that the AMT fix that expires in 2004 is not extended. In other words, if you assume that the AMT, which hits 1.5 million filers today, hits 35 million in 2011, and eventually 50 million, 60 million, the sky is the limit, you can get the cost of the tax cut down to 1 percent, but that is not legitimate.

This is the joint tax estimate, assuming all of the provisions are extended, compared to the trustees' estimate of Social Security, and the result is clear it is nearly twice as large. This means that if the tax cut took effect as scheduled and continued after 2010, their long-term costs would substantially exceed the long-term benefit to the budget of eliminating the entire 75-year deficit in Social Security. It also means that if the tax cut were scaled back so three-fifths of it took effect and the other 40 percent of it were dedicated instead to strengthening Social Security, the entire long-term deficit in Social Security could be eliminated.

Now let me emphasize that I am not recommending canceling 40 percent of the tax cut and devoting all of that to Social Security. The Nation faces serious strains when the boomers retire. The Medicare hole is bigger than the Social Security shortfall. There undoubtedly will be other problems in the future that we cannot foresee today.

I believe a long-term balanced fiscal policy is likely to entail some changes in Social Security to reduce its future claims on the budget, rather than simply providing it with whatever level of resources are needed to close the entire shortfall. But providing resources from the rest of the budget to close a portion of the Social Security shortfall, in conjunction with other Social Security reforms, is likely to be essential if any reform plan is to get anywhere

on Capitol Hill. Otherwise the benefit cuts or payroll tax increases that would be needed, whether you do individual accounts or not, are likely to be too large to make any plan politically acceptable.

And I would note that most of the partial privatization plans offered on Capitol Hill in recent years, like the Archer-Shaw plan, did contain—and Senator Grassley's plan, I believe—did contain an element of general revenue transfer, and part of our problem today is that the magnitude of the tax cut precludes a general revenue transfer without running deficits outside of Social Security and Medicare.

I think what this indicates, among other things, is that the rhetoric that we often hear, that the tax cut is modest and prudent, and the Social Security shortfall is an enormous chasm that threatens the Nation's future fiscal health cannot both be true, since the tax cut is larger than the Social Security shortfall.

One final point, Mr. Chairman, you have championed the Social Security lockbox, and the evidence is that this does help in dealing with the long-term Social Security shortfall. We have had this question in recent weeks since the report of the Social Security Commission, of, given that Social Security can pay full benefits after 2016 until 2038, but it does show through income from the rest of the budget, in the interest on the bonds and ultimately from redeeming the bonds, people ask, "Where does the rest of the budget get the money from?"

As this chart shows, if we save the Social Security surpluses, the amount the government will save in interest payments on the publicly held debt, more than offsets the increased costs of Social Security benefits for the next couple of decades. And if you look at the chart, you will see that between now and 2020, Social Security costs rise by 1.5 percent of GDP. If we do successfully lockbox the Social Security surpluses, other than in times when the economy is weak, and we pay off the publicly held debt to the level that Chairman Greenspan has advised, then over that same period interest payments on the publicly held debt come down by 1.9 percent of GDP. In other words, for a while, this covers the additional costs, and even when you get out to 2038, if we have essentially eliminated the publicly held debt, at least down to that so-called irreducible level, then the interest savings on the debt equal, even out in 2038, 75 to 80 percent of the increased costs for Social Security between now and then.

Social Security reforms are needed, but the lockbox definitely helps, and given the political difficulties in moving forward on Social Security, is one of the best immediate things that we can do.

Thank you.

[The prepared statement of Mr. Greenstein follows:]

TESTIMONY OF ROBERT GREENSTEIN
Executive Director, Center on Budget and Policy Priorities
before the
Senate Budget Committee
August 2, 2001

I appreciate the invitation to appear before you today. I am Robert Greenstein, executive director of Center on Budget and Policy Priorities. The Center is a policy institute that focuses on fiscal policy issues and has a particular interest in the effects of government policies on low- and moderate-income families.

My testimony focuses on the Social Security financing shortfall and how the magnitude of that shortfall compares to the size of the recently enacted tax cut. The testimony also looks at the role of policies to wall off the Social Security reserves and devote them to debt reduction.

Social Security's Financing Problems

The Social Security commission appointed by President Bush argues in its recent draft interim report that Social Security faces financial difficulties starting in 2016 because the program's benefit costs will begin to exceed its tax revenue in that year. As a number of economists, fiscal policy experts, and Social Security experts have explained, Social Security itself does not face financial difficulties in 2016, because the Social Security Trust Fund will hold $5 trillion in bonds at that point and the interest on those bonds will cause Social Security still to be in surplus.[1] But as the baby boomers retire in large numbers, increasing Social Security and Medicare costs will place growing pressure on the rest of the budget. And in 2038, the Social Security Trust Fund will be exhausted.

Social Security's long-term financing problems have several dimensions to them. The increase in Social Security and Medicare costs as the population ages will place pressure on the rest of the budget before 2038. In addition, since it is inconceivable politically that Social Security benefits will be reduced and/or payroll taxes raised sufficiently to restore long-term solvency solely through such steps, additional resources are virtually certain to be needed as part of any politically viable reform package that restores long term Social Security solvency. This is true regardless of whether a reform plan either includes individual accounts or provides for investment of a portion of the Social Security Trust Fund in equities.

Restoring long-term solvency to Social Security and ensuring a sustainable long-run fiscal policy for the United States are issues of major importance. To help illuminate these issues, our Center has just completed an analysis examining the fiscal dimensions of two major items: the projected long-term deficit in Social Security and the long-term cost of the recently enacted tax

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[1] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Perspectives on the Draft Interim Report of the President's Commission to Strengthen Social Security," Center on Budget and Policy Priorities and The Century Foundation, July 23, 2001. Also see the response from Aaron, Blinder, Munnell, and Orszag to the co-chairs of the commission, Center on Budget and Policy Priorities and The Century Foundation, July 24, 2001.

cut (assuming that the provisions of the tax cut are extended beyond their scheduled expiration dates).

If one listens to some pundits and policymakers, the tax cut is modest on size while the long-term Social Security shortfall is enormous. But such statements cannot both be true. The size of the tax cut is *more than double* the entire long-term Social Security shortfall. The tax cut is not as modest as some of its proponents claim, while the Social Security shortfall — although surely a significant problem that must be addressed — is not as gargantuan as it is sometimes portrayed as being, especially by some who seek radical changes in Social Security.

The Size of the Tax Cut and the Social Security Shortfall

According to the official estimates that the Social Security actuaries and trustees issued in March 2001, the projected long-term deficit in Social Security over the next 75 years — the period used for measuring long-term solvency — equals 1.86 percent of the wages, salaries, and self-employment income that will be subject to the payroll tax during this period, or $3.2 trillion in present value. (Present value is the amount today that, with interest, would exactly cover these future costs.) The trustees' report also shows that, measured as a share of the economy, the Social Security shortfall equals 0.7 percent of the Gross Domestic Product over the next 75 years.[2]

To measure the long-term cost of the tax cut, we take the Joint Tax Committee's estimate of the cost of the tax cut in 2011 if all of its provisions are extended, and assume that these costs will remain constant as a share of GDP after 2011. Assuming that the cost of tax cuts will remain constant as a share of GDP once the tax cuts are fully in effect is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office all use when preparing long-term fiscal projections. In this case, such an approach is likely to understate the long-term revenue loss because the costs of several provisions of the tax bill such as estate tax repeal and the introduction of "Roth 401(k) pension plans" are virtually certain to grow faster than GDP for a number of years after 2011.[3] For this reason, our estimates of the long-term costs of the tax cut are likely to be conservative.

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[2] Under the Social Security actuaries' intermediate projections, the projected 75-year deficit amounts to 1.86 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 37.6 percent of the Gross Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.7 percent of GDP, which is equal to 1.86 percent multiplied by 37.6 percent.

[3] The assumption that the tax cut will remain a constant share of GDP after 2011 is likely to be conservative. Before the tax cut was enacted, both income tax revenues and estate tax revenues were projected to grow somewhat faster than the economy. This growth was projected to occur primarily because national income is projected to grow faster than inflation (with the result that income growth would push some taxpayers into higher marginal tax brackets even though the brackets are indexed to inflation), and because the amount exempt from the estate tax was not indexed for inflation. In addition, some provisions of the tax legislation, such as the creation of the Roth 401(k) and the increase in the amount that can be contributed to a Roth IRA, are substantially more costly in the long run than in the short run.

Cost of Tax Cut and Size of Social Security Sh rtfall Ov r 75 Y ars		
	As Share of GDP	**Present Value**
Social Security Shortfall	0.7%	$3.2 trillion
Tax Cut	1.6%	$7.7 trillion

The projected cost of the tax cut over 75 years amounts to 1.6 percent of GDP, or $7.7 trillion in present value. Thus, the cost of the tax cut over the next 75 years is more than twice as large as the long-term deficit in Social Security.

In other words, if the tax cuts take effect as scheduled and continue after 2010, their long-term cost will substantially exceed the long-term *benefits* to the budget of eliminating the entire 75-year deficit within Social Security. Moreover, if the tax cut were scaled back so that three-fifths of it took effect while the funds from the other 40 percent of the tax cut were used instead to strengthen Social Security, the entire long-term deficit in Social Security could be eliminated. Such a course would not require tax increases, but rather that the tax cuts ultimately not be as deep as the recent tax-cut legislation envisions.

I should emphasize that I am not recommending canceling 40 percent of the tax cut and placing all of the freed-up resources in Social Security. The nation will face serious financial strains when the baby boomers retire in large numbers. The long-term financing shortfall in Medicare is larger than that in Social Security, and the nation also is likely to face needs in the decades ahead that will require resources in other areas, including areas relating to children, the environment, and the large number of Americans without health insurance, as well as other problems that inevitably will arise in the future but that we cannot foresee today. A balanced long-term fiscal policy is likely to entail some changes in Social Security to reduce its future claims on the budget, rather than simply providing it with whatever level of resources is needed from the rest of the budget to close its entire long-term financing shortfall.

Providing resources from the rest of the budget to close a *portion* (rather than all) of the Social Security shortfall, however — in conjunction with other Social Security reforms — is likely to be essential if any reform plan to restore long-term solvency is to have hope of being enacted. Otherwise, the Social Security benefit cuts and/or payroll tax increases that will be required as part of any solvency plan are likely to be too large for such a plan to be politically viable.

The relative magnitudes of the long-term deficit in Social Security and the long-term revenue loss resulting from the tax cut highlight an important question: Given the demographic and other challenges that lie ahead, was a tax cut that ultimately will provide approximately 35 percent of its benefits to the most affluent one percent of the population the best use of the bulk of the surplus projected outside Social Security and Medicare Hospital Insurance? The figures on the relative size of the Social Security shortfall and the tax cut also show the fundamental inconsistency in the rhetoric of those who portray Social Security as facing an enormous financial chasm that threatens the nation's long-term fiscal health while touting the tax cut as modest and prudent.

As alluded to above, the tax cut is likely to make Social Security reform considerably more difficult, if not impossible, for the foreseeable future. The tax cut consumes non-Social Security resources that are likely to be essential to the development of a politically viable package of reforms to restore Social Security solvency.

Transfers from the non-Social Security budget are likely to be crucial to the political viability both of Social Security plans that include individual accounts and of plans that do not. Without such transfers, individual accounts will have to be financed from existing Social Security revenue. Diverting revenue from the Social Security Trust Fund into individual accounts, however, would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system. Restoring long-term balance to the Social Security system while shifting revenue from the Trust Fund to individual accounts requires larger reductions in Social Security benefits (relative to the benefits that would be paid under the current-law benefit formula) than otherwise would be needed.

A recent analysis by four leading economists and Social Security experts — Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag — found that if payroll tax revenues equaling two percent of wages were shifted from Social Security to individual accounts and Social Security benefits were maintained at current-law levels for people currently 55 and older, Social Security benefits for workers 30 and under would have to be cut more than 50 percent.[4] Including the income from individual accounts, the overall retirement income for such workers (their reduced Social Security benefits plus the retirement income they would receive from the individual accounts) would average 20 percent below current-law levels (with some workers losing considerably more than that) *if* stock market returns were as high in future decades as promoters of private accounts predict. As these figures suggest, the magnitude of the reductions in Social Security benefits that would be necessitated by action to create individual accounts *without* securing additional revenue from the non-Social Security budget is likely to doom individual account plans that lack another revenue source.

In short, regardless of whether Social Security reform includes individual accounts, transfers from the non-Social Security budget are almost certain to be essential to the development of a politically acceptable reform plan. Such transfers are not likely to be possible without creating deficits outside the Social Security and Medicare Hospital Insurance trust funds, unless the tax cut is modified rather than extended in its current form.

The next section of this testimony explains in more detail the projections of the relative sizes of the long-term deficit in Social Security and the revenue loss from the tax cut.

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[4] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation and the Social Security Network, June 6, 2000.

The 75-year Deficit Within Social Security

As is well known, Social Security currently owns assets — Treasury bonds backed by the full faith and credit of the U.S. government — totaling more than $1 trillion. In addition, Social Security is currently running annual surpluses of roughly $150 billion, and these surpluses are expected to increase in size for a number of years. According to the current projections of the Social Security Trustees, annual Social Security tax revenue (which does not include interest on the bonds the Trust Fund holds) will fall below Social Security benefit expenditures starting in 2016, but Social Security as a whole will run a surplus of more than $250 billion in 2016 because it will earn interest income on the bonds it holds. The Trustees expect Social Security to remain in surplus until 2025, even with the increase in the cost of benefits that will occur as a growing share of the "baby boom" generation retires. At that time, the Trust Fund's assets will total $6.5 trillion (or $3 trillion if measured in today's dollars).

The Social Security actuaries calculate, however, that those assets, along with the interest on them and future Social Security revenue, will be insufficient to cover all of Social Security's future costs. Over the 75-year period used for long-term Social Security planning, the shortfall is projected to be $3.2 trillion.[5] In other words, if Social Security currently had $4.3 trillion in assets rather than $1.1 trillion, projected revenues plus its expanded reserves would cover projected costs for the next 75 years.

Another measure of the long-term deficit under Social Security is that the system faces a projected 75-year imbalance equal to 0.7 percent of the Gross Domestic Product. In other words, if Social Security had additional revenue equal to 0.7 percent of GDP each year, its 75-year deficit would be eliminated.

The 75-year Cost of the Tax Cut

Budget policies are not commonly discussed in terms of their costs over 75 years, in part because the resulting figures would be mind-numbing. But it is instructive to do so, given the concerns over the long-term health of the federal budget that are being emphasized in the Social Security debate.

To calculate the long-term costs of the tax cut, we use estimates of the tax cut supplied by the Joint Committee on Taxation (JCT), the official tax estimator for Congress. The tax cut includes several provisions that expire before 2010, and all of its other provisions expire in 2010. Administration officials and other prominent supporters of the tax cut have made clear, however, that they expect the tax cut to continue. The JCT estimates used here show the costs that will

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[5] Office of the Chief Actuary, "Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Programs," April 5, 2001. The $3.2 trillion is the net present value of the 75-year deficit.

The Deficit Within Social S curity and the Cost of the Tax Cut, Measured in P rpetuity

It also is possible to examine the size of the deficit in Social Security in perpetuity and the cost of the tax cut in perpetuity. Such a comparison can be made by using the same methodology as described here to estimate the permanent cost of the tax cut, and by using figures from the Social Security actuaries to estimate the permanent Social Security deficit. In both cases, the projection horizon is extended far beyond 75 years.

Calculations of costs in perpetuity are subject to even more uncertainty than the already-uncertain estimates for 75 years, or even for 10 years. Birth, death, and productivity rates a century or several centuries from now are highly speculative. I would not recommend basing analyses or making policy decisions on estimates of costs in perpetuity. (I discuss costs in perpetuity here because some proponents of Social Security privatization have said that Social Security faces a $12 trillion shortfall but claimed the tax cut is much smaller.)

The Social Security actuaries have estimated that the present value of the cost of transforming Social Security from a primarily pay-as-you go system to a fully funded system would amount to $11.7 trillion.* This cost is approximately equal to the projected deficit in Social Security in perpetuity.** (This $11.7 trillion figure also is the cost that would have to be paid to transform Social Security fully into a system of individual accounts.)

The cost in perpetuity of the recently enacted tax cut (estimated as above, but extending the analysis beyond 75 years) equals $11.8 trillion. Shifting the focus beyond 75 years thus does not alter the basic finding of this analysis: the long-term cost of the tax cut is at least as large as the long-term deficit in Social Security.

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* Office of the Chief Actuary, "Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Programs," April 5, 2001.

** For further discussion of the connection between the cost of transforming Social Security to a fully funded system and the deficit in Social Security in perpetuity, see John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Social Security's Money Worth,"in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999).

occur in 2011 if the provisions are made permanent law. The JCT supplied these estimates to Congress on June 20, 2001.[6]

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[6] The JCT estimates, provided to Rep. Charles Rangel, include costs relating to extension of a provision of the tax law scheduled to expire in 2004 that provides relief from the Alternative Minimum Tax. Through 2004, this provision holds the number of taxpayers subject to the AMT to roughly the number that would have been subject to the AMT under the law in place prior to enactment of the new tax legislation. In preparing its estimate of the cost of the tax cut legislation in 2011 with the various provisions extended, the JCT assumed continuation of this provision in such a manner that the number of taxpayers subject to the AMT would continue to track closely the number of taxpayers who would have been subject to the AMT under prior law. (This approach almost certainly understates the ultimate cost of addressing problems in the AMT, since under the prior law and hence under the JCT estimates used here, the number of taxpayers subject to the AMT still would rise from about 1.5 million in 2001 to more than 20 million in 2011.) The estimate used here for the cost of the tax cut does *not* include the cost of extending an array of

(continued...)

To project the cost of the tax cut beyond 2011 (the last year for which JCT estimates are available), we assume it will remain a constant share of the economy thereafter. Based on the conservative assumption that the tax cut will remain a constant share of the economy from 2011 on, the cost of the tax over the next 75 years amounts to 1.6 percent of GDP over that period.[7] In dollar terms, the long-term cost of the tax cut amounts to $7.7 trillion in present value.[8] The cost of the tax cut thus is more than twice as large as the long-term deficit in Social Security, which amounts to 0.7 percent of GDP, or $3.2 trillion.

How a Social Security Lockbox Helps

As this testimony indicates, restoring long-term Social Security solvency is likely to entail both a combination of benefit and/or tax changes in Social Security and a transfer of funds from the general fund to Social Security. Preserving Social Security's cash-flow surpluses and using them to pay down debt also plays a role; it helps the nation to afford the provision of adequate Social Security benefits.

The draft interim report of the Social Security commission suggests Social Security faces serious financial problems starting in 2016, when the cost of the benefits that Social Security pays will begin to exceed the tax revenue it receives. As many analysts have explained in the past few weeks, Social Security does not itself face problems in 2016 because it will have accumulated $5 trillion in assets in the form of U.S. Treasury bonds. In fact, the Social Security Trustees project that the Social Security Trust Fund will receive more than $300 billion in interest payments on these bonds in 2016 and actually will run a *surplus* of more than $250 billion that year.

Total Social Security income — including the interest the Trust Fund earns on its bonds — will start to fall below Social Security expenditures in 2025. At that point, the Trust Fund will begin to redeem its bonds. All of these bonds will have been redeemed by 2038, at which point the Trust Fund will not be able to pay full benefits.

These realities have led a number of commentators to ask: if Social Security will continue paying full benefits between 2016 and 2038 because of the interest it will earn on its bonds and the proceeds it will later receive from redeeming the bonds, where will the rest of the government secure the funds to make these interest payments and ultimately to buy back the

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[6] (...continued)
popular tax credits that are regularly extended for a few years at a time and are virtually certain to continue being renewed. That cost is not included here because the recently enacted tax law does not address the issue of extending these credits.

[7] In conducting this analysis, we used the actuaries' estimates of GDP in calculating the amount of the tax cut to assure consistency in our cost estimates.

[8] The $7.7 trillion is the net present value of the tax cut over the next 75 years, discounted at the same discount rate as the Social Security actuaries use to compute the 75-year deficit in Social Security.

bonds? Part of the answer is the large savings the government will realize in interest payments on the publicly held debt as a result of using the Social Security surplus to pay down the debt.

If the Social Security cash-flow surpluses are devoted to paying down the publicly held debt, the debt will be greatly reduced — and interest payments on the debt will fall sharply as a consequence. *If we save the Social Security surpluses, the amount the government will save in interest payments on the publicly held debt will more than offset the increased Social Security costs the government will incur in the next few decades as the baby boom generation begins to retire and Social Security costs rise.*

Consider the following figures. Interest payments on the publicly held debt today equal 2.0 percent of the Gross Domestic Product. Social Security expenditures equal 4.1 percent of GDP. If the Social Security surpluses are saved and the publicly held debt is paid down substantially — for example, to the level the Federal Reserve has suggested — interest payments on the publicly held debt will fall to 0.1 percent of GDP in 2020, a decline of 1.9 percent of GDP. Social Security costs are projected to reach 5.6 percent of GDP in that year, an increase of 1.5 percent of GDP over current levels. The decline of 1.9 percent of GDP in the cost of interest payments between now and 2020 thus will *exceed* the increase in the cost of Social Security benefits over this period.

In other words, the answer to the question of where the government will find the money to make increased interest payments to Social Security after 2016 — to cover the growing cost of benefits — is that the government will be able to use funds that have been freed up by the reduction in interest payments on the publicly held debt, which will have been caused in whole or in large part by devoting the Social Security reserves to debt reduction.

Preserving the Social Security surplus and dedicating it to debt reduction helps Social Security in another way as well. It increases national saving, which will result in a larger economy and, as a consequence, a larger flow of revenue to the federal government and the Social Security Trust Fund. A CBO analysis issued last year that contained projections through 2040 projected a larger economy and higher levels of revenues over the next four decades if the Social Security surplus is saved rather than consumed.

To be sure, modifications in Social Security are needed. Indeed, sooner or later, modifications will have to be made (with sooner being much better than later). Placing Social

Declining interest costs help pay for increasing Social Security costs
costs as a share of the economy (percent of GDP)

	Costs in 2001	Costs in 2020	Change in costs, 2001-2020
Social Security benefits and administration	4.1%	5.6%	1.5%
Net interest on publicly held debt*	2.0%	0.1%	-1.9%

* This analysis assumes that the publicly held is reduced to the level Federal Reserve Chairman Greenspan has suggested.

Security in a "lockbox" except in times when the economy is weak should, however, improve the ability of the government to finance Social Security's costs over the next few decades without placing as much strain on the rest of the budget.

Conclusions

Measured over the next 75 years, the costs of the tax cut, if extended permanently, are more than twice as large as the shortfall in Social Security. Policymakers concerned about both the long-term fiscal health of the nation and the restoration of long-term Social Security solvency would do well to examine options for canceling some of the scheduled tax cuts before they take effect (particularly provisions narrowly targeted on those with the highest incomes) and using a portion of the resources as a downpayment in restoring solvency to the Social Security system. Canceling part of the tax cut could provide the resources for transferring some general revenues to Social Security. Such transfers are likely to be an essential ingredient of a sound Social Security reform package that makes changes in the Social Security program.

Without the resources consumed by the tax cut, the President's Social Security commission — and ultimately the Administration and Congress — are likely to have an exceedingly difficult time in fashioning a politically acceptable solution to the long-term Social Security deficit. In addition, if the tax cuts take effect as scheduled and are continued after 2010, the long-term drain on the budget will exceed the long-term benefit to the budget of eliminating the entire Social Security shortfall.

Chairman CONRAD. Thank you. Let me just say to the other witnesses, that in fairness, we will give each of you 8 minutes.

Senator GRAMM. What about fairness to us?

Chairman CONRAD. Do you feel you have been treated unfairly some way, Senator?

Senator GRAMM. Well, you said you are going to be fair. I am kidding you. [Laughter.]

Senator GRAMM. I am learning so much. I would just love to hear it. [Laughter.]

Chairman CONRAD. Would we like to have Mr. Greenstein start over and—— [Laughter.]

Chairman CONRAD. We will certainly go to 8-minute rounds for the senators as well.

Dr. ORSZAG.

STATEMENT OF PETER R. ORSZAG, PRESIDENT OF SEBAGO ASSOCIATES, INC. AND SENIOR FELLOW IN ECONOMIC STUDIES AT THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. ORSZAG. Mr. Chairman, I will try to stay below the 8 minutes, run a surplus to pay for Mr. Greenstein's deficit.

Mr. Chairman and members of the committee, it is an honor to appear before you to discuss Social Security reform and long-term budgetary pressures. My testimony will focus on the interaction between the recently enacted tax cut and the prospects for Social Security reform.

As you know, the Social Security trustees project a long-term imbalance within the Social Security program, and I should note in reference to Senator Grassley's comments, well, faster economic growth is not going to solve this problem. So there is a problem there and it does need to be addressed.

Restoring solvency to Social Security is an important policy goal, but the basic problem I want to highlight this morning is that non-Social Security revenue is a necessary ingredient in the mix that would make Social Security reform politically viable. The recently enacted tax cut, however, means that non-Social Security revenue is not available for this purpose.

The necessity of general revenue to play some role in a sound Social Security reform plan applies regardless of whether that plan includes individual accounts. But since the President's Commission is focusing on individual accounts, let me focus on them also.

The Commission faces a basic dilemma. It is not possible to finance individual accounts out of the non-Social Security budget without creating deficits there. Yet, financing individual accounts by diverting funds from the Social Security surplus, the other alternative, would involve politically unappealing reductions in traditional benefits.

First on the accounts financed outside Social Security. According to CBO estimates, the projected surplus over the next 10 years outside of Social Security and the Medicare HI program amounted to $2.7 trillion prior to enactment of the new tax legislation. Taking into account the new tax law and other initiatives in the congressional budget resolution, the remaining surplus appears on paper to be about $500 billion. Over the next 10 years contributions to

individual accounts equal to 2 percent of payroll would amount to more than $1 trillion without including the interest that would accrue on the higher public debt. So contributions to individual accounts cannot be financed out of the non-Social Security budget without creating deficits there. And once you included the interest, the point would be even stronger.

And the situation is even less promising than these figures would suggest, because the figures ignore the artificial sunsets in the tax law, the cost of expiring tax credits that are routinely extended a few years at a time, the additional defense spending needed to finance the administration's plans, the cost of maintaining non-defense discretionary spending at a more reasonable level than assumed in the baseline, and the effects of the recent economic slowdown on the projected budget surpluses.

When realistic assumptions are taken into account, there is no surplus, let alone enough of a surplus, there is no surplus left to finance individual account contributions.

So the alternative is to create carve-out accounts financed out of existing Social Security revenue. By itself, however, diverting revenue from Social Security to individual accounts would exacerbate the program's long-term financial imbalance because it reduces the revenue that is available to the system.

To improve Social Security's long-term balance, while diverting revenue out into individual accounts, requires some combination of higher payroll taxes, a higher rate of return on the Social Security Trust Fund, transfers to the Social Security system from the rest of the budget, or reductions in benefits. Now, the first three of those options are ruled out by the administration's Social Security principles, or by the lack of revenue in the non-Social Security budget for the transfer. So we are left with reductions in traditional benefits.

Henry Aaron, Alan Blinder, Alicia Munnell and I have examined the size of the benefit reductions that would be required in order to reach long-term solvency in Social Security while diverting payroll tax—2 percent of payroll into individual accounts. We found that under one plausible approach to doing so, Social Security benefits, the traditional guaranteed benefits, would have to be reduced by 29 percent for those who are age 50 in 2002, and by 54 percent for those who are age 30 or younger. My written testimony goes through the basis intuition for those numbers, and we could go through them in the question and answer period, if you are interested.

Now, to be sure, the income from individual accounts would offset some of these benefit reductions, but a large, overall reduction would nonetheless occur. We estimated that the expected combined retirement income from Social Security and the individual accounts for single young individuals with average earnings, would be 20 percent below the level they would receive from Social Security under the current benefit structure. It is worth noting that these figures are, if anything, favorable to individual accounts. They are based on assumptions that Professor Martin Feldstein of Harvard has used, and we just used his assumptions, even though we think they are, if anything, too favorable to individual accounts.

So that is the basic dilemma. Individual accounts cannot be financed with non-Social Security revenue without creating deficits because there is no money there, and they cannot be financed with Social Security revenue because the required reductions in traditional benefits would be so overwhelming, that they are unlikely to be politically viable.

So what to do? To avoid these unappealing choices for financing individual accounts in the aftermath of the tax cut, policymakers may be tempted to adopt an accounting gimmick. At least three such gimmicks could be employed. We have come up with three, but presumably there are other ones that clever people will come up with, but let me just highlight three possibilities very quickly.

First, policymakers could credit the same funds to both Social Security and individual accounts. Under this approach, the annual Social Security surpluses would be credited to the Social Security Trust Fund. Rather than being used to reduce public debt, however, these funds would then also be used to make contributions into individual accounts. Indeed, some proponents of individual accounts have recently suggested precisely this approach. They may not realize that under current budget rules, the contributions to individual accounts would be scored as expenditures from the non-Social Security part of the budget, so they would bring us back to creating deficits there, and it would require a change in the budget scoring rules in order for this gimmick to actually work from the perspective of proponents of individual accounts.

The second accounting gimmick would involve loans from the General Fund to the Social Security Trust Fund. The Social Security reform plan proposed by then Representative John Kasich in 1999, employed such loans. Under current budget scoring rules, loans from the General Fund to the Social Security Trust Fund would not be scored as non-Social Security expenditures because they are loans repaid with interest, and thus would not cause a deficit in the non-Social Security budget. But they also would not help on Social Security solvency. A loan that is repaid with interest does not do anything in present value, and therefore it does not solve the long-term problem facing Social Security. Here is where the approach could be turned into a gimmick, and this is actually what Representative Kasich's plan did. The loans could be—the repayments could be extended beyond the 75-year window that is traditionally used to evaluate Social Security solvency. So if the loan repayments are outside of the window applying to Social Security, it makes it look like the Social Security Program is helped, non-Social Security budget is not harmed, and we get out of the box that we would otherwise be in. The problem really is just not taking the loans into account properly within the Social Security system, and my written testimony talks about that.

A final possible accounting gimmick involves a form of dynamic scoring which has been used, for example, by Marty Feldstein of Harvard. Feldstein assumes that an individual account plan would raise national saving. The higher national saving then boost corporate income and corporate profit taxes. The higher corporate taxes are then dedicated to Social Security, and the program appears to pay for itself. The assumption of an increase in national saving, however, is implausible, and without that assumption, the

whole plan falls apart. The key is, as Mr. Greenstein noted, is that given the lockbox, the Social Security surplus is already being used to pay down debt and to contribute to national savings—and that contributes to national saving. Diverting a dollar from paying down debt into an individual account does not raise national saving.

And I am now going into deficit myself, even though I promised I would not. Let me just sum up quickly.

In conclusion, the large size of the tax cut required policymakers to adopt one or some combination of three alternatives for financing individual accounts: a deficit outside Social Security and Medicare; large reductions in traditional Social Security benefits; or an accounting gimmick. Since all of these approaches are politically problematic, the tax cut considerably weakens the chances that the Commission will succeed in designing a credible plan to restore long-term Social Security solvency. In a fundamental sense, the tax cut undermines the opportunity that we had, and could potentially recapture, to use the projected budget surpluses as a substantial down payment on the longer-term budgetary pressures facing the nation.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

"The Implications of the Tax Bill for Social Security Reform: The Challenges Facing the Bush Social Security Commission"

Testimony before the Senate Budget Committee
August 2, 2001

Peter R. Orszag[1]

Mr. Chairman and Members of the Committee, it is an honor to appear before you this morning to discuss Social Security reform and long-term budgetary pressures. My testimony will focus on the interaction between the recently enacted tax cut and the prospects for Social Security reform.

On May 2, President Bush appointed a commission on Social Security reform, which held its first meeting on June 11 and its second meeting on July 24. The commission faces a daunting challenge: how, in the aftermath of the enactment of the recent tax cut, to finance such accounts.

Contributions to individual accounts could be financed either by transfers from the non-Social Security budget or by diverting revenues from the Social Security Trust Fund. The new tax law, in combination with other priorities reflected in the Congressional budget resolution, has consumed essentially all of the previously projected surpluses in the non-Social Security budget. As a result, any attempt to transfer funds out of the non-Social Security budget to create "add on" accounts (that are added on top of existing Social Security revenue) would cause large deficits outside of Social Security and Medicare.

The alternative is to finance "carve out" accounts from existing Social Security revenue. This approach seems most consistent with President Bush's Social Security principles. Such an approach, however, would either exacerbate the long-term deficit in Social Security or require deep reductions in traditional Social Security benefits. Neither of those outcomes is likely to be viable politically.

The tax cut thus leaves the commission and policy-makers in general with politically unappealing choices. Policy-makers might be tempted to sidestep these unappealing choices by using budget gimmicks. My testimony this morning explores the dilemma in which policy-makers committed to Social Security reform find themselves following the tax cut, and includes an examination of the types of accounting gimmicks policy-makers could be tempted to consider to finance individual accounts.

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[1] Peter R. Orszag is the President of Sebago Associates, Inc , a public policy consulting firm, and effective August 2001, Senior Fellow in Economic Studies at the Brookings Institution. This testimony is based on joint work with Robert Greenstein and Richard Kogan of the Center on Budget and Policy Priorities, although they should not be held accountable for the conclusions or any inaccuracies in this document.

The Long-Term Deficit in Social Security and Individual Accounts

The Social Security Trustees project that under current law, Social Security faces an imbalance over the next 75 years equal to 1.86 percent of taxable payroll, or 12 percent of projected expenditures. According to current projections, annual Social Security tax revenue (which does not include interest on the bonds the Trust Fund holds) will fall below Social Security benefit expenditures in 2016. In 2025, *total* Social Security revenue (including interest earned by the Social Security Trust Fund) will fall below benefit costs, and the Trust Fund will begin to redeem its bonds. The Social Security Trust Fund is then projected to be exhausted in 2038.

To improve Social Security's financial condition, four basic options exist: increase Social Security tax revenue, reduce Social Security benefits, raise the returns on the Social Security Trust Fund, or transfer funds from the rest of the budget to Social Security. Individual accounts, in and of themselves, do nothing along these four dimensions and therefore do not directly improve Social Security's financial condition. Rather, the typical argument is that the income from the individual accounts would permit reductions in traditional Social Security benefits without causing significant hardship for beneficiaries. The implicit argument behind individual accounts is thus that the long-term deficit within Social Security could be eliminated through traditional benefit reductions, but that the income from individual accounts would provide a replacement for those benefit reductions.

As explained below, however, carve-out individual accounts (financed out of Social Security revenue) would result in substantial declines in expected *total* retirement income, including the income from the individual accounts, relative to the current Social Security benefit formula. The reductions would be so large that financing individual accounts out of current Social Security revenue is unlikely to be politically viable. (It should be noted that with or without individual accounts, a significant reduction in total retirement income would be necessary to restore long-term Social Security solvency in the absence of general revenue transfers. Such transfers are thus a critical component, albeit not the only component, of a sound Social Security reform plan regardless of whether individual accounts are created.) Furthermore, the large tax cut precludes financing add-on accounts without creating deficits outside Social Security and Medicare.

In short, carve-out accounts would involve politically unappealing reductions in traditional Social Security benefits. Add-on accounts might have proven to be more politically attractive, but given the tax cut recently signed into law, they would create large deficits in the non-Social Security budget. The basic problem is that non-Social Security revenue is needed to make a Social Security reform package (whether or not it includes individual accounts) politically viable, but the tax cut undermines such an approach.

Financing Add-on Individual Accounts out of the Non-Social Security Surplus

Add-on accounts would be financed from the non-Social Security budget. In the aftermath of enactment of the new tax, however, financing accounts in this way would cause deficits outside of the Social Security and Medicare Hospital Insurance Trust Funds.

According to estimates from the Congressional Budget Office, the projected surplus over the next 10 years outside of Social Security and Medicare Hospital Insurance amounted to $2.74 trillion prior to enactment of the new tax legislation.[2] Taking into account the new tax law and the other initiatives in the Congressional budget resolution, such as a prescription drug benefit, the remaining surplus outside the Social Security and Medicare Hospital Insurance Trust Funds appears on paper to be about $500 billion between 2002 and 2011.

Between 2002 and 2011, contributions to individual accounts equal to two percent of wages would amount to more than $1 trillion. Such contributions consequently could not be financed from the non-Social Security, non-Medicare part of the budget without creating deficits there.

Moreover, the situation is even less promising than such a simple comparison would suggest, because the official budget forecast embodies several extremely unrealistic assumptions, and as a result, not even $500 billion is likely to be available for individual account contributions. The unrealistic assumptions include:

- Artificial sunset. The figures above assume that the $1.35 trillion package of tax cuts, as signed by the President, actually will expire on December 31, 2010, and that several other provisions of the law — including a measure providing relief from the Alternative Minimum Tax — will expire between 2004 and 2006. These "sunsets" are not credible. In the absence of an underlying shift in policy, it is unrealistic to assume the wholesale expiration of the tax cuts after 2010 or termination of AMT relief after 2004.

- Expiring tax credits. The figures also assume that the tax credits that are routinely extended a few years at a time (and are always renewed with strong bipartisan support) will *not* be extended and will therefore be ended in the next few years. These "extenders," including the popular research and experimentation tax credit, are certain to continue being renewed.

- Defense spending. The figures assume that funding for defense will be limited to the level assumed in the budget plan that Congress adopted in May. The President has since requested an increase of $18 billion over that level for fiscal year 2002, which translates into an additional $200 billion over ten years if the requested 2002 level

[2] Such projections are highly uncertain, as CBO itself emphasizes. This estimate also is likely to be revised downward later this summer, when CBO issues a new forecast.

is simply maintained in subsequent years, with an adjustment only for inflation. Since the $18 billion request does not include funds for a national missile defense, the added defense costs over the next ten years could easily be well in excess of $200 billion.

- Non-defense discretionary spending. The figures assume that funding for *non*-defense discretionary programs over the next decade will fall significantly in real per capita terms over the next decade. The Congressional budget plan assumes a spending level for these programs that is $45 billion below what is needed simply to keep pace with inflation over the next ten years, and more than $200 billion below what is needed for these programs to remain constant in real per-capita terms (i.e., for the appropriation levels for these programs to keep up with inflation and changes in the size of the U.S. population). Past experience strongly suggests that the level the budget plan assumes for non-defense appropriations is unrealistic and unattainable. The current bipartisan interest in boosting funding for education, health research, and other areas adds to the likelihood that this level will be surpassed.

After making an adjustment just for the extension of the expiring tax credits (the second item above), the available non-Social Security, non-Medicare surplus vanishes for the years from 2003 to 2006.[3] Yet even this does not reflect likely defense spending increases or realistic levels for non-defense discretionary programs. Nor does it include *any* funds for relief from natural disasters — such as hurricanes, floods, and earthquakes — which have been averaging $5.6 billion a year. Finally, these figures do not reflect the impact of the recent economic slowdown on the budget forecast.

When realistic assumptions are taken into account, there is thus no meaningful surplus over the next 10 years left to transfer to Social Security or individual accounts. The upshot is that the tax cut and the other provisions reflected in the budget resolution prevent add-on individual accounts (or general revenue transfers directly to the Social Security system) without creating a deficit outside the Social Security and Medicare Trust Funds.

Financing Carve-out Individual Accounts out of the Social Security Surplus

An alternative approach would be to create carve-out accounts financed out of existing Social Security revenue. Over the next 10 years, Social Security is expected to run cash-flow surpluses totaling approximately $2.5 trillion. Over the longer term, however, Social Security is expected to run a significant deficit, amounting to about 1.9 percent of taxable payroll over 75 years. The Social Security Trustees project that the Social Security Trust Fund will become insolvent in 2038.

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[3] See Richard Kogan, Robert Greenstein, and Joel Friedman, "How Much of the Surplus Remains After the Tax Cut?," Center on Budget and Policy Priorities, June 2001.

President Bush could finance his individual account proposal by diverting part of the projected Social Security cash-flow surpluses into individual accounts. That approach seems most consistent with language he has used to describe his proposal. By itself, however, diverting revenue from Social Security to individual accounts would exacerbate Social Security's long-term financial imbalance because it would reduce the revenue available to the Social Security system (see Table 1). For example, if individual account contributions amounted to two percent of payroll, the Social Security Trust Fund would be exhausted in 2024 rather than in 2038 if no other changes in Social Security were made (i.e., if Social Security benefits were not reduced or payroll taxes raised).

Table 1

Impact of diverting revenue into individual accounts on Social Security solvency		
	Current law	**Divert two percent of payroll into individual accounts, starting in 2002 (with no other changes)**
Payroll taxes less than benefits	2016	2007
Total income (payroll taxes plus interest on Trust Fund) less than benefits	2025	2015
Trust Fund exhaustion date	2038	2024

To *improve* Social Security's long-term financial situation while diverting revenue into individual accounts requires some combination of higher payroll taxes, investing part of the Social Security Trust Fund in higher-yielding assets (such as stocks), transfers to Social Security from the rest of the budget, and reductions in Social Security benefits. The Administration's principles for Social Security reform rule out raising the payroll tax or having a portion of the Trust Fund reserves invested in equities. Furthermore, as already explained, transfers from the non-Social Security surpluses to the Social Security system would cause substantial deficits outside the Social Security and Medicare Hospital Insurance Trust Funds given the tax cut. Consequently, the only remaining choice to prevent Social Security's projected long-term deficit from worsening if funds were diverted from the Trust Fund to individual accounts would be to reduce Social Security benefits.

Henry Aaron, Alan Blinder, Alicia Munnell, and I have examined the size of the benefit reductions that would be needed to restore Social Security solvency while diverting payroll tax revenues equal to two percent of wages into individual accounts starting in 2002.[4] President Bush has promised to protect benefits for current retirees, older workers, survivors, and the disabled. To protect benefits for these people while diverting payroll tax revenue equal to two percent of payroll

[4] Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation, June 2000.

into individual accounts and also eliminating the long-term deficit within Social Security would require reductions in Social Security benefits (relative to the benefits that would be provided under the current-law benefit formula) of more than 40 percent (see box).

Why Benefits Would Have to be Reduced More than 40 Percent

To see why benefit reductions averaging 40 percent or more would be required if revenue equal to 2 percent of payroll were diverted from Social Security into individual accounts, note that the Social Security actuaries project that maintaining current-law benefits would cost an average of 15.4 percent of payroll over the next 75 years. The projected long-term deficit in Social Security equals just under 2 percent of payroll. Diverting two percentage points of payroll into individual accounts thus would raise the long-term deficit to almost 4 percent of payroll. The benefits that the President has said he would protect — benefits for current retirees, near retirees, and the disabled — amount to about 6 percent of payroll. This leaves 9.4 percent (15.4 percent minus 6 percent) available to be reduced. Eliminating a deficit of almost 4 percent of payroll when the available benefits that could be reduced amount to 9.4 percent of payroll requires a reduction in benefits averaging roughly 40 percent (since 4 percent equals about 40 percent of 9.4 percent).

Such an across-the-board reduction in traditional benefits would impose greater burdens on older workers (who would have less time to build up their individual accounts) than younger workers. To avoid a sharp reduction in total retirement income for older workers, which would not be politically viable, the reductions in Social Security benefits would have to be phased in over an extended period of time. Because less would be saved in early years as a result of this phase-in of the benefit reductions, the reductions for workers who are young today would have to be larger to ensure that Social Security remains solvent over 75 years. Our analysis found that under one plausible approach to phasing in the benefit reductions, Social Security benefits would have to be reduced by 29 percent for those who are aged 50 in 2002 and by 54 percent for those now aged 30 or younger, relative to the Social Security benefit levels under the current benefit structure.

To be sure, income from individual accounts would offset some of these benefit reductions. But a large net benefit reduction would occur. We estimated that the expected combined retirement income from Social Security and individual accounts for single individuals with average earnings who are 30 years old in 2002 (and who retire at age 65 several decades from now) would be 20 percent below the level they would receive from Social Security under the current benefit structure (see Table 2). For one-earner married couples with average earnings who are 30 years old in 2002 and retire at age 65, the expected combined income from Social Security and individual accounts would be 33 percent below the level these couples would get from Social Security under the current benefit structure.

It is worth noting that these figures are based on assumptions that are favorable to individual accounts and are more likely to understate than overstate the benefit cuts that would be required.

These assumptions generally are identical to those made by Professor Martin Feldstein, a leading advocate of individual accounts. These assumptions were used to show that even under assumptions favorable to individual accounts, the required benefit reductions would be substantial.

Table 2

Impact of Two-percent Individual Account Contributions Financed out of Social Security Revenue for a 30-year-old Single Earner with Average Wages	
	2000 inflation-adjusted dollars
Annual Social Security benefit under current-law benefit structure	$15,877
- 54% reduction	-$8;510
+ Individual account retirement income	+$5,305
Total combined benefit	$12,672
Relative to current law	-20%

Source: Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation, June 2000.

In summary, financing individual accounts out of projected Social Security reserves would involve either a significant deterioration in Social Security's long-term financial health or substantial reductions in Social Security benefits. Either choice would be likely to encounter stiff opposition on Capitol Hill.

This reality is why many analysts believe that serious Social Security reform requires additional funds from outside of Social Security to be politically viable. Nearly every major plan in recent years to restore long-term Social Security solvency, regardless of whether it creates individual accounts, has relied in part on transferring some of the surpluses projected in the non-Social Security budget to the Social Security Trust Fund. For example, President Clinton proposed transfers of non-Social Security surpluses to Social Security. So did the Social Security plan advanced in the last Congress by then-Ways and Means Committee chairman Bill Archer and Social Security subcommittee chairman Clay Shaw. In the aftermath of the tax cut, however, no such funds are available.

Accounting Gimmicks

To avoid these obstacles to financing individual accounts in the aftermath of the tax cut, policy-makers may be tempted to adopt an accounting gimmick. The purpose of the accounting gimmick would be to hide the difficult tradeoffs involved in financing individual accounts. Such gimmicks would disguise, but not remove, the cost of the individual account contributions.

At least three accounting gimmicks could be employed:

- "Double-counting" the Social Security surplus while changing budget accounting rules to mask the effect of this approach on the budget;
- Making "loans" from the rest of the budget to the Social Security Trust Fund and not repaying the loans within the next 75 years; and
- Adopting assumptions (often called "dynamic scoring") under which individual account contributions are said to raise national saving and corporate profits, and amounts equal to the additional corporate tax revenue that is assumed to materialize are transferred to Social Security.

These section explores these possible accounting gimmicks.

Double-Counting and Changing the Budget Accounting Rules

To avoid the appearance of either undermining the long-term health of Social Security or necessitating larger reductions in Social Security benefits than would otherwise be necessary, the commission's individual account proposal could credit the same funds to both Social Security and individual accounts while changing the budget accounting rules to mask the cost that such an approach entails.

Under this approach, the annual Social Security cash-flow surpluses would be credited to the Social Security Trust Fund. Rather than being used to reduce public debt, as under the current rules, these funds would then be used to make contributions into individual accounts. In other words, the same funds would both be credited to Social Security and deposited in individual accounts. Peter Ferrara, a leading advocate of individual accounts, has urged in a recent memorandum addressed "to the conservative movement" that this approach be used, writing: "When the [Social Security] surplus funds are used for personal accounts, the government should again provide government bonds to the Social Security trust funds in return. The account option would then not reduce the Social Security trust funds in any way, or reduce at all the funds available to pay current Social Security benefits."[5]

This use of the same funds both to credit the Social Security trust fund (and thereby enlarge its reserves) and to finance another program — in this case, individual accounts — is sometimes referred to as "double counting." It represents a type of budget accounting that was common until the mid-1990s, but has been eschewed in recent years. A return to this type of budget accounting (which usually entails running deficits outside Social Security and the Medicare Hospital Insurance program) may be necessary for a temporary period if the nation enters a recession or extended period of abnormally slow growth, but a broad consensus has developed among policy-makers against using such budget accounting except in periods when the economy is weak.

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[5] Peter Ferrara, "Increasing Retirement Benefits for Working People," Americans for Tax Reform, May 22, 2001.

To see how such an approach to hiding the costs of individual accounts would work, imagine a dollar of surplus Social Security payroll tax that flows into the Social Security Trust Fund under current law. Since the dollar is not needed to pay Social Security benefits now, the Treasury provides the Social Security Trust Fund with Treasury bonds in exchange for these surplus revenues. Today, the Treasury would then use these funds to pay down the publicly held debt. The reduction in public debt contributes to national saving and also reduces the interest payments the Federal government must pay on the debt in the future. It thus reduces future budget pressures outside Social Security, which makes it somewhat easier for the government in the future to honor its promises to pay Social Security benefits.

Now consider what would happen under the double-counting approach that Mr. Ferrara advocates. A dollar of Social Security payroll tax revenue would flow into the Treasury, and the Treasury would issue a bond to the Social Security Trust Fund in exchange for the surplus Social Security revenue. Under the budget accounting rules that the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) have long used, once the Treasury issues this bond to the Social Security Trust Fund, anything the Treasury does with the revenue (other than paying down debt) is considered an expenditure from the non-Social Security side of the budget. Therefore, if the funds were used to finance individual accounts, that would count as an increase in federal expenditures outside Social Security. Such an increase would result in a return of budget deficits outside Social Security and Medicare Hospital Insurance, since (as explained above) no room exists in the projected surpluses outside Social Security and Medicare to finance individual account contributions.[6]

To avoid showing a deficit outside of Social Security and Medicare, the budget accounting rules could be altered through use of an egregious budget gimmick. The Administration and Congress could seek to mask the resulting deficits in the non-Social Security budget by directing CBO and OMB to reverse their existing budget rules and to fail to count the use of these funds to finance individual accounts as an expenditure.

Such a gimmick would camouflage the cost of individual accounts financed with Social Security revenue. It would mask the cost to the Social Security system by continuing to credit the Trust Fund with the surplus Social Security revenue, while camouflaging the cost to the budget by failing to record the deposits in individual accounts as an expenditure. The costs of the accounts must, however, be a cost to either the Social Security system or the rest of the budget. Using a gimmick to make it appear as though this maneuver entails no cost to either Social Security or the rest of the budget would constitute dishonest budgeting and would not be fiscally responsible.

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[6] Note that despite the rhetoric surrounding Mr. Ferrara's proposal, the outcome is equivalent under current budget scoring rules to simply making contributions to individual accounts out of the non-Social Security budget, thereby creating a deficit outside the Social Security and the Medicare Hospital Insurance Trust Funds.

Loans from the General Fund to the Social Security Trust Fund

A second accounting gimmick would involve loans from the general fund to the Social Security Trust Fund. To see how this would work, assume that $1 in payroll taxes is diverted from the Social Security Trust Fund into individual accounts. All else equal, that would reduce the funds credited to the Trust Fund and cause the Trust Fund to become insolvent at an earlier date. To avoid exhaustion of the Trust Fund earlier than under current law, the general fund would — under this approach — lend funds to the Social Security Trust Fund. Such loans would be repaid in the future, with interest, from the Trust Fund back to the general fund. The Social Security reform plan proposed by then-Representative John Kasich in 1999 employed such a mechanism.

Under current budget rules, loans from the general fund to the Social Security Trust Fund would not be scored as non-Social Security expenditures — because they are loans that will be repaid with interest — and thus would not cause a deficit in the non-Social Security, non-Medicare budget. Such loans, however, also would do nothing to improve Social Security's long-term deficit, since they would have to be repaid with interest. The loan repayments the Trust Fund eventually would have to make would be equal in present value to the loans the Trust Fund earlier received, with the result that there would be no effect on Social Security's long-term imbalance.[7]

Here is where this approach can be turned into a flagrant gimmick. Such loans could be used to reduce the 75-year Social Security deficit (as opposed to the program's permanent deficit) *if the loan repayments are deferred for such a long period of time that they extend beyond the next 75 years*. This is precisely the approach the Kasich plan used; under that plan, the loan repayments would not even begin until 2060 and would be stretched out for many years after 2075. Placing some of the repayment outside the 75-year window has no effect on the *permanent* imbalance within Social Security, but reduces the apparent imbalance over the 75 years traditionally used to measure Social Security's long-term solvency.

This gimmick thus can be used to help finance individual accounts and make such accounts look like a "free lunch." Loans from the general fund to the Social Security Trust Fund could be employed as a multi-trillion dollar budget gimmick to avoid hard choices and make it look as though long-term Social Security solvency could be restored and individual accounts implemented without either reducing Social Security benefits or causing deficits outside Social Security. Once again, a gimmick would be used to conceal the costs associated with individual accounts.

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[7] Loans do, however, allow the Trust Fund to avoid liquidity (as opposed to solvency) problems: They ensure that the Trust Fund does not become negative for a temporary period, as under many proposed plans, such as the one proposed by Martin Feldstein and Andrew Samwick. See Martin Feldstein and Andrew Samwick, "Allocating Payroll Tax Revenue to Personal Retirement Accounts," *Tax* Notes, June 19, 2000, and as NBER Working Paper 7767, http://www.nber.org.

One reason that this gimmick might be possible is that the accounting rules that apply to transactions of this type have not been thoroughly examined. The gimmick relies on inconsistencies in the treatment of loans between the lender (the budget) and the borrower (the Social Security system). In particular, the gimmick relies on the fact that the loan is not counted as an expenditure from the general fund but is counted as income to the Social Security system over the 75-year period. To avoid such a misleading result, one of two changes should be adopted:

- The Social Security Administration could evaluate 75-year solvency on the basis of the *net* financial position of the Social Security Trust Fund (that is, the financial assets of the Trust Fund minus the financial liabilities of the Trust Fund), rather than just on the basis of the financial assets of the Trust Fund without the financial liabilities being taken into account.

- Alternatively, the Social Security Administration could evaluate 75-year solvency on the basis of the gross assets of the Trust Fund (that is, without subtracting any loans the Trust Fund must repay), while the Congressional Budget Office would treat any loan to the Social Security Trust Fund as on-budget expenditure.

Either approach would eliminate the potential for this gimmick to be employed. My preference would be for the first alternative, under which the Social Security actuaries would evaluate solvency on the basis of the net financial position of the Trust Fund and the current budget scoring rules for loans would be maintained. That approach appears the most analytically sound.

Dynamic Scoring and Corporate Tax Revenue

A final possible accounting gimmick involves a form of budget accounting that Martin Feldstein and Andrew Samwick have suggested, but that has been rejected by most budget analysts and by the CBO.[8] Feldstein and Samwick would undertake a form of "dynamic scoring," in which assumptions are made about the macroeconomic effects of Social Security proposals and these assumptions are then reflected in the cost estimates for those proposals. (Using dynamic scoring for tax proposals, for example, entails making assumptions about the impact of proposed tax policy changes on economic growth and on the resulting change in revenues that is assumed to arise from the change in economic growth.) This approach has been rejected by CBO, OMB, and policy-makers of both parties because there is little agreement among economists about the response of the economy to changes in tax and budget policies, which makes this approach particularly susceptible to manipulation.

Despite the lack of support for dynamic scoring among budget experts, Feldstein and Samwick would transfer to the Social Security Trust Fund the extra corporate revenue they assume

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[8] See Martin Feldstein and Andrew Samwick, "Allocating Payroll Tax Revenue to Personal Retirement Accounts," *Tax Notes*, June 19, 2000, and as NBER Working Paper 7767, http://www.nber.org.

would result from creating individual accounts. Corporate income tax collections would be higher, they claim, because a Bush-style individual account plan would boost national saving, investment, and GDP. The amount of additional tax collections they assume over the next 75 years is very large — $3 trillion in present value. In other words, their proposal entails transferring the immediate equivalent of $3 trillion from the rest of the budget to Social Security.

Feldstein and Samwick implicitly argue that these $3 trillion worth of transfers to the Social Security Trust Fund would impose no additional burdens on the rest of the budget, because the transfers would reflect net additional revenue from higher corporate income tax collections. Their key assumption is that individual accounts would raise national saving and that higher national saving would then boost corporate income and therefore corporate tax revenue.

The assumption of an increase in national saving, however, is implausible. First, it rests upon another assumption: that in the absence of individual accounts, the Social Security surpluses will *not* be used to pay down debt — which increases national saving — but instead will be used to finance increases in other government programs, despite pledges by both parties to wall off these surpluses. If the Social Security surplus is walled off, the Feldstein-Samwick argument falls apart (Social Security surpluses would already be committed to national saving by paying down the public debt, so shifting these funds from debt repayment to the financing of individual accounts would not increase national saving). In fact, shifting the Social Security surpluses from debt repayment to individual accounts could *reduce* national saving, since individuals may be more likely to reduce their own saving in response to the establishment of individual accounts in their names than in response to a reduction in the government's debt.

In other words, the Feldstein-Samwick argument — that individual accounts would boost national saving, which then would increase economic activity and boost corporate tax collections to such an extent that the added revenue would effectively pay for the individual account contributions — collapses once the suspect assumption is removed that the Social Security Trust Fund surpluses would otherwise be expended.

Furthermore, the magnitude of the increases in national saving and corporate income tax revenues that Feldstein and Samwick assume is so large as to strain credulity. They assume that individual accounts would result in an increase in corporate income taxes equal to 1.7 percent of projected GDP in 2075; by comparison, the entire corporate income tax today amounts to only 1.9 percent of GDP. They assume corporate tax revenue would *nearly double* as a share of GDP as a consequence of individual accounts.

The dynamic scoring approach is essentially another accounting gimmick, as it is predicated on the dubious assumption that national saving would increase dramatically from the creation of carve-out individual accounts and result in massive increases in corporate tax revenues. If the additional corporate revenue failed to materialize, as would likely be the case, the financing of individual accounts under the Feldstein-Samwick approach would entail either large-scale budget

deficits, or substantial program cuts or tax increases in the rest of the budget, to make up for the $3 trillion being transferred from the rest of the budget to the Social Security Trust Fund.

Conclusion

The size of the recently enacted tax cut requires policy-makers to employ one of two unappealing mechanisms for financing individual accounts:

- The individual accounts could be financed by transferring funds from the non-Social Security budget. Because the projected non-Social Security, non-Medicare surplus has been depleted by the new tax cut legislation and other priorities in the budget resolution, however, this approach entails running deficits outside Social Security and Medicare.

- The individual accounts could be financed by diverting payroll tax revenue from the Social Security Trust Fund. That would either accelerate the date on which the Social Security Trust Fund would become insolvent or require large benefit reductions within the traditional Social Security program.

The only other alternative is some form of accounting gimmick. In essence, the large size of the tax cut requires policy-makers to adopt one, or some combination, of three alternatives for financing individual accounts: A deficit outside Social Security and Medicare Hospital Insurance (or substantial budget cuts or tax increases to avert such deficits), large reductions in traditional Social Security benefits, or an accounting gimmick.

Since all of these approaches are politically problematic, the tax cut considerably weakens the chances that the President's commission will succeed in designing a credible plan to restore long-term Social Security solvency. In a fundamental sense, the tax cut has undermined the opportunity that we had, and could potentially recapture, to use the projected budget surpluses as a substantial down-payment on the longer-term budgetary pressures facing the nation.

Chairman CONRAD. Thank you, Dr. Orszag.

And, Dr. Schieber, again, welcome, and please proceed.

STATEMENT OF SYLVESTER J. SCHIEBER, Ph.D., VICE PRESIDENT, WATSON WYATT WORLDWIDE

Mr. SCHIEBER. Thank you very much.

Mr. Chairman, members of the committee, thank you for inviting me here to testify before you today on the budgetary tradeoff and transition issues related to Social Security reform. I think you

should be congratulated for taking up this very important issue. It is time that the American public began to understand the scope of the Social Security financing issues that we face and the mechanics of trying to deal with it.

The Social Security actuaries estimate the present value of the under funding of the OASDI benefits defined in current law as approximately $3.2 trillion today. This is a difference in the present value of obligations under law and the current trust fund balance, plus the present value of future tax collections for the system. It is the amount that the trust funds today are short in order to maintain the benefits now defined in law, with workers and employers continuing to pay taxes in accordance with current law. Delay in addressing this imbalance until 2016 or 2037, and the $3.2 trillion shortfall that we are facing today will grow to be much larger. We face transition costs no matter what we do.

The law establishing Social Security, limits the revenue sources for the program, primarily due to payroll tax revenues and some small amount of revenue collected through taxes on benefits. There are no provisions for the system to borrow from the Treasury or elsewhere at the current time. Under current law Congress is faced with the prospect of either raising payroll taxes or cutting benefits or some combination of the two. The magnitude of those adjustments in today's dollars, if you could do it today, would be $3.2 trillion. If you wait until tomorrow or sometime later, it is going to be more.

The transition cost to a reformed Social Security system that would include individual accounts would not be any higher than this $3.2 trillion unless the shift increased benefits or somehow kept a revenue stream coming into the total reform system. Congress has to pass legislation at some point to resolve the Social Security financing imbalance. We have heard this morning that the cost of fixing this imbalance has somehow been affected by the recent adjustment to the tax code. This conclusion is based on two assumptions that I think are questionable.

The first is that the marginal revenue collected under the prior law would have been held in the form of a surplus that could be devoted to this purpose. The great American philosopher, Yogi Berra, has said, quote, "You can observe a lot by watching." I am 55-years-old. During my lifetime the Federal Government has run a deficit in 44 of those years. On the basis of watching our legislative process over many years, I am skeptical that the projected surpluses under prior law would have been preserved for the purposes the other witnesses on this panel have said they would be used for, or could be used for.

The second questionable assumption is that the general revenue surpluses would be devoted to Social Security financing. To rely on general revenue financing of Social Security to any significant degree would be a very substantial departure from traditional policy. This policy has not been an accident. Franklin Roosevelt was adamant that his Social Security program was going to be financed by worker and employer contributions. Roosevelt was convinced that general revenue financing would change the nature of the program to that of a means-tested welfare program. He characterized it as "the dole."

The issue of general revenue financing has been raised repeatedly throughout the history of Social Security and has been consistently resisted by Congress for two reasons. The first is that the payroll tax financing puts a Governor on the program because of the direct linkage between benefit outflow and the taxes that have to be collected to provide for them. The second is that if these benefits are thrown into the cauldron of annual budget negotiations on our national priorities, they will ultimately become much less secure than they have been under the contributory structure. All we have to do is look at the differences in the attitudes about benefit rights under Social Security and welfare programs for children to see this conclusion writ fairly large.

The problem with Social Security today is that current contribution rates will not finance the current retirement patterns when the baby boomers reach retirement eligibility ages. We have to cut benefits or increase contribution rates. There seems to be a tremendous reluctance though in our willingness to do either, or even to talk openly with people about the necessity of doing this. I believe the solution lies in stimulating higher savings rates, and I think in that regard I am in complete agreement with my colleagues here this morning.

If a worker regularly saves from his or her early 20's and continues to do so until retirement age, by the time they get to retirement age, 60 to 75 percent of the amount that they have accumulated will be interest, interest payments on their contributions. The savings in such a system will grow the capital base of the economy, improving workers' productivity, which also is something we talked about here this morning. Higher productivity reduces the relative burden of providing for a dependent population.

Under the current model we have to come up with $3.2 trillion to restore financing balance. If we can increase savings as part of that solution, the added interest returns will also help to pay off a $3.2 trillion burden that was now going to be imposed on workers and retirees. The more saving we can generate, the more interest returns can help to eliminate this funding deficit.

Moving from a pay-as-you-go retirement system to one that is funded will be akin to changing from renting a home to buying it. Early on there may be some added annual payments with buying the home, but in the long term the owner is going to end up better off by owning than renting. As in buying the home, there may be a period at the beginning where some form of mortgage would be necessary to facilitate the process. But in the long term the goal of reform should be that such a mortgage would be fully paid off. When that is accomplished, the ongoing cost of a funded system should be considerably lower than the current one.

Without the Bush Commission specifying any inkling of the plan, there has already been a great deal of criticism of the commission and its members and where they are heading. Mr. Orszag and some of his colleagues published a paper last week, where they concluded that, quote, "Diverting revenue from Social Security into individual accounts would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system." No one can possibly know what setting up an individual account program will do to the long-term deficit of Social Security without

knowing the details of the plan, and they have not even begun to talk about the details of the plan at this juncture. If the use of Social Security funds in the creation of an individual account is exactly offset by adjustments to the residual Social Security benefits, then the creation of an account will have absolutely no effect on the projected long-term deficit of the system.

The same analysis concluded, quote, "Since an individual account system would favor people who live longer and would include a benefit formula that does not favor lower earners, it would be regressive on a lifetime basis." Once again, a conclusion has been drawn about a plan that the Bush Commission might devise, without one iota of information on what the members will propose in terms of a plan structure that might actually increase income redistribution. You can look at the plan that Senators Gregg and Breaux have worked on in conjunction with Representatives Kolbe and Stenholm. I would argue that it is more redistributive than the current structure, and that it guarantees anyone who works a full career at least a poverty level income. The current system does not do that. These systems can be just as redistributive as the current system. It is all a part of the reform structure.

The other witnesses here at the table this morning have assumed that a plan drawn in accordance with President Bush's principles for Social Security reform cannot possibly result in added savings. I reject that conclusion. In my prepared remarks, I go through a possible alternative that would take advantage of our widespread experience in this country with 401(k) plans, where we would ask people to contribute to a voluntary account over time, and that money would be matched through contributions, matching contributions from Social Security. We could generate very substantial additional savings into our retirement system through a voluntary plan if we really have the will to do so.

Thank you very much.

[The prepared statement of Mr. Schieber follows:]

Social Security: Budgetary Tradeoffs and Transition Costs

by

Sylvester J. Schieber, Ph.D.
Vice President
Watson Wyatt Worldwide

Testimony before the
Senate Budget Committee

August 2, 2001

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Introduction

Mr. Chairman and members of the Committee, thank you for the invitation to testify before you today on budgetary tradeoffs and transition costs related to Social Security in our aging society. You are to be congratulated for taking up this extremely important matter now. It is time that the American public began to understand the scope of the Social Security financing issues that we face as we look at the pending retirement of the baby boom generation and beyond. Some analysts who are involved in the current discussion regarding Social Security would have us believe that they have a way of reforming the program that would eliminate transition costs.

I have spent much of the last thirty years studying the implications of the baby boom generation on our Social Security system. I have written two books on Social Security. I have testified many times before this and other congressional committees on the subject and submitted to questions from them. I have discussed and debated various points about the system with many, if not most, of the prominent analysts who have been involved in the evolution of Social Security policy over the last two decades. I served as a member of the 1994-1996 Advisory Council on Social Security. I am currently a member of the Social Security Advisory Board that recently issued a report on Social Security financing. My conclusion from all this study, discussion, and debate is that there is no way the current Social Security system or any alternative structure can survive the baby boomers' retirement period without our society incurring substantial transition costs. The transition costs associated with moving from our current system to an alternative one arise to a very significant degree, because the current system is facing a

substantial financing deficit. That underfunding will require additional financing whether we stay with a current law structure for the system or some alternative.

The Nature of the Social Security Financing Problem under Current Law

The present value of the underfunding of the Old-Age and Survivors and Disability Insurance (OASDI) benefits defined in current law is approximately $3.2 trillion as estimated by the Social Security actuaries. This is the difference in the present value of obligations under current law and the current trust fund balance plus the present value of future tax collections for the system. This number says that the OASDI trust funds today are $3.2 trillion short of what they would have to be for us to maintain the benefits now defined in law with workers and employers continuing to pay taxes in the future in accordance with current law.

If we put off addressing the imbalance in the current system until 2016 or 2037 or any other future date, the $3.2 trillion shortfall in current law will be much larger. The reason is that the discounting period that is used in calculating the present value of future shortfalls will be much shorter. In the discussions about solutions to our Social Security problem we often hear about the magic of compound interest as a potential solution to our financing dilemma. A dollar invested over a significant period of a worker's career has the potential to pay several dollars of retirement benefits. Rarely in this discussion do we hear that compound interest calculations play the opposite role in defining the magnitude of the problem we face. An unfunded dollar's worth of benefits that has been earned at age 40, or even age 50, becomes several dollars worth of promised benefits at age 65. If there are no funds backing those promises at age 40 or 50, compound interest works against the system not for it.

Some people have taken to heart implications of compound interest on our Social Security system and advocated that a portion of the OASDI trust funds be invested in the stock market in order to garner higher returns. There is considerable debate over how such investment might be accomplished. Some analysts and policymakers advocate that the trust funds invest directly in the stock market like any other pension plan. Others advocate that such investment be accomplished through individual ownership of Social Security accounts and self-directed investment. At the heart of which option people prefer is a debate about whether it is feasible and desirable for a federal government entity to own a significant share of private capital. Some analysts question its desirability.[1] Others believe it is appropriate.[2]

Ultimately whether Social Security trust funds will buy and manage an equity portfolio is a political debate that will have to be resolved by the U.S. Congress. It is not a new debate. The original Social Security Act included funding provisions that were strongly advocated by President Franklin D. Roosevelt. Roosevelt insisted that his Social Security program be financed through employer and employee contributions and that it not include any general revenue financing. In addition, he insisted that its benefits were to be fully funded by the end of an initial transition period spread over 30 to 35 years. There were concerns in the early days of Social

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[1] Joan T. Bok, Ann L. Combs, Sylvester J. Schieber, Fidel A. Vargas, and Carolyn Weaver, "Restoring Security to Our Social Security Program," *Report of the 1994-1996 Advisory Council on Social Security* (Washington, DC: Social Security Administration, 1997), pp. 126-129.

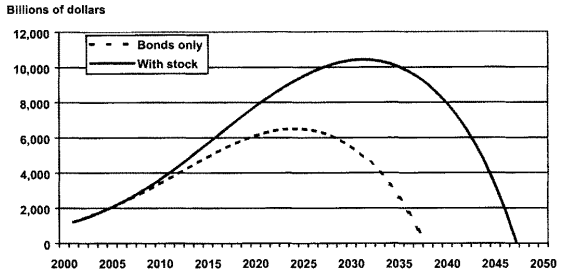
[2] Peter Orszag and Robert Greenstein, "The Greenspan Concern over Public Ownership of Private Assets: Can the Social Security Trust Fund Safely Own Such Assets?" Washington, DC: Center on Budget and Policy Priorities, February 26, 2001.

Security's history about the potential size of the trust funds and how they would be invested. These concerns led Senator Arthur Vandenberg and others to support pay-as-you-go financing of the program over the funded approach that Roosevelt strongly advocated until his death. By the mid 1950s, the goal of funding the system was abandoned and the question of whether the trust funds could invest in anything other than government bonds was never resolved. But one of the major reasons that President Roosevelt and his associates did not prevail in their efforts to fund our Social Security system was because they could not convince Congress that a trust fund that would pay off all federal debt and invest in the economy was desirable.

Assuming for the sake of discussion that some portion of the trust funds could be invested in equity markets and that the portfolio could be centrally managed, it would change the timing of a variety of events related to Social Security financing as reflected in Figure 1. Such a policy would help address Social Security's current funding shortfall but it would not resolve the current law deficit. The trust fund accumulation with "bonds only" in Figure 1 is derived directly from the projections in the latest *Trustees Report*. The "with stock" accumulation is based on the assumption that surplus assets accruing from tax revenues starting in calendar year 2002 would be invested in an equity index portfolio until 40 percent of the total trust fund balance was invested there. In deriving the estimate, I assumed that equities would generate returns at a rate of 4 percent above the bond return rates assumed by the actuaries. At the end of each subsequent year after the year-end balance in equities exceeded 40 percent of the combined trust funds, I assumed there would be a rebalancing of the funds so the equity fund would hold 40 percent of the total. This is about as aggressive a proposal of investing trust fund assets in equities as I am

aware of and corresponds with the recommendation made by Robert Ball during the deliberations of the 1994-1996 Advisory Council on Social Security.

Figure 1: Social Security Trust Fund Balances with and without Equity Investment



Source: Derived by the author from the ***2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*** (April 2001).

The net effect of this alternative investment strategy on the trust funds would be to extend the date at which the trust fund would actually start selling assets from 2025 to 2034. It would extend the date of depletion of the trust funds from 2037 to 2048. This projection does not take into account the volatility in stock returns and, in that regard, does not show the range of potential outcomes that might be achieved. In fact, some economists still believe the market is overpriced and suggest that we could have as much as a decade with lower returns before returning to a longer historical mean return tendency. If the assumption on real return from stocks is reduced to 4.5 percent just for the first decade of the investment period and then restored to 7.0 percent instead of using the 7.0 percent for the whole period in deriving Figure 1,

the date at which the trust fund would be depleted would be 2045 instead of 2048. In any event, the projections show that even a relatively aggressive policy of investing in equities is not likely to fully resolve Social Security's long-term financing problem.

From a federal budgetary perspective, the implementation of a policy that resulted in the accumulation of equities under this scenario would result in stock purchases with a nominal value of nearly $1 trillion dollars over the coming decade. This would reduce by an equivalent amount the federal debt reduction that would be accomplished by continuing to pursue current investment policies with Social Security trust funds. After about a decade, the flow of funds from the equity accounts would be reversed, assuming that the goal of limiting total equity investment to 40 percent of total trust fund assets was enforced.

While pursuing a revised investment strategy of this sort might improve the long-term financing of the Social Security trust funds, it would have no practical effect on the overall economy's ability to pay for the benefits provided under current law. The reason is that the purchase of equities for the trust funds would be at the expense of selling additional bonds to the public or buying back fewer bonds than under the current funding approach. The trust fund would be swapping bonds for equities and someone on the other side of the transaction would be doing just the opposite. If the trust fund realized a higher return as a result of this swap, someone on the other side would realize an offsetting lower return. Another possible outcome is that there would be some equalizing of returns between stocks and bonds as stockholders insisted that the government pay them higher interest in order to get them to swap their stocks for the bonds the trust funds would otherwise own.

I believe from a general policy perspective, any solution for the Social Security funding shortfalls we adopt should help not only resolve the potential depletion of the trust fund but also enhance the economy's ability to deliver retirement security for the baby boomers. There is fairly broad agreement that some form of additional savings will be required to do that. These savings can be achieved by increasing the revenues flowing into the system, decreasing the expenditure rate or some combination of the two. To the extent that new saving is created it will lead to greater pre-funding of benefits than has persisted in the past. At the same time, new saving should lead to enhanced worker productivity and larger levels of output from our economy, thus reducing the relative burden the retirement of the baby boomers will put on it. Additional savings can help in almost any case but there is considerable concern that any new savings be used as efficiently as possible. The challenge that policymakers face, then, in devising Social Security reform options is finding options that will enhance our national savings rates and put the added savings to good use. There are different perspectives on how to meet that challenge and these have led to a number of alternative proposals on how to modify the current system.

Social Security Reform Options and Transition Costs

Much of the current debate about Social Security reform is being conducted around the concept of "privatization." This term has come to have so many meanings that it is confusing the discussion about the various ways we might reform the first tier of our nation's retirement system. Part of the Social Security reform debate is over the desirability of greater funding of the system than is provided under current law. Here there seems to be more agreement across various parties involved in discussions about Social Security reform than often is apparent to the

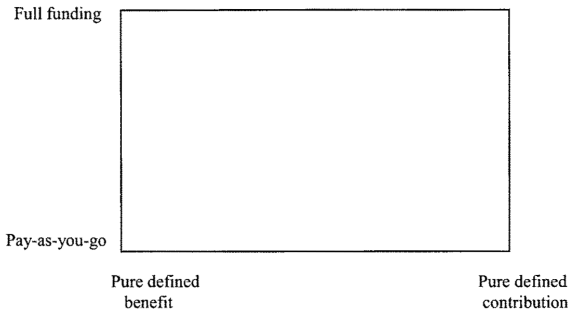
public. Another part of the debate is whether we should continue to have complete dependence on the defined benefit approach in current law or should move more toward a defined contribution system. Here there is significant disagreement and the rhetoric about the alternatives may be complicating our rational consideration of our alternatives and is almost certainly confusing the public about the options we face.

To help clarify the discussion about Social Security reform that is underway in this country today, consider our reform options within the context of Figure 2. It defines the policy field of choices we face by bringing together the issues of funding and plan structure. Currently Social Security is a defined benefit (DB) program that has largely been financed on a pay-as-you-go basis up until now. If it were funded purely on a pay-as-you-go basis, it would reside at the southwest corner of the figure. Since 1983, we have structured the program to deviate somewhat from pure pay-as-you-go and we are now accumulating a trust fund. Despite a trust fund of more than a trillion dollars today, the present value of future obligations are currently projected to outstrip that trust fund and present value of future revenues to the tune of $3.2 trillion over the next 75 years as discussed above.

Some policy advocates would have us return to almost pure pay-as-you-go financing. For example, Senators Daniel Moynihan and Bob Kerrey's proposed legislation in the last congress that would adjust payroll tax rates and benefits within Social Security so it ran on a stricter pay-as-you-go basis in the future. Their proposal would achieve this by cutting payroll taxes in the short run and then letting them rise again as the baby boomers moved into their retirement

period. Most of the adjustment in the program under their proposal would be made in the form of benefit cuts.

Figure 19.1: Policy Field of Social Security Reform Options



Other policy analysts would have us maintain the current DB structure but attempt to fund it more than now. They propose partial funding because the interest on the accumulated fund would help to lower the payroll taxes needed to pay future benefits. If their proposals were adopted we would stay on the western boundary of the policy field but move north from the corner. The accumulation of funds, of course, would raise questions about what to do with the money. Higher average rates of return in the stock market relative to government bonds leads proponents of this approach to suggest that some of the proposed funding should be invested in equities. Many policy analysts oppose this approach because they do not believe the government

can accumulate wealth to the extent implied, and if it did, they are concerned about governmental intrusion into private capital markets.

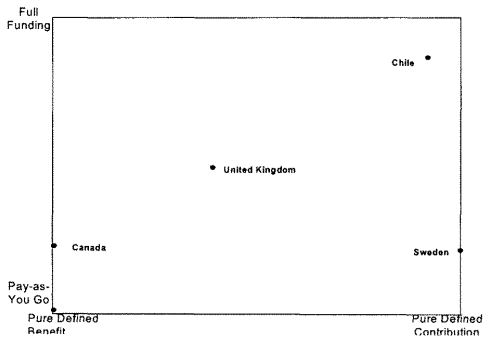
There is a third set of policymakers and policy analysts who would move more toward the defined contribution side of the policy field. Most of these claim that their proposals would end up with additional funding of our pension system although some of these proposals have been criticized because they would rely almost purely on higher returns to achieve this added funding rather than additional savings. The net effect of a defined contribution system that does not increase national savings but does invest in equities would be no different than that of a defined benefit system that invests in equities without creating added savings. Many of these proposals have also been criticized because the cost of administering the plans would be higher than for staying under the defined benefit model. I believe legislative proposals put forward by Senators Judd Gregg (R-NH) and John Breaux (D-LA) and similar proposals would largely overcome the administrative efficiency concerns but that is the subject of another discussion.

What Have Other Nations Done About This Problem

One of the interesting things about the provision of retirement income security around the world is that many countries have changed their retirement systems significantly in recent years because they are facing the same or worse demographic challenges than we do. These countries are interesting case studies because they all started with defined benefit plans that were predominantly funded on a pay-as-you-go basis. They all changed the positioning of their retirement systems vis a vis the policy field location. In Figure 3 and the following discussion, I focus on four specific countries. They have each approached their pension reforms differently. I

have chosen them because they offer a range of solutions that have been chosen. Other countries could be substituted for each chosen here. In my choosing the countries that I have chosen, I am not advocating anything that any of them have done in reforming their systems. In fact, there are some things that some of these countries have done that I would recommend against us doing. I simply offer them so I can more easily discuss some of the design and transition issues we face in addressing our own Social Security reform options.

Figure 3: Location of Selected Nations in Providing Retirement Income Security on the Policy Field of Social Security Options



The reformed Canadian pension system is shown in the field as being a defined benefit plan but having some funding. Until 1998, the system was run largely on a pay-as-you-go basis. The accumulated fund behind the plan was equivalent to two years of benefit payments, quite similar to the U.S. Social Security system holdings at this time. The Canadian system is a two-

tier program with universal eligibility for the bottom tier but with a "claw-back" provision—i.e., a means test—for retirees with substantial income. The second tier of the system is known as the Canadian Pension Plan (CPP). At the end of 1997, the contribution rate for the plan was 6.4 percent of covered pay. Legislation adopted in 1998 will increase the payroll tax to 9.9 percent of covered pay by 2003 where it was projected to be level thereafter.

The significant increase in the payroll tax under this legislation, coupled with some moderate benefit adjustments, was based on the estimate that the system's costs would reach 14.2 percent of covered pay by 2030. The accelerated increase in the tax and benefit modifications were an attempt to pre-fund some of the obligations that will accrue between now and 2030. The goal is to take advantage of the returns on accumulating assets to help defray some of the costs of the system as Canada's baby boom generation makes its claim on the system. In the coming years, the trust fund is projected to grow to roughly the equivalent of five years of benefits. The intent is to invest the funds in a diversified portfolio of securities in the hopes of getting higher returns than on the government bonds in which the fund had been invested in historically.

Sweden is shown in the figure as having a system with some funding but having retirement benefits provided purely from a defined contribution environment. This is based on reforms adopted during 1998 and being phased in on a gradual basis. Their old plan was a pay-as-you-go financed defined benefit plan. People born in 1937 and earlier will receive their pension under the old system. Those born between 1938 and 1953 will receive part of their retirement benefit based on the old system and part on the new based on a gradual phasing out of the old benefit and gradual phasing in of the new. Those born in 1954 and later will receive

benefits purely under the new system. The placement of Sweden on the policy field is a representation of where the retirement system will be once the new provisions are fully phased into operation.

Sweden's revised retirement system requires contributions of 18.5 percent of pay on earnings up to $37,000 per year. Of that, 16 percentage points of the contribution are used to finance current benefit payments to retirees. The extra 2.5 percentage points are contributed to a "premium reserve account," a funded account, that will earn interest during a worker's career. The worker can choose an investment manager for his or her account. Since roughly 85 percent of the total contributions are still used to finance pay-as-you-go benefits, I have only plotted Sweden's position about 15 percent of the way up the funded dimension of the policy field. Workers' contributions under the pay-as-you-go element of the new system are credited to individual accounts based on each individual worker's earnings level and taxes paid. The account is also credited with an interest accrual each year that is equal to the rate of growth of incomes in the economy. Since the contribution is actually spent to finance current benefits, these accounts are phantom accounts in that they do not hold accumulating real wealth. Accounts of this sort are often called "notional" accounts. At retirement, a worker's individual account will be converted to an indexed annuity. The index is the average income growth in the economy. The size of the initial annuity will be based on the life expectancy of the birth cohort to which the worker belongs and his or her age at retirement.

People can retire as early as age 61 under the new system and will receive a benefit that is 72 percent of the benefit they would receive by waiting to age 65 to start taking their pension. If

they wait until age 70, their benefit would be 157 percent of the age 65 benefit. The incentives to work extra years are clearly stated and are there for workers to take or leave. By moving to a defined contribution system of this sort, the effects of increasing life expectancy are automatically recognized by the system. The issues to setting normal retirement ages through political deliberation are also largely eliminated.

I have depicted the United Kingdom as being somewhat in the middle of the policy field on social security provision and financing. The United Kingdom has a two-tier public retirement system with voluntary employer-sponsored pensions as the third tier. The bottom tier of the U.K. system is the Basic State Pension, a floor old-age benefit that everyone qualifies to receive. The benefit at the end of 1997 was around $100 per week, about 15 percent of the average wage for full-time male workers. The second tier of the U.K. system is called the "Supplemental Earnings-Related Pension Scheme" or SERPS for short. Since Margaret Thatcher was prime minister of the United Kingdom, the government has allowed workers to opt out of this second tier of their system, and today about 83 percent do so. These workers are required to use employer-based pensions or personal pensions if they opt out of the state provided system. In that regard, the SERPS program establishes the minimum benefits or contributions that must be provided for by workers who opt out of the state program.

The reason that I put the United Kingdom roughly in the middle of the policy field is because the benefits for workers who contract out of the state plan are funded, so some of the overall system benefits are funded and some are not. Some of the benefits are provided through employer-sponsored defined benefit plans but the indexation provisions for benefits for workers

who leave jobs prior to the end of their career make them essentially the equivalent of defined contribution arrangements. In addition, the trend in the United Kingdom away from defined benefit and toward defined contribution plans at the employer level are following those in the United States. It is possible to quibble that we have the United Kingdom placed a little too low or too high on the funding scale, or too much toward the DB or DC ends of that dimension. The point is that they are well out in the middle of the policy field in their provision of retirement security to workers.

The approach to Social Security reform that has received by far the most attention by the press and policymakers around the world in recent years is that of Chile. Chile's 1981 reform of its pay-as-you-go retirement system was revolutionary at the time. The government basically transformed its pay-as-you-go defined benefit system into private individual retirement accounts that are mandatory, fully funded, fully vested, and completely portable. Because of its structure and nature, it is placed toward the upper right hand corner of the policy field in Figure 2. Workers must contribute 10 percent of earnings to their retirement accounts. Currently they can choose from a relatively narrow number of funds offered by highly regulated, specialized fund management companies. Workers are also required to purchase term life insurance and disability insurance, offered by the same pension managers. The combined contributions covering retirement, life and disability insurance, and administrative expenses are about 13 percent of payroll, roughly comparable to contributions in the U.S. system for retirement, survivors and disability benefits. Upon retirement, Chileans can choose between a phased withdrawal of their account balances or an inflation-indexed annuity sold by insurance companies. I did not put the

Chilean system in the extreme northeast corner of Figure 2 because they still have certain guarantees that underlie workers defined contribution accounts, thus retaining an element of pay-as-you-go financing and defined benefit structure.

Transition Costs Associated with Social Security Reform Options

One of the issues that has generated considerable controversy in the consideration of Social Security reform for the United States is the issue of the transition costs associated with such reform. At times it is possible to get the impression that any change from doing exactly what we do today has tremendous costs associated with it but staying with it does not. That is not the case since the current benefit structure is underfunded in present value terms to the tune of $3.2 trillion over the next 75 years. In moving to current law from something else, it is only possible to estimate the transition costs of doing so, how to pay them, and the incidence of those costs within the context of specific proposals. There are a number of proposals that have been put forward for reforming our Social Security system that allow us to assess their transition cost implications. Before addressing them, a word on what other countries have done will help to provide context for our situation. Most of the transition financing approaches that have been used in reforming Social Security systems elsewhere in the world have been considered in one or the other of the reform options that has been discussed here in the United States.

In Canada, most of the transition of moving to their increased funding of their national defined benefit plan is being borne through increases in payroll taxes. Most of the burden will fall on current and future workers. Sweden has adopted a combination of benefit adjustments and increased contributions. On the benefit side, they are not only moving toward a system

where benefits depend on each worker's lifetime contributions and age at retirement, they are implementing a special adjustment factor that will keep expected benefits in line with expected contributions over time. If the former exceeds the latter, retirees will simply have their benefits reduced by the ratio of the two. The adjustments are going to be imposed on future retirees on a phased basis with the full effects being implemented for workers born from 1954 onward. In part, the added contribution for the funded individual accounts is to make up for some of the benefit reductions future retirees will incur. Part of the reduction will be covered by the contribution themselves and part by the earnings on these contributions over workers' careers. In other words, they are trying to cover the transition costs on the benefit side with added contributions that workers will make into individual accounts. The United Kingdom is basically phasing out the support provided by its basic pension on a gradual basis by price indexing the initial benefit over time rather than wage indexing it. This reduces the wage replacement capacity of the benefit over time. The cost of the transition will be largely borne by future retirees. To the extent that they will be relying more on a funded pension in the future, they are reducing the redistributive nature of the current system. Other elements of their welfare system may make up for this to a greater extent than ours would. Chile has used surpluses in the general government budget to continue paying residual pensions under the old system while they allow workers to accumulate the wealth to finance their own benefits under the new one. Chile's population age structure is much younger than that of the United States and the relative cost of this approach is reduced accordingly.

In the United States we could attempt to rebalance our system along the lines proposed by Senators Moynihan and Kerrey as discussed earlier. They proposed making the system more dynamically pay-as-you-go than it is now. They have recommended that this be largely accomplished by reducing benefits over time. Alternatively, we could legislate that the payroll tax rate simply increase as the age structure of our society drives up benefit costs. If we do any of these things, the present value of benefit reductions or tax increases will have to sum to $3.2 trillion to restore actuarial balance to the system. Tax increases will be absorbed by workers and the incidence of the cost will depend on the nature of the tax increase. Increased payroll tax rates will be spread broadly. Taxation applied to higher levels of earnings than now covered would concentrate the increased taxes on higher-level earners.

Benefit reductions will be absorbed by retirees and would likely be disproportionately concentrated on future retirees. I reach this conclusion by reading prior history. When we have amended Social Security benefits in the past we have invariably made a bigger adjustment to future retirees' benefits than to those already retired at the time the adjustments were made. I do not want to get into the debate about whether the trust fund holds real assets or not, but I will assert that when the Social Security expenditures start to exceed the tax collections there will be tremendous budgetary pressure on Congress to bring the two back into balance. Expenditures will not exceed tax revenues in OASDI until 2016 according to current projections but that is well within the normal life expectancy of most people retiring under the program this year.

Let's assume for discussion purposes that we defer making any changes to the system until 2020. In that year, expenditures will exceed tax revenues by 12 percent. I believe it is

highly unlikely that we would consider having an across the board reduction in benefits of 12 percent at that time. We are not going to cut the benefits of people in their 70s and 80s by 12 percent, even on a prospective basis. But the mass of people that will be drawing benefits in 2021 and even the majority of people drawing benefits in 2030 may be retired by 2020. If we want to cut benefits enough in 2020 to make up the financing shortfall but largely exempt those already retired, we will have to reduce their benefits by much more than the average underfunding at that point in time. While the tax revenue shortfall in 2020 may only be 8 percent of expected benefits, for people retiring that year, revenues over their retirement life expectancy will fall more than 30 percent short of benefits defined in current law. If we delay dealing with this issue but ultimately decide to deal with it on the benefit side of the equation, the transition costs that future retirees incur will be much greater than the average funding shortfalls themselves suggest.

What would investing the trust funds on a centralized basis do to reduce the transition cost burden that workers and retirees would incur? In the 1994-1996 Advisory Council on Social Security deliberations, Robert Ball proposed an option that was almost identical to the one I discussed earlier. At that time, the Social Security actuaries estimated that the proposed swap in government bonds for equities would reduce the financing deficit by 0.82 percent of payroll.[3] Using this as a back of the envelope estimate of the current effect if we were to implement such a policy, it would reduce the current estimated deficit from 1.86 percent of covered payroll to 1.04.

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[3] *Report of the 1994-1996 Advisory Council on Social Security* (Washington, DC: Social Security Administration, 1997), p. 181.

If we start with an unfunded liability of $3.2 trillion as estimated by the actuaries, the alternative investment strategy would cover about $1.4 of it and would leave a residual $1.8 trillion to be addressed through other tax or benefit mechanisms. If we pursue this policy, however, without creating new savings, the $1.4 trillion that the trust fund gains from the equity investment would be a cost imposed on other investors who would get reduced returns on the new bonds they would be holding. Unless policymakers put on the table how they would cover the remaining $1.8 trillion in unfunded liability over and above the returns on equity investment, the investment swap would actually return much less than the $1.4 billion estimated here. The reason is that Ball's proposal included a variety of other elements that would keep the trust funds from being depleted during the 75-year projection and thus would result in equity investment for the whole valuation period. If we don't do anything else, the system still would run out of money by 2050 and there would be no equity returns beyond that.

What about using general revenues to cover the financing shortfall? This strategy would not change the cost of transition, it would merely distribute it differently than by using more traditional methods that have been used to adjust Social Security in the past. It would also raise some fundamental questions about the program that date back to its inception. Franklin Roosevelt was adamant that his Social Security program not be financed with general revenues. He was convinced that doing so would change the nature of the program to that of means tested welfare--what he characterized as the "dole." The issue of general revenue financing has been raised repeatedly throughout the history of Social Security and has consistently been resisted for two reasons. The first is that payroll tax financing puts a good governor on the program limiting

the appetite of participants and of policymakers for benefits largely paid to middle class members of our society. The second is that if these benefits are thrown into the cauldron of annual budget negotiations on our national priorities, they will ultimately become much less secure than they have been under the current contributory structure.

Why will increases in personal savings help to solve this problem more effectively than any of the other options discussed thus far? There are two reasons, one microeconomic and the other macroeconomic. If a worker regularly contributes to a funded retirement account starting at an early age, say 21 years of age, and continues to contribute to that until reaching retirement, say at age 65, under reasonable assumptions, 60 to 75 percent of the accumulated funds at retirement will be from interest earnings. In an economy where there is little or no growth in labor supply and where the return on assets regularly exceeds general wage growth, a savings based system will generate larger benefits, on average, than a wage-based pay-as-you-go retirement system. The savings that workers do in such a system can be used to grow the capital base of the economy over time and to help improve the productivity of workers. Higher levels of productivity reduce the relative burden of providing for a dependent population. Both the micro and macro effects of funding a share of our Social Security system have the potential to reduce the costs of financing that system.

Doesn't expecting that workers do additional saving add to transition costs rather than reducing them? If we use the current model of financing Social Security benefits primarily on a pay-as-you-go basis, we have to come up with $3.2 trillion in present value terms to get the program back into balance. In the current system almost all of that amount would come out of

either added taxes on workers' wages or reduced benefits for retirees. If we can begin to save some added amount, then the added savings will generate interest returns that will also help to pay off part of the $3.2 trillion. By saving and earning returns on those savings, we can reduce the direct burden on workers or retirees. The more savings we can generate, the more interest returns can help to work us out of the current funding deficit.

Why not do the added saving and pension funding through the centralized defined benefit plan with the trust fund investing some of the new funding in the equity markets? I personally believe that such an investment policy will simply create one more area of political tension in our country that is ill advised. I sat across the 1994-1996 Advisory Council on Social Security table and heard one of the members representing the organized labor community say that investment of these trust funds in equities would be okay as long as they were invested in companies that build American and buy union. Ultimately the senior management of the AFL-CIO came out against such investing. I believe here are also conflict of interest issues that would invariably arise if this policy were pursued. If investing in equities by the trust fund is to be a serious option, then proponents for it in the respective houses of Congress should call for a discussion and vote on the "sense of the Congress" on the matter. If there is no way this is going to be seriously considered then we have to find alternative ways of resolving the Social Security financing issues.

Moving from a pay-as-you financed retirement system to one that is funded will be somewhat akin to changing from renting your home to buying it. During the initial period, at least, there may be some added annual costs with buying the home, but in the long term the owner ends up better off than in renting. As in buying a home, there may be a period where

some form of mortgage will be required to facilitate the transaction. But in the long term, the goal of any reform should be that such a mortgage be fully paid off. When that is accomplished, the ongoing cost of a funded system should be considerably lower than the current one.

President George W. Bush and Social Security Reform

During his presidential campaign, George W. Bush repeatedly indicated that if elected he would form a commission to put together a Social Security reform proposal subject to a set of principles that he stipulated. These included that no current beneficiaries or people close to eligibility status have their benefits cut, that the disability program be left as is, that there be no new taxes, that the system include some form of individual accounts, and that it be voluntary. His statements gave the impression that he favored individual accounts that would receive at least 2 percent of covered payroll. He has now appointed a commission, as he said repeatedly that he would during his campaign, and the members have now set upon their task with a great deal of public and political scrutiny.

Without the Bush Commission specifying any inkling of a plan there already has been a great deal of criticism of this commission and its members. For example, one widely cited analysis of the commission's activities to date concludes that: "diverting revenue from Social Security into individual accounts would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system."[4] No one can possibly know what setting up an

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[4] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Perspectives on the Draft Interim Report of the President's Commission to Strengthen Social Security," (Washington, DC and New York: Center on Budget and Policy Priorities and the Century Foundation, July 23, 2001), p. 9.

individual account program will do to the long-term deficit of Social Security without knowing the details of the plan. If the use of Social Security funds in the creation of an individual account is exactly offset by adjustments to the residual Social Security benefits, then the creation of an account will have absolutely no effect on the projected long-term deficit of the system.

This same analysis concluded that: "Since an individual account system would favor people who live longer and would include a benefit formula that does *not* favor lower earners, it would be regressive on a lifetime basis."[5] Once again, a conclusion has been drawn about a plan that the Bush Commission might devise without one iota of information on what the members will propose in terms of a plan structure that might include more redistribution than the current system. I have personally been centrally involved in the development of a Social Security reform proposal that would be as redistributive as the current system if not more so. The proposal that was originally put forward by Senators John Breaux and Judd Gregg and Representatives Jim Kolbe and Charles Stenholm (BGKS) would provide a poverty benefit to anyone who worked a full career, a more redistributive benefit pledge than in current law.

I fully understand that President Bush has set a table for his commission that increases the likelihood that their ultimate proposal, assuming they come up with one, will not be judged satisfactory by many people concerned about individual account reforms of Social Security. However, before we rush to judgement on the Bush Commission's proposals, it might be better for people who are concerned about this issue to put on the table their own criteria for judging

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[5] Ibid., p. 21.

such a proposal. Then we all have a better chance of the commission devising something that can be the basis for a political dialogue rather than a tool to incite political "cleansing."

Is the task facing the Bush Commission impossible? I do not believe so. Sometimes our perspective on our own potential is inhibited by our closeness to our situation. In my work, I often interact with people from elsewhere in the world who are themselves involved in various aspects of retirement programs in their home countries. One of the amazing things is the perspective that many of such people have on the "miracle" of our 401(k) system. Indeed, national pension reform discussions in both Germany and Japan over the last couple of years have focused on emulating the environment we have created here in the United States to empower people to make provisions for their own funded retirement. Maybe we should look at our own successful retirement model as we attempt to achieve additional Social Security funding

In the spirit of trying to move the discussion on Social Security reform in a more constructive direction, I offer a voluntary variant on a plan that I have worked on previously. Within the context of such a plan, it would be possible to explore the costs to various segments of society, the timing, and how a plan might be adjusted to deal with equity issues that invariably arise in doing something like this. In drafting this proposal I have attempted to create a reform option that would generate some additional savings in the economy but still comply with President Bush's principles that participation in the individual account program be voluntary and include no new taxes. I have also attempted to devise a Social Security reform option that would respond to some of the criticisms of individual account plans. This proposal is far from complete

but might be a framework to change the nature of much of the current discussion that is now underway.

A Partial Outline of a Potentially Popular Approach to Social Security Reform

The major problem with Social Security today is that we are not contributing to it at sufficient rates to allow people in the future to retire in patterns similar to those exhibited by the current population at similar relative benefit levels. There is a strong reluctance on both sides of the political aisle to raise payroll tax rates to make up the shortfall. There is similar reluctance to reduce benefits, including such reductions through further increases in the normal retirement age. No matter how magical compound interest is, by itself, it is not sufficiently powerful to get us out of our current situation. We need a larger share of wages going into the system than today.

Social Security reform is not likely to help resolve the long-term retirement burden in this society if we do not figure out how to increase our national saving as part of the process. I argued earlier that having the centralized trust fund invest in equities will not make our society better off if we simply swap its bond holdings for equities. Exactly the same logic applies to individual accounts. Indeed, most individual account approaches could use up some of the equity returns in higher administrative costs than through central investing. So one criterion that someone concerned about the plan the Bush Commission might stipulate is that the plan should create added saving. Another might be that the revised system retain redistributional characteristics similar to those in the current system. Such a condition might even stipulate that the new system provide some characteristics to address the commission's concerns about short-lived groups in our society through the provision of life-certain annuities or something similar.

John Shoven at Stanford University and I have advocated a Social Security reform option that is an evolutionary derivative of a plan that Carolyn Weaver and I developed when we were on the 1994-1996 Advisory Council on Social Security. Our proposal results in a much larger individual account component than would result under most reform options.[6] We propose that workers and their employers be required to put a combined 2.5 percent of covered pay into a Personal Security Account (PSA) and that their contributions would be matched dollar for dollar from Social Security. We have proposed that the remaining Social Security system be gradually transitioned to pay a flat benefit, i.e., equivalent benefits to everyone with at least 35 years of covered earnings at retirement. The flat benefit from the remaining defined benefit system would be a floor of protection provided to all workers in society. The variable benefit that would be paid out of the PSA would reward workers based on their lifetime earnings.

If we reform Social Security along lines that begin to give people some true ownership of part of their contributions in the form of individual accounts, the residual Social Security system has to be modified. The residual system could take on a variety of forms and it makes little difference whether it takes the form that John Shoven and I have proposed, the form that Carolyn Weaver and I devised earlier, the form that Senators Breaux and Gregg and Representatives Kolbe and Stenholm have put forward, or some alternative pattern. As a practical matter, I believe the current Social Security provides insurance for four hazards that workers face. It provides insurance for workers:

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[6] See Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven: Yale University Press, 1999), Chapter 23.

1. Who die and leave juvenile dependents;
2. Who become disabled and can no longer earn a living;
3. Who experience bad labor market outcomes; and
4. Who suffer from the myopia that workers have about making adequate protection for their own retirement needs.

In addition to these sorts of hazards that workers face, Social Security provides longevity insurance and inflation insurance during retirement.

We can consider the survivor and disability insurance programs to be term-insurance programs that should not provide an overly burdensome obligation on society to operate on a pay-as-you-go basis. There are certain public good features to them and there are likely relative efficiencies that might be realized by running them through government, although I believe that some consideration might be given to reforming the administration of the disability program under any circumstances. The potential reform of the administration of the disability programs is an issue that should be considered outside the realm of reform to the retirement plan or basic benefit structure of Disability Insurance or any other facet of Social Security. Insurance against bad labor market outcomes suggests the need for some continued redistribution in the new program and that is why I have advocated the maintenance of some residual redistributive retirement system.

I believe that the fourth sort of worker insurance provided by Social Security is distinctly different than the first three. For the overwhelming majority of workers, the prospect of reaching an advanced age is a near certainty and retirement patterns developed during the twentieth

century suggest most people will end up with a period at the end of their lives when they no longer earn a direct wage. To the extent there is a public interest that elderly people maintain some minimum standard of living, it is reasonable to force people to "save" some portion of their earnings to provide for their needs when they no longer work. If we do not require that workers save, they may fail to do so on their own and become wards of the state. Given the relative certainty that most workers will get old and most will quit working before death, I believe this form of insurance should be funded given future economic and demographic prospects in our society. The extent to which we want to require indexed annuitization of accumulations in the "saving" component of the retirement system depends on one's perspectives about the role of government, the public interest in elderly folk's consumption patterns, and the like.

I believe that there are reasons why a mandatory system of this sort is preferred and I also believe that the system would be more robust if we required added contributions at least for some period of time. However, I understand there may be reasons that we lack the political will to mandate such added contributions at this time. That said, it seems to me the proposal that John Shoven and I have retooled from the one that Carolyn Weaver and I originally crafted has significant potential to generate added retirement contributions even if implemented on a voluntary basis that could substantially ameliorate the Social Security financing problem. The difference between what we originally proposed and a voluntary system would simply be that workers would decide whether or not they wanted to participate rather than being forced into the new system with its added contribution obligations.

Assume for the moment that the Personal Security Account system that John Shoven and I have proposed (PSA 2000) called for contributions on a voluntary basis. Basically, it would allow workers to make a voluntary contribution of up to 2.5 percent of their pay to their PSA. For each dollar that the worker contributed to the account, Social Security would match it dollar for dollar. This would essentially replicate the way many employers sponsor and structure their 401(k) plans.

We know how people behave under 401(k) plans and might expect that they would behave somewhat similarly under this version of a PSA plan. For example, Table 1 shows the participation rates in a sample of 401(k) plans in 1995. We excluded workers who were earning less than $5,000 per year and who had not been with their employer for at least a year when we derived the table. In addition, we excluded workers who were not yet 20 years of age. We excluded low-wage workers because most workers with very low earnings in a firm sponsoring a 401(k) will only be temporary or low-level part-time workers. These are not the targets of most 401(k) plans but would be included in a national PSA-type plan. We excluded workers with less than one year of service because many plans do not cover workers until they have been employed for a year. This happens primarily because most employers experience relatively high turnover during workers' first year of employment and because covering such workers add considerably to administrative expenses. Such workers presumably would not be excluded from a national PSA plan. We excluded workers not yet 20 years of age in our 401(k) analysis because most of them have not yet begun their career nor would they be expected to contribute to a voluntary retirement saving plan until they do.

The table shows relatively high participation in these 401(k) plans across the age and earnings dimensions presented. It is clear, though, that older workers participate at higher rates than younger ones and that lower-wage workers participate at lower rates than their higher-wage counterparts. Overall, however, nearly 80 percent of all workers included here participated in their plans on a totally voluntary basis.

Table 1

Participation Rates for Workers Eligible for 401(k) Plans by Age and Wage Levels in 1995

Age group	Wage levels of 401(k) participants stated in thousands of dollars (participation rates are stated in percents)								
	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.00 +	Total
20-29	43.5	61.7	71.4	79.5	86.3	91.3	91.0	91.1	66.2
30-39	59.3	71.5	76.6	81.2	87.7	91.3	93.6	89.0	78.6
40-49	63.7	76.0	78.8	81.8	86.1	90.3	92.0	89.2	81.1
50-59	73.8	81.5	82.4	85.0	87.8	92.9	95.1	92.3	84.7
60-65	75.9	82.0	80.9	84.9	90.5	96.6	93.1	92.4	84.4
Total	59.6	72.1	77.1	81.8	87.2	91.4	93.2	90.2	78.6

Source: Sample of 87 plans collected by Watson Wyatt Worldwide.

The results in Table 1 may be perceived as not representing the potential of 401(k) plans because of the restrictions we put on the workers considered or because of the restricted number of plans that we considered. Table 2 considers the participation in 401(k) plans during 1993 by a representative sample of the U.S. population based on the *Current Population Survey* done by the Census Bureau for the Department of Labor. The table considers the participation rates in 401(k)

plans by workers who were offered such plans. It shows the participation rates by earnings decile grouping, where a decile is one tenth of the total population group, where the definition of each group is based on the workers' earnings levels. In this case, workers' participation rates are somewhat lower than in Table 1, but they are still quite impressive. Part of the reason that they might be lower is that some workers may not have responded appropriately to the questions of whether their employers offered 401(k) plans and whether they participated in them.

Table 2: Participation in 401(k) Plans in 1993

Earnings decile	Participation rate (percent)
First	35.7
Second	49.8
Third	59.0
Fourth	62.5
Fifth	62.9
Sixth	69.0
Seventh	75.7
Eighth	77.6
Ninth	80.8
Tenth	83.7
All	70.8

Source: James M. Poterba, Steven F. Venti, and David A. Wise, "Informing Retirement-Security Reform, 401(k) Plans and Future Patterns of Retirement Saving," *The American Economic Review* (May 1998), vol. 88, no. 2, p. 181.

There are two important reasons that many workers participate in 401(k) plans. The first is that they get the advantage of the income-tax preference accorded their 401(k) accumulation. The second is that many of them work for employers who match their own personal contributions to their retirement savings. We presume that the tax preference that accorded workers

participating in 401(k), 403(b), or section 457 plans would also be accorded to participants in voluntary PSAs and, thus, would encourage workers to set up such accounts. In addition, we have the Social Security matching contribution that should further enhance participation in the system.

Our analysis of participation in plans using administrative records suggests where plan sponsors provide a 100 percent match of employee contributions, 90 to 95 percent of workers earning more than $35,000 per year participate in their 401(k) plan. Slightly more than three-fourths of those earning between $25,000 and $35,000 do so. There is some decline in the participation rates at the very highest earnings levels, but this is typically due to restrictions that plan sponsors put on their most highly-compensated workers limiting their participation in 401(k) plans. These limitations are often imposed to facilitate the passage of discrimination tests required by the tax code and to assure that other workers classified as highly compensated but at somewhat lower earnings levels can participate in the plans. Those at the top end of the earnings distribution who have their participation limited in the tax qualified 401(k) plans, typically have alternative non-qualified benefits that they receive in lieu of 401(k) opportunities to save.

Where the participation rates fall off in a way that should be of concern in considering a voluntary PSA proposal is at lower earnings levels, especially among younger workers. We must also note that there is a positive correlation between age and earnings meaning that workers at younger ages disproportionately represent those with lower earnings levels. Getting workers with relatively low earnings to participate at nearly universal levels in voluntary retirement savings plans, especially very young ones, clearly takes more than just a direct match of their

contributions. Many of the young workers with low wages who forego voluntary retirement savings early in their careers will undoubtedly take it up later as they age and their earnings rise. But missing out on saving early in a worker's career can exact a particularly high price in the long term because of the effectiveness of interest compounding over time. Some workers with low wages throughout their careers may never be able to save voluntarily because of current consumption demands throughout their working lives.

Once workers are motivated to participate in 401(k) plans, their contribution rates are significant as shown in Table 3. Even workers at the lowest earnings levels and at the youngest ages tend to contribute at rates significantly above the 2.5 percent level that would be allowed in the national voluntary PSA plan. This suggests that if a 100 percent match on contributions was proffered, those who entered on their own would likely take advantage of the whole match offered to them. The researchers who developed the data in Table 2 cited above, found that in 1993, contributions by families participating in 401(k) plans averaged 8.7 percent of salary, with employee contributions accounting for roughly two-thirds of the total and employer matching making up the rest. They also found little variation in contribution rates across the earnings spectrum.[7] These independent research efforts both lead to the conclusion that a voluntary savings program that allowed workers to contribute up to 2.5 percent of pay to an individual account where Social Security matched it on a dollar-for-dollar basis would entice the overwhelming majority of workers to participate in the plan.

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[7] James M. Poterba, Steven F. Venti, and David A. Wise, "Informing Retirement-Security Reform, 401(k) Plans and Future Patterns of Retirement Saving," *The American Economic Review* (May 1998), vol. 88, no. 2, p. 181.

Table 3

Employee Contribution Rates as a Percent of Wages for Workers Participating in 401(k) Plans by Age and Wage Levels in 1995

Wage levels for 401(k) participants stated in thousands of dollars
(contribution rates are stated as a percent of pay)

Age group	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.00 +	Total
					Employee contribution rates				
20-29	4.4	4.4	4.9	6.1	6.8	7.5	5.6	4.2	5.0
30-39	6.4	6.4	6.1	6.5	7.2	7.5	7.2	5.5	6.6
40-49	7.5	7.3	6.6	6.8	7.3	7.6	7.4	5.9	7.0
50-59	8.2	9.1	8.1	8.1	8.3	8.4	7.6	6.0	8.2
60-65	9.3	10.4	8.9	9.2	9.4	8.8	7.9	5.6	9.2
Total	6.9	6.9	6.4	6.9	7.5	7.8	7.4	5.8	6.9

Source: Sample of 87 plans collected by Watson Wyatt Worldwide.

One way to address the natural tendency of workers at low earnings levels to forego participation in voluntary retirement savings plans is to provide them with a tax credit to help them participate in a national voluntary PSA plan of the type outlined here. For example, you might want to give a full credit for any worker whose annual covered earnings were less than or equal to full-time employment at the national minimum wage. You could phase the credit out on a sliding scale up to an annual earnings level at twice that amount. The tax credit clearly makes the plan redistributional toward lower-wage workers. This would give you virtually universal participation by workers up to $20,000 per year. If you estimate that 90 percent of the workers above that would buy in on their own, you would end up with 96 percent of all workers participating on a voluntary basis. It would all be voluntary but would potentially be bringing a great deal of new saving into the system.

One reason that I believe this model might work is because of the widespread popularity of 401(k) plans. In fact one of the major criticisms of this element of our retirement system is that it is not universally available to all workers. A proposal such as the one briefly outlined here would resolve that problem and give all workers an opportunity to participate in such a plan. With the careful restructuring of the system, we could maintain its redistributional nature, and concentrate financial market risks in the middle and upper income ranks of the population where they can be most appropriately managed. I believe that many people will be much more inclined to put more money into this vital leg of our retirement system under this approach than under any other alternative that we can devine at this juncture.

Chairman CONRAD. Thank you, Dr. Schieber.

Let me give each of you a chance to respond to something that you have heard from one of the other witnesses. Why do we not start that way? Mr. Greenstein, if there is some point that you were not able to make, or you want to respond to something else you heard from another witness, Dr. Orszag, Dr. Schieber, give each of you a chance for an additional observation here.

Dr. GREENSTEIN.

Mr. GREENSTEIN. I guess I would just respond to Mr. Schieber's comments about some general revenue financing for Social Security, as though this is something that is unheard of, and were we to go in that direction, would inevitably or potentially lead to the means testing of benefits and radical changes in the structure of the program. In fact, we already have some general revenue financing for Social Security. We do that by taxing a portion of Social Security benefits for higher earners. We collect that as income tax revenue, and we then deposit it in the Social Security Trust Fund. Some of it goes in the Medicare HI Trust Fund, some of it goes in Social Security. That is a piece of general revenue financing we already have.

Medicare Part B, of course, has 75 percent general revenue financing, and that is not a means-tested program.

But let me make two more important points here on this issue. No. 1: the reason Social Security is a pay-as-you-go system is that when it started, policymakers had a decision to make, what do you do with the people who were elderly then; they were already old; they had not paid payroll taxes, or they retired in a few years and they had only paid payroll taxes for a few years? Policy makers of that era, in the late 1930's, 1940's, made the decision that those people would get Social Security benefits. There was no past payroll tax that those people had paid that funded their benefits. That made it a pay-as-you-go system.

One of the wisest budget experts I know, Bob Reischauer, and Henry Aaron as well, another one of the best experts, in their book on Social Security, make the point that it is a very legitimate use of general revenue to help pay off the part of the unfunded Social Security liability that was created by the decision made when the system began to fund benefits, which was really a general revenue responsibility, to fund benefits for the people who were old at that point, and obviously had not paid in payroll tax themselves. And one can do that and deal with that liability and make a fixed amount of payment till you get to the point that you have dealt with that liability and then not continue to do it.

The final point that I would make is Mr. Schieber said we are going to have to cut benefits or increase contribution rates. I agree. I think all three of us agree. But I think it is inconceivable that Congress, at any point, under any party, will do that enough to restore long-term solvency. And therefore, I think the only way to be able to look at things like cutting benefits and increasing contribution rates is if they are part of a larger package that gets you all the way there because it marries those tough changes with a general revenue contribution, which we would have more room for if we did not eliminate the tax cut—I am not suggesting that at all—or take away anybody's tax cut in full, but just give some people, particularly at higher income levels, a somewhat lesser tax cut than they otherwise would get, to help us free up some general revenue, that in combination with some tough measures, could get the job done.

Chairman CONRAD. Dr. Orszag.

Mr. ORSZAG. Yes, just three quick points.

First, in response to Dr. Schieber, the logic of Mr. Greenstein's chart and the comparisons, applies to add-on individual accounts

just as much as general revenue transfers directly into the Social Security Trust Fund. So in other words, lack of non-Social Security revenue is a constraint on individual account plans as much as non-individual account plans, and if the commission had the revenue available to finance add-on individual accounts, in my opinion, they would have a politically easier job than what they now have. So I want to make sure we keep this issue distinct from individual accounts versus non-individual accounts and what you can do through the trust fund or not do through the trust fund. The key question is: do we have the resources to pay the transition costs, or to pay for individual accounts or general revenue transfers to the trust fund, regardless of what you are doing within that, and the answer, unfortunately, is, given the tax cut, no.

Second, on some of the quotations from the document that I coauthored with Henry Aaron, Alan Blinder and Alicia Munnell, I would just point out that those were selective quotations, and that in the following sentence we said things like, "if no other changes were made to the system." The statements are about harming long-term solvency in Social Security by diverting revenue out into individual accounts, really speaks only to if you do nothing else to the program while you are diverting revenue out.

On progressivity and individual accounts, it is true that there have been plans, especially the most recent Kolbe-Stenholm plan, that pay a lot of attention to how individual accounts treat lower earners, and arguably may do a lot to help lower earners. But I want to emphasize is an individual account plan does not naturally lead to that. You really have to go out of your way to make sure it works that way. And what I think the real lesson of the Kolbe-Stenholm plan is, given the political reaction to it, if you do not have additional revenue to try to solve part of the Social Security problem, the choices that you have to make, especially to make the accounts progressive, are so painful that it does not work. So in a sense, actually, I think the Kolbe-Stenholm plan illustrates the point that both Mr. Greenstein and I are making. Without additional revenue to help solve part of the problem, the choices involved are just politically not viable.

Chairman CONRAD. Dr. Schieber.

Mr. SCHIEBER. Well, I would like to take exception with what was just described here as the reason we have a pay-as-you-go plan. It is just wrong. FDR was adamant that we have a funded Social Security system. He went to his grave feeling very strongly that we have a funded Social Security system because he was very concerned about the unfunded liabilities that would arise in a pay-as-you-go system. His Secretary of Labor, Frances Perkins, said that he described building such a system as immoral. The reason we ended up with a pay-as-you-go system is because there was an argument broke out right after the law passed over whether or not the accumulation of a trust fund was really funding.

Now, we have seen that argument explode again here in the last couple of weeks. Arthur Vandenberg and the Senate Finance Committee and Arthur Altmeyer, the Chairman of the Social Security Board during the early days of the system, argued about this year in and year out for the first decade of the program. The debate goes

on, and it does not make any difference whether you are a commission member or not.

I would like to read you something here from an exchange between the Social Security Commissioner and a senator on the Senate Finance Committee in 1998, that is, Senator Bob Kerrey.

The Commissioner said: "We had to save these surpluses so we could secure these benefits in the future."

Senator KERREY SAID. "We are not prefunding. Are we holding the money in reserve someplace? We are not prefunding. The idea in 1983 was that we would prefund the baby boomers. We began to use it immediately for the expenditure of general government. We did not prefund anything. What we are doing is asking people who get paid by the hour to shoulder a disproportionate share of deficit reduction. That is what we are doing. And the beneficiaries, on the other hand, they suffer from the illusion inflicted by us very often that they have a little savings account back here. They are just getting back what they paid in. They don't understand that it is just a transfer from people that are being taxed at 12.4 percent."

Now, we did not need to operate this on a pay-as-you-go basis because we wanted to pay people full benefits at the beginning of the program. When the program started, we started collecting taxes in 1937 on 60 percent of the U.S. work force. In 1940, when we started paying benefits, we paid benefits to people who were 65 years of age, who had paid into the system for 3 years. All of the people who had already retired never got Social Security benefits. In fact, we did not reach the portion of the population actually getting benefits, the portion of the population over age 65 getting benefits, to equal the portion of the work force paying taxes until the mid 1970's, because it took a very long time for that front edge group of people to die off. When we started this program, we could have paid people full lifetime benefits, the small group that we paid them, on the basis of this very large group of people that were paying taxes. The reason we went to a pay-as-you-go system was because this argument broke out, Vandenberg and Altmeyer on the one hand, over whether or not this was really funding, and there was concern about what the government would do with these funds if they grew to be very large, and then also because we wanted to keep the payroll tax rates low during the early years. And there was repeated—there were repeated bills went through this Congress, year after year, during the 1940's, that kept the original scheduled payroll taxes that Franklin Delano Roosevelt insisted upon, from coming to pass, because Congress did not want to impose on people the true charge for the program they were sponsoring. This has got nothing to do with trying to pay people full benefits at the beginning.

Now, many of the issues that this Congress has dealt with over the years are still at the heart of this debate. This argument over whether these trust funds are trust funds has been going on for almost 70 years now. At some juncture, I would think we would give up, and we would go try to find another way, and that is actually why I have advocated we ought to have individual accounts, because I think we could use an individual account mechanism, and it would not be a totally free account mechanism, that would allow us to do some real funding. I think we are going to sit here and

we are going to argue until we are all in the grave, about whether or not these surpluses are real and whether we can really save them for Social Security, and we are never going to resolve this. All we are going to do is argue. So we ought to try and find a mechanism where maybe we can actually put some money away somewhere and save it over time.

Chairman CONRAD. Thank you.

Senator Gramm.

Senator GRAMM. Mr. Chairman, let me thank you. I think, since I did not get an opening statement, I just would like to make a few points.

First of all, I do not understand why our witnesses, in fact, our members of the Budget Committee that are so concerned about the tax cut being too big and endangering Social Security, why they are silent about the fact that on the floor of the U.S. Senate right now we have an ag bill that spends $7.5 billion, when we wrote a budget calling for one that spent $5.5 billion. I hear great outcries. I see hurt feelings when we are talking about giving money back to working people, but when we are spending it in Washington, the silence is deafening, and the hypocrisy is clear everywhere.

Second, if there is anybody from the press here, and they missed it, basically, what the Democrats are saying here, and I have a mock-up of this check, what they are saying here is they would like to pare this check that you are getting in half, and they wanted to keep the other half. So I do not want anybody to be confused. Democrats, at least that are presented here, did not want you to get your tax cut, and I am not the least bit shy about people knowing it. I want them to know it.

Now, it seems to me we are down to two questions about Social Security, and they are no-brainers in my opinion. One, do you want to raise taxes and slash benefits or, two, do you want to take the surpluses that we are accumulating today and invest them in real assets that will accumulate earnings, and those earnings can then be used to pay benefits in the future? That is a no-brainer.

Like, I assume, all three people here, I have TIAA CREF, college teacher retirement. By miracle, I have five times as much money in TIAA CREF right now than I ever put in. How did that happen? It happened because of what Einstein called the most powerful force in the universe, the power of compound interest. We get no interest on the so-called Social Security Trust Fund because there is no Social Security Trust Fund. It is a fraud, and everybody knows it.

The second question is, do you want Government to own these investments and do you want Government to make the investment or do you want them in the names of the workers, where they own them, and they are part of their Social Security benefit? That, again, is an absolute no-brainer.

Now, I asked myself how is it possible that very intelligent people go around on this subject and make absolutely ridiculous, absurd statements? How is it possible? And I conclude there are only two reasons:

One, they really want to spend this money on Government, and therefore they do not want to invest it. But, you know, I think that is only partly the reason. I believe that perfectly intelligent people

argue that it is better to have meaningless IOUs than to have real wealth because they fear the impact of real wealth politically. They fear that if seniors have real wealth, they are going to want investment advisers; whereas, when they got Government IOUs, they want politicians, and that you are going to change political behavior and that it is going to affect the country politically.

I just have to conclude, and this is a harsh judgment, but I have got to conclude one of two things: One, either people believe unbelievable, ridiculous things or they are fearful that a rational system of basing retirement on wealth is going to have a political impact that they fear in the country.

You asked, Dr. Schieber, how is it we continue this debate, we continue this debate? We are not having a debate. Nobody really, that has the least bit of knowledge of economics, can possibly believe that we ought to be taking these surpluses we are running this year—$173 billion, Social Security surplus—and instead of running that money in real wealth that can earn a real interest and that principal and interest can be spent in the future, that we ought to be using money from Social Security to "pay down" the general debt of the Federal Government. That is pilfering Social Security.

Let me also say that everybody knows that when the estimates from CBO and OMB come out in August, that we are going to be spending not only—we are certainly going to be spending by those estimates the Medicare surplus, which I do not worry about because we do not have a Medicare Trust Fund. We have got a surplus in one part, in part, because we changed the definition of what was in Part A and Part B; and, second, we are putting more general revenue in it than we have got an accumulation in Part B.

But with Social Security surplus, I am concerned about spending it because I hope someday we will invest it on behalf of the working people of this country. But yet, with all of this talk about this lockbox business, and I see I have got 1 minute, let me just use it on lockbox. What a fraud. What a fraud. There is no lockbox. This is a "crockbox." [Laughter.]

Senator GRAMM. This idea that we are locking this money away—what a fraud. President Clinton said of this so-called Social Security surplus in his budget, "These balances are available to finance future benefit payments and other trust fund expenditures, but only in a bookkeeping sense. These funds are not set up to be pension funds, like funds from private pensions. They do not consist of real economic assets."

Basically, what we are doing is perpetuating a fraud, and I do not understand why. I can understand people not understanding it doing it, but I do not understand how intelligent people can do it, unless they have another goal. There are only two that strike me: they want to spend the money or, two, they fear the political consequences of having seniors that are secure in their retirement.

I am glad that what I want to do helps seniors, and it helps America at the same time.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

We turn now to Senator Stabenow for her questions.

Senator STABENOW. Thank you, Mr. Chairman.

First, let me thank you for holding this hearing on an incredibly important topic. And if I might say to my good friend from Texas, I could not disagree more with what he just said, in terms of what is reasonable and how we should proceed in terms of a thoughtful discussion about people's money, in terms of Social Security.

Let me start by saying that I think there is an important piece that we miss when we talk about this subject. Social Security is not just retirement, otherwise we would call it a retirement system. Social Security is a disability policy. Any worker on the job today who becomes permanently disabled, has minor children, it is a disability policy. It is a life insurance policy. If someone loses their life, it is a life insurance policy, as well as retirement.

And from everything that I have seen when we analyze the costs of private citizens for disability policies, retirement policies, life insurance policies, the low cost of administration of Social Security and the fact that it is invested in a no-risk form of investment, it is a good deal. I would consider Social Security a great American success story.

The challenge for us is that we are living longer, which is the good news—we are living longer—but the challenges of living longer relate to the costs of Medicare and Social Security as we live longer, and as there are more people in retirement, and fewer people working. So we have some important challenges.

I would, to my friend from Texas, who is no longer with us, I would just challenge him, first of all, to say we all want people to save. We all understand that. I tell my children that who are now 21 and 25. The miracles of compound interest, if they just put a few dollars a year aside. I wish someone had convinced me of that when I was 21. That is not what this is about. This is about how best to make sure that Social Security and the benefits of that are available to our citizens in a changing world, in a changing economy.

And we all know that when we look at vested interest, there are those now who make their living out of investing other people's money who want to be able to invest Social Security dollars. I understand that. It is good business for them to be able to do that, to be able to earn dollars from being able to invest in other people's money. I think that is certainly a part of the debate, in terms of who supports what.

I would suggest that when we look at the situation and whether or not it is reasonable or foolish to question private investments, I guess the first thing that I would ask our witnesses is, when we look in a reasonable sense of what is best for all of us, as Americans, and how to proceed, and if you believe that Social Security makes sense, how to strengthen that for the future and make sure that those investments are available, the Nasdaq has dropped 60 percent in value in the last 18 months. We certainly want things to improve, things are beginning to improve again. But when Congress considers setting up private accounts for Social Security, what lessons should we learn from this drop and how should we fold that into the discussion?

Mr. Greenstein.

Mr. GREENSTEIN. I think one of the key lessons is the mistake of replacing part of the guaranteed or defined Social Security ben-

efit with individual accounts invested in the stock market. If, for example, you have two workers, and they each were average wage earners, they each invested the same portion of their earnings each year of their career in an index fund that mirrored the S&P 500, they each retired at the same age, and they each annuitized their account upon retiring, but the difference was that one was 1 year older than the other and one retired in March 2000, converted the account to an annuity, and one retired in March 2001. The one who retired in March 2001 would have a monthly payment one-third lower to live on every month for the rest of his or her life.

In fact, if we began to convert Social Security to accounts that had that kind of an effect, I think you would have generations that retired when the stock market was done rushing Congress in ways that the made the notch babies pale by comparison, demanding that Congress fill in the gaps.

I think the lesson is to go back to our concept that people have often talked about of the three-legged stool of savings, and pensions, and Social Security. We do have a serious problem that too few workers have private pensions. We do need to fill those gaps. And the idea to look at expanding individual accounts, for example, on top of Social Security, in the context of pension reform, I think makes a lot of sense.

Given that we probably are going to need some benefit modification on Social Security, that can also help ease the changes in Social Security. But the notion of replacing part of the Social Security benefit with a stream of income that is dependent on the fluctuations in the stock market does not make a lot of sense to me.

Senator STABENOW. So what you are really referring to is what we have called Social Security Plus; in other words, Social Security as a base and then encouraging people and creating other options for people to save, pensions, investments, and so on.

Mr. GREENSTEIN. In my view, a far wiser use of some of the revenue that was foregone in the tax cut that was just enacted would have been to create a system of refundable tax credits that enable people who do not have the benefit of private pensions or who do not have adequate private pensions to build those individual accounts as a supplement to Social Security. That would have made a lot more sense than some of the provisions that are in the tax cut that passed.

Senator STABENOW. Mr. Orszag, I wanted to ask you to expand on something additionally when you were speaking about the analysis that you, and Henry Aaron, and others did that related to how much benefits would have to be cut if there was a 2-percent set-aside of the payroll tax diverted into private accounts. And you indicated that if 2 percent of the payroll taxes were diverted into private accounts and benefits were fully maintained for those 55 and older, that there would be anywhere, for people under age 30, anywhere from 20-percent to 54-percent cuts.

I wonder if you might expand upon that for the committee.

Mr. ORSZAG. Sure. Thank you for giving me an opportunity to do that.

President Bush has stated that he would like to protect benefits for current retirees, near retirees, the disabled and survivors. One way of thinking about the implications of diverting payroll revenue

into individual accounts, given those promises, is the following: Over the next 75 years, benefit payments are projected to amount to 15.4 percent of taxable payroll. And when you subtract off the revenue, that is when you get the 1.86 percent of taxable payroll deficit that is commonly cited.

The benefits protected for current retirees, near retirees amount to 6 percent of payroll. So the unprotected benefits, the ones that could be cut to balance the system, amount to about 9.5 percent of payroll. We have got a 2-percent hole already. You divert another 2 percent out, you have got 4 percent. Four percent over 9.4 percent is about a 40-percent reduction, and that is the basic logic. You cannot get around with that without any additional revenue.

To do that, just 40 percent for everyone, would impose unbelievable reductions for those who are 54 years old today. They have been planning their retirement, and all of a sudden you are telling them that their Social Security benefits are cut by 40 percent. So most plans would phase in the traditional benefit reductions to reflect the time that workers have to buildup their individual accounts. If you do that, younger workers, for example, people who are 30 years old today, would have benefit cuts that are much larger than 40 percent, say, under one plausible approach, it is 54 percent.

They would, however, also have income from their individual accounts. And the income from their individual accounts, under somewhat favorable assumptions for the individual accounts, would amount to about 30 percent of their current benefits. So it is basically rounding minus 50 percent on the traditional benefit, and then you have the opportunity to earn back 30 percent. And, on average, you would be expected to wind up about minus 20 percent.

The fundamental logic of my testimony is I do not think that is going to be politically viable to say we are going to cut your benefits in half, give you the opportunity to make 30 percent back, you know, depending on how the stock market does.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman. I am very appreciative and hope you will continue to focus on this issue. It is so important to everyone in our country, regardless of their age.

Chairman CONRAD. Let me just take a moment, if I can, to respond to a couple of the things that the Senator from Texas said, and I will come back the you.

The Senator from Texas indicated that the farm bill on the floor breaks the budget. That is just a false statement. The budget provides $5.5 billion this year, it provides $7.3 billion next year. The bill that is on the floor uses the $5.5 billion that is available this year and uses $1.9 billion of the $7.3 billion that is available next year. It is entirely within the budget. I would challenge the Senator, if he really believes it breaks the budget, to go and bring a budget point of order against this bill. The truth is there is no budget point of order against this bill because it does not break the budget.

The second point the Senator made was that we, on our side, opposed the tax cut this year, that we were in favor of cutting it in half. That is just a false statement. The fact is the budget resolution that I put before our colleagues had a bigger tax cut this year

than what the administration advocated or what passed. In the budget resolution I put before our colleagues, we had $60 billion of tax cut this year to give lift to the economy. The administration proposed a tax cut with less than $5 billion of tax relief this year. What passed, provided $40 billion of tax cut this year.

So, you know, it is good to feel strongly about your views, but I do not think you have got a right to your own facts. The facts are stubborn things.

The final point is on Social Security. The Senator is for private accounts. I do not rule them out, but where is the money going to come from? He voted for a budget plan that took the money that could have been available and used it to fund the tax cut. And part of the problem that I have with what is going on here is that, to me, constitutes double counting. You cannot use this money twice or, in some cases, three times. It does not work.

Dr. Schieber, you wanted to——

Mr. SCHIEBER. The complicated thing about this is keeping your eye on the ball, and I would like to talk about two things that we just heard here. One is about the 50-percent loss in benefits that people are going to incur if you divert 2 percent of the payroll tax into individual accounts.

Dr. Orszag said that that would be the price you would pay in terms of benefits and then that the individual accounts would replace about 30 percent. So you come up a net loser of 20 percent. Well, the net loss of 20 percent is because we are starting out in a 2-percent hole.

We either have to figure out how to find funding for these benefits or else benefits are going to be cut, by his estimate, about 20 percent. My estimate is that it is going to be more than that the longer we delay because I think it is highly unlikely that if we go 10 years and then decide we have to cut the benefits, that we are not going to cut benefits 20 percent across-the-board. We are not going to cut benefits for widows who are 70 or 80 years old by 20 percent. We are going to have to phase in much more rapidly benefit cuts on people about to retire.

Now, I would like to also talk about the——

Chairman CONRAD. Let me stop you there if I can because we have now got four members here who have not had a shot at their questions, and we have been incredibly generous, I think anybody will say, we have been incredibly generous to the witnesses.

Let me suggest that in your answer, that you bring up the other point, if we could, and go to Senator Corzine for his questions.

Senator Corzine.

Senator CORZINE. I really do appreciate having this hearing, and I think we need many of them, because the interaction of budget and tax policy, with how we restructure Social Security, is one of the most vital issues. It also ties together with our national savings rate, which I think is one of the more important issues to make sure our economy stays on the right course over the long period of time, and then there is truth in actions.

And I want to start with one of those because I asked Chairman Greenspan last week, and this is one of the things that I felt compelled to ask because of the statement of Senator Gramm, but we are having this debate about whether trust funds are assets or ac-

counting gimmicks or devices. I worked very hard to try to get an answer out of Chairman Greenspan. He gave me a long discussion about the savings rate.

But then I came back and asked whether the assets that are in the trust fund are really that, are they something that produces available resources in the future, regardless of whether they have an assigned rate or whether they have market rates. And I think his answer was to the crucial question, are they ultimate claims on real resources, and the answer is yes.

I would like to know whether you all believe that the generated surpluses of revenues from the payroll tax that go into the Social Security Trust Fund, which is really the essence of what a lockbox is about, we just happen to be investing them in Government IOUs, I think, which are Government bonds or assets, because it gets at whether we can do other things with the trust fund over a long period of time. That would be enough just to get that straightened out and make sure that people are all talking on the same definitions.

The second is there seems to be this asymmetric concern. We can use Social Security funds for supporting general expenditures out of our budget over a period of time, whether it is the interest savings that comes because we have paid down the debt or whether it was at another time when we invaded it, and that somehow is OK, but we cannot then, in turn, look to shore up Social Security from general revenues.

And I do not understand that asymmetrical argument, and I would like to hear, certainly, I know Dr. Schieber is probably chomping at the bit to get at that, but I do not understand why we have an asymmetrical view. And even if Franklin Delano Roosevelt said that was the way it should be formed, it is now 60/70 years later, and we have a different set of issues that we need to deal with, and we ought to deal with them realistically.

And, finally, I was going to be cute and tear up a piece of paper because, instead of that tax cut which got cut in half, we are talking about cutting benefits or raising taxes in a very serious way if we do not deal with this issue appropriately, and part of that is making sure we have the general revenues that actually can address this issue.

Mr. GREENSTEIN. Well, probably all three of us have something we would like to say on this front.

Let me say I completely agree with your point about the asymmetry. I also happen to disagree with Dr. Schieber's accounting of the history, but I do not think we have the time to go into a discussion of what happened in the 1930's.

On your point on whether the trust fund has real assets, I do not see how there can be any question here. There is a certain amount of obfuscation going on. The draft general report of the Social Security Commission had a box of quotes from GAO, CBO, and so forth, which purported to show that they agreed the trust fund had no real assets. None of the quotes said that. In fact, if you read the GAO quote closely, it said the trust fund does have real assets.

Here is the issue: The trust fund has real assets. They are Treasury bonds. There is no plausible explanation for why if GM has a Treasury bond or a foreign investor has a Treasury bond or a Wall

Street trader has a Treasury bond, that is a real asset that is the safest asset you can have, but if Social Security has a Treasury bond, it is a worthless IOU. That is indefensible argument.

The argument that is really being made is that the trust fund's bonds, which are a real asset to the trust fund, are a liability to the rest of the Government. So, for the Government as a whole, they are not an asset, and no one disagrees with that, but for the trust fund, they are an asset, and of course they will be honored, which takes one to the larger question of how we afford everything down the road. And your point about building national saving is important, and it might be noted that if we had had a smaller tax cut and we had saved more of that money, we would be building national saving.

Mr. ORSZAG. I agree with what Bob just said.

Just to followup, since Senator Gramm had quoted from the Clinton administration's fiscal year 2000 budget. And as a former Clinton administration official, I feel like I want to correct the record a bit. In the subsequent year, fiscal year 2001 budget, let me read you the following quotation, which I think exactly characterizes the issue appropriately.

"Increases in trust fund balances do strengthen the ability to pay future benefits if the surplus in the trust fund is matched by an improvement in the Government's net financial position. If a trust fund surplus is matched by a corresponding reduction in publicly held debt, then the Government's financial position will be improved."

The key question, in a fundamental economic sense, is: Are we saving those surpluses? If we are using them to reduce publicly held debt, we are saving them. And all of the accounting identities of the fact that it is an asset to the Social Security system and a liability to the rest of the Government, those hold regardless of whether we are actually saving the money, and so they do not speak to that question.

The thing we have to keep our eye on is are we contributing to national saving. And over the least few years, certainly, there is no dispute we are. I would say even during the 1980's and 1990's we were, at least to some degree.

Mr. SCHIEBER. Two things. One, as to my interpretation of history, I co-authored a book with John Shovan from Stamford University that was published by Yale University Press in 1999. That book received a special certificate of merit in the annual Paul E. Samuelson Awards last year. It was reviewed and read by quite a number of very prominent economists. If anyone wants a copy of that book, I would be happy to provide it for you, and then you can judge whether or not our interpretation is correct. It is very well documented?

Now, in the issue of whether or not the trust funds are funds, the point I made earlier is that this debate, this argument has been going on for a very long period of time, and I do not think that the public can sort it out because the people sitting around these kinds of tables have not been able to sort it out over a very long period of time.

Absolutely the bonds that are in these funds represent a claim that the trust funds can make on the Federal Government stream

of revenue. The point I think other people are making is when you get down the line and you really start cashing these on a substantial basis, it is going to put a tremendous demand upon the budget of the Federal Government, and at that juncture, you are going to have to start sorting out a variety of priorities that we have not had to deal with yet. That is the problem. It is not that anybody does not want to pay these benefits. It is at some juncture, you are either going to have to be willing to go tax the American people at much higher rates than we have traditionally, or you are going to have to cut in to other things that government does if you are going to cash these bonds to deliver the benefits that they imply. And I think that is going to put even people who are dedicated to this program in a relatively difficult position.

I think that the plan that Senator Moynihan and Senator Kerrey put on the table last year, or a couple of years ago, was extremely austere. I would not support it. But it would cut benefits very significantly for a lot of—across the board, low-income people that do not have any other resources, and I think in kind of the classical definition of liberalism, I think the thing that bothered Senator Moynihan was this program, these programs have a potential to crowd out everything else that government does, and there is a question of whether or not we want to get ourselves into that position.

It is not an ideological thing. I think it is a very practical thing.

Chairman CONRAD. Thank you, and thank you, Senator Corzine.

Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman. I thank you for calling the hearing.

I would like to use my time to make some comments and share a little bit of information that we gathered from my constituents on their preferences in this area, and then ask a question.

At stake is whether our elderly live in comfort or in poverty. Before Social Security most elderly Americans lived in poverty. Before Medicare, more than a third of the elderly still lived in poverty, 35 percent in 1959. Fewer than 10 percent do now. And Social Security and Medicare have been, of course, essential to this achievement. Nearly two-thirds of elderly Americans rely on Social Security for most of their income. Social Security has been one of the most successful government undertakings in history.

Last month the President's Commission painted what many regarded as an alarmist picture of Social Security's future. I do not agree with its tone, but I am not among those who say that we should just do nothing about Social Security's challenges. As President Kennedy said, "The time to repair the roof is when the sun is shining."

The Social Security Trustees' more sober report, released in March, indicated to maintain solvency for 75 years we need to take actions equivalent to raising payroll tax receipts by 1.86 percent of payroll or making equivalent cuts in benefits. When Social Security exhausts its assets in 2038, annual Social Security tax revenues will be sufficient to cover 73 percent of annual expenditures. The Trustees' report thus sounds a warning. We can fix Social Security for 75 years if we make changes now equal to less than 2 percent of our payroll taxes or 13 percent of benefits, but if we wait till

2038, we will need payroll tax increases of more than 5 percent or benefit cuts of more than 27 percent.

The President's Commission seems bent on taking 2 percent of the payroll taxes away from the present Social Security system, and devoting those funds to private accounts. As Chairman Conrad has pointed out, this 2 percent plan could require Social Security to come up with another $1.3 trillion in the next 10 years alone. And as Clinton economic advisor Gene Sperling pointed out Tuesday, it will move forward the date when payroll taxes no longer cover benefits from 2016 to 2007. The 2 percent plan would just add to Social Security's problem. It would take resources away from Social Security that we would have to make up either with more taxes or more benefit cuts. As The Wall Street Journal reported last month, it would require making huge offsetting benefit cuts, averaging 40 percent.

Now, Congressmen Kolbe and Stenholm have done a service by introducing their new bill, because it spells out just how unacceptable the cuts are that this plan would force. Their bill, which largely tracks the President's 2 percent approach, would also reduce Social Security's guaranteed benefit, reduce cost of living adjustments, and raise the retirement age. Reducing cost of living adjustments would disproportionately hurt older beneficiaries, particularly women, who have longer life expectancies. And raising the retirement age would disproportionately hurt blue collar workers and African-American beneficiaries when African-American men have a life expectancy of 68 years. It is therefore not surprising the both Speaker Hastert and Leader Gephardt said they could not support the bill, and I cannot either.

We need solutions to Social Security challenges that preserve its vital role of combatting poverty. This past year I have had a series of discussions with the people of Wisconsin about Social Security at town hall listening sessions, through letters to my office, and through a special page on my website. Of course, this was not a scientific sample, but hundreds of my constituents have expressed some clear opinions when given a list of options. Each year I conduct a listening session in each of Wisconsin's 72 counties.

Since January of last year, people raise Social Security with me at these listening sessions more than 100 times. It was one of 7 issues that people brought up most frequently last year. Nearly 4 out of 5 people writing to me about Social Security privatization since January of last year have opposed privatization. And in the same period, hundreds have also written to support a lockbox for Social Security and Medicare.

And in June of last year, in order to engage Wisconsinites in a more detailed discussion of Social Security, I uploaded a section of my website that allowed people to choose among various options to save Social Security. Respondents rejected most options. The people I am hearing from in Wisconsin do not want us to cut Social Security benefits or raise taxes significantly. However, a majority of respondents did support five options, which taken together, would keep Social Security solvent for 75 years. They supported President Clinton's plan, including transferring to Social Security general revenues equal to the interest savings Social Security generates, and having an independent board invest 15 percent of trust fund

assets in the stock market. They also supported two other structural changes to the Social Security program: requiring all new state and local government employees to participate in Social Security and raising the cap for earnings subject to Social Security taxes at a level of salary that a Member of Congress makes. Respondents also rejected a number of other options, many by a resounding majorities. They overwhelmingly opposed across-the-board benefit cuts, COLA cuts, across-the-board payroll tax increases and raising the retirement age.

So, Mr. Chairman, I would ask unanimous consent that a report of the responses to my website be printed in the record of this hearing at the close of my remarks.

Chairman CONRAD. Conrad. That will be done.

[The report of responses to Senator Feingold's website follows:]

Senator FEINGOLD. And I just want to ask one question of Mr. Orszag. Would not the kind of reforms endorsed by Wisconsinites in this survey be more certain to contribute to Social Security solvency than would privatizing 2 percent of the program?

Mr. ORSZAG. Well, let me answer that in two ways. First, one of the options that your constituents embraced was general revenue transfers, as you noted. And as we have noted today, there is no revenue left to transfer without creating deficits outside of Social Security and Medicare. So partly the answer is: would that it be so, that we could do that. That I think would help substantially to improve the political viability of any plan to reform Social Security.

Beyond that there are a series of options. For example, covering state and local workers. That was embraced by all three plans that were part of the Gramlich Commission in the mid 1990's. It is politically controversial, but it is something that probably should be done.

There are other things like the Bureau of Labor Statistics will be coming out with a new index, price index, a superlative index that will be an improvement on the consumer price index. The system could be indexed to that index, rather than the consumer price index.

As you mentioned, earnings to which Social Security taxes are applied could also be raised. There are tradeoffs involved. That level is somewhat below its historical—let me rephrase it. the percent of earnings that is subject to Social Security taxes is somewhat below its historical level, and it could be raised back up to its historical average. One should note that as those taxes accrue, in the future workers will get higher benefits as a result. So the impact on the actuarial balance is not quite as large as one would initially think, but it is certainly something that could be explored.

But in any case, there are a whole series of options like the ones that your constituents have embraced, that in combination with general revenue transfers, could form a politically viable plan, but without that general revenue piece, you are left with a lot of broccoli, and too much broccoli to make the plan work.

Senator FEINGOLD. Thank you so much. Thanks, Mr. Chairman.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman, and thank you for having this hearing. I think these kinds of discussions are ex-

tremely important, and ones that we need to be having as we work toward some difficult decisions.

I am sorry Senator Gramm left, and I am more sorry actually that he ripped up his check. He probably needs it for his heartburn medication, and I do not think he is going to have that now.

But I really appreciate all of you being here and talking about this. You know, when I listen to Senator Gramm and I hear these discussions about privatization and changing Social Security, I think it is really important that we remember why we enacted Social Security in this country to begin with, long before I was born, but 50 percent of the women in our country, back in 1935, lived in poverty. These were people's mothers and grandmothers, who did not have food on the table and lived in terrible conditions, and this country decided that was something that as a country we could not live with. I think it is terribly important that we do not forget those women now as we look at how we are going to change Social Security, and we have to be very careful that whatever changes we make, does not impact women in specific ways.

And I am very concerned when I start hearing about privatization and other proposals that are out there, because of the current Social Security system protects women like I am talking about, from inflation, and makes sure that their benefits do not run out. When you get to privatization it is going to be women who have not been in the work force as long, who earned less to begin with, who are going to be impacted by those first, and I do not think we want to be the Senate or the Congress or the administration that turns its back to a point we were at before. So I think it is very important to remember those women.

The other women that I keep in mind in particular are the women that are talked about in the book—it is called "Nickel and Diming", that was written by—right. If you have not read the book, you ought to read that book, and you ought to think about those women every single day as we change policies like this. These are women who are earning minimum wage, who—the company they work for might provide health care coverage, but because it means a $25 payment out of their pocket, they do not get health care because they cannot afford that. They are living in motels during the week for their minimum wage jobs. They are eating nothing during the day as they work at minimum wage jobs, because they are trying to care for kids at home. It is a terribly eye-opening book, and I think those are the women we have got to think about when we look at any changes to Social Security.

Now, privatization is not going to help those women. They do not have the money for a 401(k). That is even out of the realm of their thinking. They are barely making it now. They do not have cars. They live in transitional housing. They do not eat well now. And to talk to them about a 401(k) is talking about Mars.

So I think we have to be very careful and we need to keep those kinds of women in mind as we propose changes to Social Security and privatization.

And, Dr. Schieber, as you talk about that, and I think about these women, and I think about what happens in terms of inflation, guaranteed benefits, and in terms of benefits running out, what do you say about——

Mr. SCHIEBER. In the plan that I devised, working with John Shovan, and working on this book, we actually would have raised the inside Social Security benefit for those kinds of workers. So I think you have to really think about how the whole system is going to be restructured before you come to a judgment about whether one approach is good and another is bad. Again, I would advise that you take a look at this story, because I think it is an important story, and it tries to put the current situation in the context of where we have come from, but also where we are.

This structure, this plan was devised in the 1930's in the middle of the Depression when family structures were very different than they are today, when we did not have financial markets, when we had very little savvy about what was going on. All I ask is that you kind of come at this with an open mind and think about what we can do.

Senator MURRAY. Sure. I could agree with you. And times did change. And during the 1980's we made some changes to Social Security for women in particular, because the divorce rate had changed. And I worry again about how privatization plans would affect women, whether or not the spousal benefits would remain the same. I mean, those things cost money, and we have to look at how——

Mr. SCHIEBER. I worry about that also. My grandmother was on SSI. I am very worried about low-income older women, believe you me.

Senator MURRAY. OK. Well, I would like to hear what our other witnesses have to say as well.

Mr. GREENSTEIN. If you think of how Social Security works, many groups of women get a Social Security benefit that exceeds what they would get based on their own earnings alone. Social Security is designed that way. It favors people with lower than average earnings. Women have lower than average earning. It favors people who have a longer than average life expectancy. Women have a longer than average life expectancy. It has special benefits for spouses, widows and divorced women. As a result, women pay about 38 percent of the payroll tax and get 53 or 54 percent of the Social Security benefit.

Now, if think of, hypothetically for a moment, replacing all of Social Security with individual accounts, you have an individual account that has a dollar in it. That same dollar cannot simultaneously pay a male worker, pay the spouse after he dies, pay a divorcee from a first marriage. The same dollar can only be used once. Individual accounts, by their nature, do not redistribute. Social Security is designed to redistribute to women.

Now, as Mr. Schieber said, you can on paper design a plan that has individual accounts, and that then greatly increases the redistribution within Social Security so that the two together do not have less redistribution for women than under the current system, but such a system I think is not politically sustainable over time.

Think of what it would mean. First you would be cutting Social Security benefits enough to restore long-term balance. You would be cutting Social Security benefits further to make up for the money you were diverting from Social Security into the individual accounts, and you would be cutting Social Security a third time for

middle income workers in order to have more money in Social Security to redistribute to the lower income workers to make up for the lack of redistribution in individual accounts.

The result would be that down the road, not someone like Mr. Schieber, I do not doubt that for a moment, but others, the Catos and the Heritages of the world, would hold up how the middle income person did in Social Security compared to how they did in the individual account, and say, "Look at what a terrible deal Social Security is compared to the individual account." It would put us on a slippery slope. I do not think a Social Security system redesigned that way can survive.

The answer is to shore up Social Security as is, and not start to replace it with non-redistributive individual accounts, but an even greater redistributive burden on Social Security and have Social Security collapse politically over time as a result.

Chairman CONRAD. Senator Clinton is next.

Senator CLINTON. I am going to echo the thanks to the chairman for this hearing, which I believe is so important, and certainly helps to highlight the problems, if not come up with solutions.

I, for one, would like a copy of your book, Dr. Schieber. I read you testimony, and I appreciate greatly the thought and concern that you have put in over many years in trying to not only design a system in the United States, but work with other countries who are faced by the same demographic reality of an aging population and the implications that that poses for the burdens on taxpayers and workers.

What concerns me about this whole debate though—and I walked in in the middle of the Senator from Texas's peroration, is that it is easy to mistrust one another's words because of the political and ideological agendas that are not very well disguised behind the rhetoric. And if it is difficult for us, it must be nigh on impossible for the American public. And I regret that it appears as though the President's Commission is off on the same footing, and I regret that because we know we have a problem that we have to address, but the first salvo from the Commission in the form of a report that I think rightly could be criticized for its presentation, means that, you know, we are back into the swamp again.

And, Mr. Chairman, I do not have any allusions that we could do any better than anyone has ever done, and I know full well that fools rush in where angels fear to tread, but I have very high regard for the three gentlemen sitting before us. They bring different levels of experience and attitude and perspective. But I think it behooves us on the Budget Committee to come up with specific proposals, you know, not merely to be in the peanut gallery, taking shots at people who do venture into this territory, to try as best we can to sort out the ideology and the politics from the reality, and to get at the economics.

But it is—I guess it is troubling because many of us believed our options would have been much greater had we not done the tax cut. We would have been in the same position. We would have had to face these issues. They were not new post-tax cut signing. We know that. But as several of you have pointed out, the tradeoffs are difficult under any set of circumstances. We have just rendered them excruciating, and that seems so unfortunate.

And I also regret that our colleague from Texas—I missed this, but Senator Corzine told me in great colorful detail how exciting it was to see him tear up the check—but the fact is that you could line up all kinds of public investments and tear them up because of the tax cut. This is not a one-way street. And we have undermined our capacity to make these difficult political decisions because of this fiscal year responsible tax cut.

Nevertheless, we are where we are, and we have to try to address the reality.

Let me ask you something that, you know, I have though about a lot, because the savings rate, I think you have to see on both a macro, micro, or at least national individual level, and we are deficient in both respects, and I thought we had begun to make some progress in the last 8 years on the national level, but it did not translate or, shall we say, trickle down to individual savings rates as one might have hoped.

If we were not talking about Social Security, and we were only talking about savings rates, do each of you have any ideas as to what could be done, what you know might have been tried in other countries, what possible options there are, that would increase savings, have a sensible approach toward pensions for lower-income workers, because my colleague from Washington is absolutely right. I mean, what haunts most of us is the idea that we would go back to pre-Social Security poverty. And sometimes I feel like maybe we could start with baby steps here and take a look at that. Dr. Schieber?

Mr. SCHIEBER. One of the things I think we need to do is try and understand a little bit better what has happened to our personal savings rate. And there is a very intriguing paper by a couple of fellows at the Federal Reserve Bank that has recently been written. It is on their website. If you cannot find it, the fellows' names are Mackie and Palumbo.

They segregated the population into income classes, into quintiles, five groups, and they looked at what happened in each of these quintiles, and it appears that most of the personal—drop in the personal savings rate in the United States was attributable to the drop in the savings rate in the top quintile during the 1990's, that actually savings rates among the bottom two or three quintiles increased over this period, but the people in the top are such a dominant share of the financial markets, that when they quit saving, it dragged the whole personal savings rate down.

Now, I think probably what was going on, if you go back and think about what was going on in the stock market, is these people were realizing such tremendous run-ups in the value of their portfolios, that they went on a consumption binge. I think if you look at savings rates further down—I mean, they are distressing, it would be nice if they were higher—but the universal story is not as bad as the aggregate number suggest. My hunch is that a lot of the folk, the people that were heavily invested in the Nasdaq exchange, tended to be people with quite a bit of money. My guess is some of the consumption habits have started to change, and that may help account for why the economy is chugging along a little more slowly than we would hope.

Senator CLINTON. Yes, Peter?

Mr. ORSZAG. I have read the same study, and agree that regardless of what has happened to small changes over the 1990's, the key thing is that middle America is not saving sufficiently on their own for their retirement and other needs.

Mr. SCHIEBER. And I agree with that also.

Mr. ORSZAG. And so the key question then is what can we do about that? The fact of the matter is that economists do not have such great ideas. Most of the, for example, tax incentives that we have come up with for raising private saving, seem to cost just as much in terms of reduced government saving as they generate an additional private savings, and we are not really doing anything, we are not adding to national saving.

There is some hope that a progressive matched savings program, like one that was created in the recent tax legislation, but with a key change, could be helpful. When offered a match, even lower income workers seem to participate in a match savings program at surprisingly high rates. So, for example, if you offer a 401(k) plan to someone earning 10 or $15,000 a year, about half of them will participate, which is much higher than one might initially suspect. So one promising alternative then would be for—the problem is that most of them are not offered the 401(k) in the first place. So one promising alternative is, let the government offer the match, which would open up a match savings program to a much wider array of lower and moderate income workers.

Ostensibly, that is what the recent tax legislation does. However, the credit is not refundable. And the way it is designed basically, no one who would benefit from—or a very small number of the people who on paper would benefit from the higher match rate—there is a 50 percent match rate—actually would not get anything from it because they have no income tax liability. And then the match rate phases down so quickly, that it is really not providing much of an incentive to anyone. So it looks good on paper, but when you actually try to figure out who is going to benefit from it, it falls apart.

If you made that program refundable, it would offer the potential—I think that is the most auspicious approach to raising saving among the most vulnerable population that we have.

Mr. GREENSTEIN. I would very much agree with the comments that Peter just made. I add a couple of tales.

The provision in the tax bill that he referred to is basically a pension-related tax credit, that was put in at Senator Baucus's request, but it was put in at Senator Baucus's request, but it was a desire on those framing the tax bill, not to spend any real money on it. So it was designed, as Peter has just suggested, in a way that it is both non-refundable and for the people who benefit for it, it phases out so quickly and is so small, that it does almost nothing, which is why it has almost no cost.

The model for what Peter is talking about, taking that, making it larger, making it refundable, actually would be similar to the USA accounts that were in President Clinton's budget a couple of years ago. And the missed opportunity we had was that we could have used some of the tax cut for that, and that would have promoted saving, and instead, most of the elements of the tax cut promote consumption rather than savings.

I am sounding like a broken record here, but given that there are significant elements of the tax cut that only affect small percentages of the population, that are not in effect yet and do not take effect for a while, I am hoping there would be some opportunity to reconsider some of them, both with regard to needs like Social Security solvency, but also with regards to converting some of those provisions that are regressive, badly targeted and consumption oriented, into proposals like the one Peter mentioned, that would promote pensions, help low and moderate income elderly people and promote national saving at the same time.

Senator CLINTON. Thank you very much.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Mr. Chairman, I want to thank you for having this hearing. I want to recall to mind a day that will live in infamy. For it was the day that but for one vote the Senate was denied Senator Byrd's motion to take the reconciliation instructions out of the Budget Act.

And because for one vote Senator Byrd's motion failed, we were forced into an economic straightjacket that caused us to discuss and debate with limited ability to amend the most far-reaching tax cut for the next decade, perhaps two decades, all within the span of a limitation of 20 hours of debate. I felt like that was wrong. I think the product that was produced was wrong, and that is why I voted against it.

What we find now is the American people are starting to have some surprises. They thought, for example, when it was billed on the floor during the debate that they were going to get a rebate of $533 per taxpayer and that that was going to occur in the year 2001.

What they did not realize but are just beginning to discover is the $533 per person is not a rebate, an additional tax reduction. But it is merely an advance on the tax rebates that they would get next April when they file their tax return for the year 2001. Not an additional tax cut of $600 for a couple. But rather an advance of the refund that they would have been getting next year.

I share that with this committee simply to illustrate that there were so many sleight of hands in this tax cut that was supposed to be conforming to the $1.35 trillion, when in fact it was about $1.8 trillion because they suspended the whole tax cut in the tenth year and went back to the present tax structure.

Now I say all of this just preliminarily to say that had we been more balanced in our approach with a very substantial tax cut in the range of $900 billion over 10 years—indeed, I voted for one version of $1.2 trillion over 10 years. But that it was balanced against using part of the surplus in the investments that we want such as education and a prescription drug benefit, and defense that we are clearly going to have to spend more on, and yet reserving about a third of the surplus to shore up Social Security, and to shore up the Medicare Trust Fund, the subject of which you have been discussing today.

It is just another illustration, and I would love to have the comments. I will make this short, and I thank you for your patience, and I thank you for this hearing.

Given the constraints that we now have, if we want to exacerbate the situation, then create these private investment accounts, transfer $1 trillion out of the Social Security Trust Fund and what is left is going to have the inevitable result that you are going to have to reduce Social Security benefits, which is exactly the opposite of what the American people want. It is just going to cause the crisis to worsen.

So with that as my common sense, country boy approach, knowing full well what our people in the State of Florida feel, I would love to have your comments. Let us start with you, Dr. Schieber.

Mr. SCHIEBER. The problem we have with our current system is that we are not contributing enough to support benefits that are currently defined. We need some more money to put in there. It may have seemed easier to take general revenue taxes and put them in there then to go to the American people and tell them, if you want to continue to exhibit this kind of behavior, you need to be putting more into your retirement system.

It may have been easier, but there are some issues that this Congress needs to step up to and decide whether or not it really wants to take some of this general revenue and put it in there. And then think about the implications of taking general revenue and the claim that is going to make on other things that you do.

Senator NELSON. I would only amend what you are saying by saying that the plan that the chairman had proffered, of which I supported, was that in this unique time in history when we have surplus that you take about a third of that surplus and put it into—in his case it was about $900 billion. You take that and put it into the Social Security Trust Fund, which is going to give you additional resources.

Now what you are claiming is that on down the road you have got a train wreck coming and you had better get ready for it. I agree with you. But in the meantime, you could certainly shore up the Social Security Trust Fund to the extent of $900 billion had we followed the chairman's——

Mr. SCHIEBER. But down the road you are still going to have to address these priorities. There was recently an article in the Washington Post about Greece. Greece has decided not to buy new fighters for its air force because of its high pension cost. We are going to be in exactly those same situations and maybe we would, on a very short term basis, want to use some general revenues. But I think we have to be very careful about not getting ourselves into a box where 10 years or 15 years from now we have no discretion on other things.

Senator NELSON. I do not disagree with you. Ultimately we are going to have to make hard choices. But what the chairman from North Dakota's plan would have done would have extended the solvency of the Social Security Trust Fund from about the year 2032 all the way up to about the year 2053.

Mr. SCHIEBER. But there is still a problem of what the flow of claims is going to be as the baby boom goes into retirement. That is the problem.

Senator NELSON. Your point is well taken, and I hope you understand my point as well.

Mr. SCHIEBER. I understand your point. You are going to make a statutory claim on the future budgets by doing what you are doing. But you still are going to have a relative priorities issues that you are going to have to sort out down the road. You have not cheapened the cost of the system.

Senator NELSON. I understand that. But you know what my position is? My position is the conservative position. Take surplus and use it wisely instead of frittering it away. Let us hear Dr. Orszag and Mr. Greenstein.

Mr. ORSZAG. Yes, Senator. Two comments. One is, again moving away from just budget accounting to the fundamental economics, the key thing is to be raising national saving. Funds that are devoted to reducing publicly held debt and that are credited to the trust fund raise national saving. So keeping our eye on that ball, which is ultimately the way that we are going to prepare for the retirement of the baby boomers, general revenue transfers do contribute to national saving and are important in preparing for the retirement of the baby boomers.

Second, from the perspective of the Social Security reform debate, there is no question that hard choices have to be made. The real question is, how many hard choices can all of you afford to make and in a politically viable way? There is a limit to how much—I used the word broccoli before. There is a limit to how many of these painful steps you can take.

The key point is that general revenue transfers help to grease the wheels or make the reform plan as a whole politically viable. Without those general revenue transfers you wind up with too much pain and it is too much for, in my opinion, the political system to bear.

Mr. GREENSTEIN. I would agree with Peter. I would just add, when you are in a hole, you do not dig it deeper. I cannot help but noting that as we are sitting here this morning, the House yesterday passed a tax bill. Without getting into the merits of the energy provisions of the bill, that and two other bills the House has recently passed cost another $60 billion over 10 years. There is only $20 billion left over 10 years in the budget resolution for tax cuts, and that money is only there because of the gimmicks that were used in the tax cut that passed to make it look like it fit within $1.35 trillion when it ultimately cost much more.

If our goal is not making the box bigger when the boomers are retiring, promoting national saving, doing that by preserving the Social Security and Medicare Hospital Insurance Trust Funds, the last thing we ought to do be doing is doing further tax cuts beyond the budget resolution that are not offset and are not paid for. Yet that seems to be where the House is going now and what you will be asked to do on a number of bills when you come back in September. I think one of the first things is we do not do any further harm on that front.

Senator NELSON. Mr. Chairman, thank you very much.

Chairman CONRAD. Thank you, Senator.

Let me again thank the witnesses. This has really been an excellent panel and I appreciate the participation of all of you. I really do.

Let me say my own beliefs are, No. 1, that Social Security, whether they are real assets or not real assets, I believe they are real assets. I believe Treasury instruments are a legal claim on future revenue streams of the Federal Government. To me that is undeniable.

I also believe there is a real problem. Dr. Schieber, you used a couple of sentences I agreed with in terms of describing of problem. Because when the liabilities come due, future Congresses are going to have to make choices that will entail significant benefit cuts, or big tax increases, or additional debt. I think that is undeniable.

I personally am open to individual accounts, properly structured, in a way that holds down administrative cost, that provides protection, and better rates of return. I am open to it. But I raise the question with this hearing, where does the money come from? Where does the money come from?

I set aside very specifically in a budget resolution all of the Social Security and Medicare Trust Funds, and in addition to that, a third of the non-trust fund surpluses, to strengthen Social Security. To possibly fund transition to individual accounts, to have some other means of strengthening by way of Social Security Plus plans. But all of them cost money.

The Senator from Texas, I wish he was still here, because he has been somewhat uncharitable in the last 24 hours and repeated instances to what I have proposed. I wish he was here so he would hear the response. I think he has engaged in a giant sham. He is all for everything. How is he going to pay for it? It is real easy to be for individual accounts if you do not have to pay the transition costs. That is real easy.

I know what he is going to do. He is going to say, well, we ought to take it out of the Social Security Trust Fund surpluses. If that is not double counting. It is either double counting of you are moving up the time of insolvency of the Social Security Trust Fund. One of those two things. You cannot use the same dollar twice. That is funny money accounting.

I do have some accounting background, and I am going to resist here funny money accounting by any side. We have got folks that want to spend the money twice. I was in a meeting yesterday and I heard some of the greatest speeches I have ever heard about how we can spend the money and it will not matter. We can credit it to the trust funds and then we can turn around and spend it. Nonsense. That does have an impact.

I have heard the same thing about tax cuts. We can take the money, credit it to the trust funds, and then take the dollars and give it in a tax cut and it does not matter. Nonsense. Of course it matters. You cannot use these dollars twice and not have an impact.

You would hope there would be some integrity to this debate. You begin to wonder. But I am hopeful that cooler heads will prevail and that we can fashion something here that would be meaningful for all of the people of this country. But I know there has got to be integrity to it. This kind of double counting, use the money twice, it is all words and smoke. Because ultimately the chicken is going to come home to roost here.

We already see it coming home to roost. This tax bill, the truth is I supported a significant tax cut. Had it in my budget, $900 billion. But my $900 billion included the interest cost. The President's proposal on a fair comparison basis was $2 trillion when you include the interest cost. It is too big. It did not add up.

We talk about crowding out other priorities. Now the President comes with a big request for a defense increase and it is going to come right out of the trust funds. We have got the memos that have been leaked by the Republican side that acknowledge we are going to be into the Medicare Trust Fund this year, we are in danger of being in Social Security next year and the year thereafter. It is undeniable.

This whole thing did not add up. It did not add up when it was done. It does not add up now. It is a bunch of phoney, funny money accounting, and the chickens are coming home to roost. Already they have got to go out and borrow to pay for the rebates.

They have engaged in every kind of trick, accounting trick, to make it look as though it added up. They did not include the President's defense request in the budget. They have included no new money for education when everybody says education is the top priority.

They did not include any money for natural disasters when we have already had three. They did not include any money to deal with the alternative minimum tax that affects 1.5 million people today and is going to affect 35 million, and we are acting as though we are not going to do anything about it. It is absurd. They do not have any money in there for the expiring tax provisions like the research and development tax credit when everybody here knows it is going to happen.

This is the kind of thing that gets a great nation into big trouble. Funny money, phoney budgets. That is exactly what has been done here, and the chickens are coming home to roost. And it is not going to be the sweet by and by, it is going to be this year. When the new numbers come out in August it is going to be crystal clear. We are into the Medicare Trust Funds already and we are perilously close to going into the Social Security Trust Funds.

After all the promises to the contrary, that there was plenty of money to do it all. We could have a massive tax cut, we could have a big defense buildup, we could fund education. We could do all of these things, protect Social Security, and it all added up. Well, it did not add up, and now the chickens are coming home to roost.

We will see who was playing is straight with the American people and who was creating a mirage, because we are going to have a chance to see very soon.

Senator #I21SENATOR NELSON. Mr. Chairman, you caused me to have a flashback in your very appropriate and insightful comments as to the current budget condition. It is worth noting that there was a very similar condition shortly after the 1981 tax bill, which was a huge tax cut. I voted for it. I made a mistake. I realized that mistake shortly thereafter and so stated in a statement on the floor of the House of Representatives.

But here is the flashback that I just had. There was an admission by someone, either in the Administration of the Reagan Administration or it was a Member of Congress, and I think it was

Jack Kemp of New York who said—and this gave the clue into the mind of that Administration, and you may have hit the same thing here. The statement was, we do not worship at the shrine of balanced budgets.

What happened in the decade of the 1980's was that declaration certainly became apparent. Because deficit spending in order to fund the Government operations that had far exceeded the tax revenues coming in went, in the course of the decade of the 1980's all the way up to almost $533 billion in deficit. That was $533 billion annually of spending more than we had coming in in tax revenue. That caused the national debt to almost triple.

I thought of that statement, we do not worship at the shrine of balanced budgets, just as you were stating what you see the projections coming out this year. All of these new demands on spending that are going to have to be satisfied, whether it be a direct expenditure for emergency appropriations or whether it be an expenditure through a tax cut extension such as the R&D tax cut.

That maybe that same philosophy that took us to record national debt is being expressed by the same Administration, we do not worship at the shrine of balanced budgets.

Chairman CONRAD. They certainly did not worship there. Goodness knows we have got some of the same architects of that plan sitting at this table. They have come with the same kind of plan this time. It did not add up then. It does not add up now. Ultimately it quadrupled the national debt. I hear the same voices, the same siren songs all over again.

I am not part of that crowd. I do not believe in it. I think an enormous disservice was done to this country in the 1980's when they exploded the deficits and the debt of this country, and I do not want to be a part of a repeat performance.

I want to be part of those places where we can provide tax relief prudently. Let us do it. But goodness, let us recognize where we are headed. We know 11 years from now the baby boomers start to retire, and we are faced with a very difficult choice, as Dr. Schieber described here.

I personally believe one way to deal with it, one part of dealing with it, is to reserve some of the surpluses of today to deal with what is to come. Unfortunately, that opportunity which existed, a golden opportunity, was squandered this year.

That did not mean we could not have tax rebates this year. This stuff about tearing up the check. I mean, come on. Come on. I had in my budget $60 billion of tax cuts for this year. What passed was $40 billion. The suggestion that we were against tax cuts this year, that is just phony. That is just false.

What we were not for was transferring $33 billion out of this year in a sham transaction by delaying corporate receipts for 2 weeks, $33 billion worth, to put it into next year to make the tax cut look more affordable next year. If it were not for that, made very clear at the time when we found out they had engaged in that funny money transaction, that that is the exactly the type of thing that gets you in financial trouble, because you phoney up the fiscal picture for the country.

The great thing is this is a democracy. We get to debate these things. We all have strong feelings and we get a chance to express them. So we are fortunate to live in this country.

Thanks to the witnesses.

[Whereupon, at 12:25 p.m., the committee was adjourned.]

THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE

TUESDAY, SEPTEMBER 4, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 2 p.m., in room SH–216, Hart Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Nelson, Stabenow, Clinton, Corzine, Domenici, Grassley, Frist, Hagel, and Allard.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. Welcome.

Director Crippen, it is good to see you. We are especially pleased to have you here today to provide us with CBO's updated budget and economic outlook. In January, when we last met on this subject, you were unable to appear because of an accident and an injury, so we are especially delighted that you are able to be with us today, and are very much on the mend. We are glad to see that. Thank you for coming today, and thank you for all of the work that has gone into these revised estimates.

It is particularly a shame that you were unable to be with us in January because then the news was so much better. In January CBO was able to project that the unified surplus would total $5.6 trillion over the next decade. It also projected that there would be a non-Social Security surplus of $125 billion in 2001, and that the surplus would grow every year through 2011. Now CBO is reporting that the unified surplus projected for the next 10 years has shrunk by more than $2.2 trillion to $3.4 trillion, and that instead of $125 billion non-Social Security surplus this year, we will have a $9 billion deficit.

But as disturbing as the deterioration of the surplus for this year is, what is most troubling is that CBO projects we will have only a small non-Social Security surplus in 2002, and that part of the Social Security surplus will once again be needed to pay for other government operations in 2003 and 2004, despite the fact that CBO anticipates the economy will grow at a very healthy rate over the next 3 years, 2.6 percent in 2002, 3.3 percent in 2003, and 3.2 percent in 2004.

The CBO projection that we will run non-Social Security deficits in 2003 and 2004, and that $139 billion of the Medicare HI Trust Fund surpluses will have to be used to pay for other government activities over the next 4 years are also particularly disturbing be-

cause they are based on current policy. That is, they do not assume any additional funding for defense that the President has requested, any additional spending for education, when the President has indicated that is his top priority, any Medicare prescription drug benefit, any changes in the inadequate assistance the Freedom To Farm Act is providing to our hard-pressed farmers. It does not provide for an extension of the popular expiring tax provisions, or any other changes in policy that the President's mid-session budget included or that were included in the Republican-drafted budget resolution.

So what CBO is telling us is that we are now in a situation which after the President and virtually every Member of Congress have pledged to protect Social Security and use the Social Security surplus to pay down the national debt, that we are poised instead to use the Social Security surplus to pay for the other activities of government in years in which the economy is growing, even if we do not add a penny of new spending or enact new tax cuts. And based on CBO's projections, if we did enact the President's increase in defense spending, and the policies included in the budget resolution, we would need to use more than $200 billion of Social Security Trust Funds and nearly $533 billion of Medicare Trust Funds to balance the books over the next 8 years, so nearly $500 billion of trust fund money that the budget resolution pledged to protect, would be used to cover the shortfalls in the budget.

CBO Surplus and Deficit Estimates - August Update
(Adjusted to include Bush Defense Request and Budget Resolution Policies)

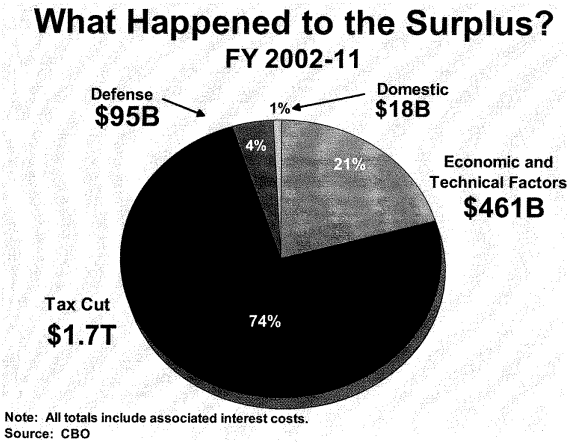
($-billions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-11
CBO August total surplus	153	176	172	201	244	289	340	389	450	507	628	3,397
Social Security trust fund surplus	163	176	190	204	224	242	262	283	303	323	345	2,551
Postal Service deficit	-2	-1	-(*)	-(*)	0	0	0	0	0	0	0	-1
Medicare HI trust fund surplus	29	38	41	42	42	45	43	43	42	39	31	404
CBO surplus/deficit without Social Security and Medicare surpluses 1/	-37	-36	-59	-45	-21	2	35	63	106	146	252	443
Bush defense request	0	12	14	15	17	18	19	21	22	24	25	187
Other budget resolution policies 2/	-0	17	24	29	34	38	52	56	60	65	71	447
Interest	-0	1	2	5	8	11	15	20	26	32	38	158
Revised surplus/deficit without Social Security and Medicare surpluses 1/	-37	-65	-99	-94	-80	-65	-52	-34	-2	26	117	-349
Raid on Medicare	-29	-38	-41	-42	-42	-45	-43	-34	-2	0	0	-286
Raid on Social Security	-8	-28	-58	-52	-38	-20	-9	0	0	0	0	-205
Total raid on trust funds	-37	-65	-99	-94	-80	-65	-52	-34	-2	0	0	-491

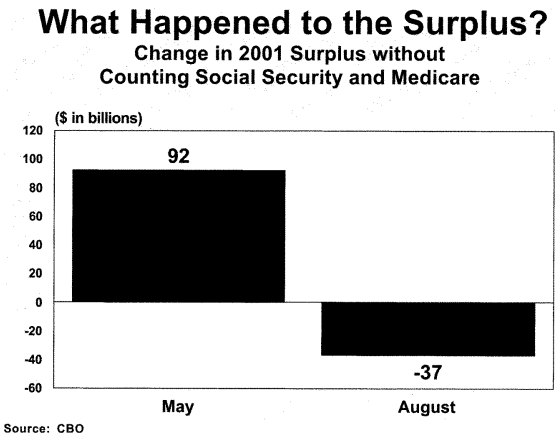
(*) Less than $500 million deficit
1/ Also excludes Postal Service deficit.
2/ Includes amounts allocated for a prescription drug benefit, expanded health care coverage, veterans programs, agriculture and other policies.

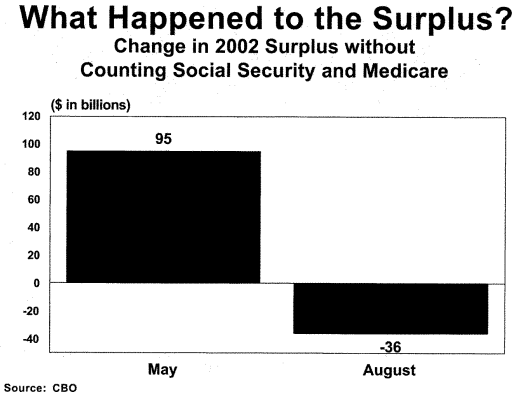
05-Sep

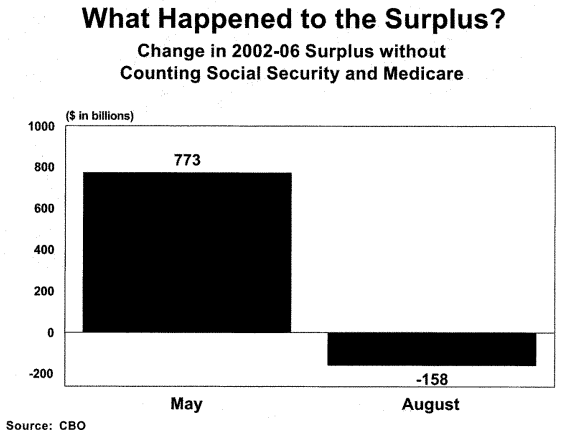
What happened to the surplus? That is going to be a big part of your testimony here today. How did we get into this situation? CBO's report makes it clear that the main reason for the precipitous decline and the projected surplus is the President's tax cut. Including associated interest costs, the tax cut accounts for nearly $1.7 trillion or more than 74 percent of the decline in the projected unified surplus over the next decade. Changes in the economic outlook and changes in technical factors that affect the budget account for an additional $461 billion or roughly 21 percent of the change. And despite the statements of some in the administration and even our colleagues, that increases in spending account for the problem, in fact, changes in spending account for just 5 percent of the reduction in the surplus, and most of that increase, 95 billion, is from the Supplemental Appropriations Bill the President said was absolutely essential. The President also supported the $18 billion increase in domestic spending for disaster assistance to farmers and

other purposes. So all of the spending which has occurred has been endorsed by the President.









CBO's new figures confirm what many of us have been saying for months, the President's budget simply did not add up. They confirm that the President's claim that we could have it all, that we could have a massive tax cut, a big defense buildup, more money for education, maximum pay down of the debt, and protect Social Security and Medicare were simply wrong. Those promises were too good to be true.

So where do we go from here? Of course one thing that CBO's figures do not tell us is how do we repair the damage? And that is not your job. That is our job and the President's job. How do we put our fiscal house back in order?

But I do hope that CBO's figures will help us take the first and most important step, which is helping the President to understand there is a problem. I stand ready to work with the President to implement a rescue plan to put us back on the right path, but that process cannot occur until he acknowledges that we have got a problem, and that he acknowledges the dimensions of the problem that we confront.

I cannot help but thinking about the stages of grief model Elizabeth Kubler-Ross described in her book on death and dying. She said that a dying person goes through five stages: denial, anger, bargaining, depression and acceptance. I think the President's budget plan is dying. We need to move on, but we cannot until the President reaches the stage of acceptance. The first step is to move beyond denial. I hope he skips anger and depression. And I think in this case bargaining cannot occur until there is acceptance. But the important thing right now is for the President to get beyond denial. I think paying attention to the new CBO report could help him take that step.

With that I turn to my very able colleague, the Senator from New Mexico, our former distinguished chairman, Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman. Thank you very much.

First of all let me say if the economy was in as good a shape as our budget, we would all be singing the praises of the President and Congress, because there is nothing wrong with our budget.

What is wrong is that the United States and many parts of the world, from Japan to countries in Europe, to everywhere you look, they are all in an economic slowdown. As a matter of fact, the slowdown in the United States started 6 months before this President took office. It has continued unabated for 14 solid months. That is a downturn in the economy approaching a recession. The same thing is happening in Japan, although worse, happening in almost every country that we expected to cause the gross product of their countries to grow.

So my answer to my good friend, the Chairman, is: there is nothing wrong with the budget. There is a lot wrong with the economy. And what we had better be focusing on is what do we do or not do to help the economy recover, because there is no question that what has happened since the President submitted his budget, since we passed the tax bill, many provisions of which were bipartisan, since we passed a tax bill which was more Democratic than Republican in the first 2 years, because they wanted more rebates and more up-front expenditures, which lead to the reduction in the surpluses because you are spending more to get those tax cuts which were definitely sought by Democrats.

So the issue is not what is wrong with the budget. Let us get on with it. We do not need a summit, which has been called for by a couple of Democrats. What we need is to get on with our business. We only have 14 working days left. We have not passed a single appropriation bill, and frankly, there is not that much real difference between the appropriations bills that the President wants and that Congress wants, when you look at the big picture.

So thank you very much, Mr. Chairman, for your comments. I totally disagree. I totally disagree that there is an easy fix. I totally disagree that we ought to be meeting to discuss this situation with the President. We ought to be meeting among ourselves. We ought to be getting together and getting it done. There is not much to getting it done. There is just reaching agreement on a few things, and we ought to get that and get on with it quickly. And then we had better ask ourselves: what do we do to help this economy come back?

Now, as we proceed through with the questions, I will have a few very simple questions. I will ask the Congressional Budget Director whether George Bush, President of the United States, this President Bush, whether he had anything to do with the slowdown that exists in the American economy. I expect the answer to be no. I will ask him did Congress have anything to do with the slowdown. I expect the answer from the Director of the CBO will be no. What has actually happened is, in the normal cycle of capitalism, we are getting a downturn for a lot of reasons. Some of them are different than we have ever had before, and we are suffering from it. And the reason that the surpluses are smaller than we had expected are not because of the tax cuts in the first two or 3 years, and if they are, then most of the Democrats wanted those tax cuts, so they are being kind of hypocritical about it. If they have anything to talk about, it would be the 8th, 9th, 10th year of this budget package that they objected to, but that is not the crisis, that is not the problem. The problem it right now, has much has the surplus gone

down because we have not had the economic growth that we expected.

Now, this downturn began 14 months ago, as I indicated, nearly 6 months before the President, and before we are finished we will put up some charts that just clearly disclose it. We did not know it was as severe as it is, but now we do, because looking back on it, we get the proof, we get the proof of what was actually happening in the American economy. With this slowing down, I know sometimes when I talk to people it is pretty hard to make the relationship, but all other things being equal, if you have a slowdown in the American economy, you lose tax revenues. We have been losing tax revenues by large amounts, not to a tax cut, but because the American economy is slowing down.

Our chairman has referred to current estimates as a sign—he has done this heretofore—a big-time physical mismanagement, and stew cooked up by the administration that is hard to choke down. Well, all very colorful statements, Mr. Chairman, and I am growing in respect for you mixing the colorful statements with the other, I am growing in respect for you. Nonetheless, I must say, these are colorful statements and simply add nothing to the problem. They are inflammatory and not one bit helpful. First, no matter what is said, the Federal Government's books—let me repeat—its budget is in much better shape than is the American economy. The budget is in better shape than the American economy. Whether you go to CBO, who today will talk to us about these numbers, whether you use the Office of Management and Budget numbers, our budget is better than our economy and the world's economy. We have the second largest surplus predicted for next year in the history of America. We are here talking about surpluses, and it will be the second largest surplus in the history of America. Second only to which one? This year's, this year's, because we have had such an accumulation of surpluses because of the sustained growth in this economy. Nothing whatsoever, no impact whatsoever because of the taxes. We expected the tax reductions, except they were a little bit bigger than we thought in the first 2 years because they became bipartisan, and instead of being Republican's, where they were going to be less in the first 2 years, they turn out to be Democratic, coming out of conference.

So now let me move on to one other issue, this whole issue of paying down the debt, I say to my colleagues, paying down the debt. Now, that is one thing we have to be worried about, paying down the debt, but we also ought to be worried about whether we are spending enough on education. Paying down the debt, that is one thing, but we ought to be worried about whether we are putting enough in defense also, so that it turns out, with these changes that have occurred, the CBO Director is going to tell us that as far as paying down the debt—now get this—I want to point out that in the January and May baseline, the Federal Government reduced debt held by the public to the maximum extent, and it will continue to be reduced to the maximum extent possible by 2006, and after that, the debt continues to decline down to $818 billion from more than 4 trillion.

Now, under the revised budget numbers of CBO, we will reduce the debt to the maximum extent possible by 2010, and the debt

continues to decline to $876 billion, unheard of, by 2011. That is with the current downturn, taking our setback for the tax receipts during the current downturn. So is that not interesting? Even with $1.3 trillion tax cut over the next decade, despite a slowing of the economy, despite some supplemental appropriations and additional agricultural spending—which I am sure everyone knows we just had a little bit, $5.4 billion worth and we will probably have more—but we will approach the maximum debt reduction possible under the United States Treasury Bills that are outstanding. The fiscal plan adopted earlier this year was the correct one. We adopted it earlier, and it was the correct one for a weakening economy. It spent money at a reasonable rate, and it cut taxes. If we had followed the Democratic proposals, it is clear that dipping into Social Security, which is now the new word around, and Medicare Trust Funds, would have been even greater than estimated by the Congressional Budget Office. And whenever I hear that the Republicans are dipping, I would say, the Democratic plans would have dipped more. They just did not get passed. The truth of the matter is, neither they nor us, expected a 14-month gradual recession that has been upon us, and was on this President for many months before he took office.

So, let me close by saying some of the Democrats favorite—one of their favorite witnesses, Robert Greenstein, said, "Whether or not the non-Social Security budget runs a modest deficit would have no appreciable effect on either the Social Security Trust Fund or the Social Security solvency." And then even the "Washington Post", in a lead editorial of a few days ago, stated, and I quote, "The tapping of the funds (Social Security) is more than a matter of political symbolism. It is more that than it is of substance, and more so because not all that much money is likely to be involved. The great bulk of Social Security surplus will be used to pay down the debt, and the symbolism itself gets a little muddy for Democrats in that the parts of the tax cut taking effect in these early years, were to a large extent their ideas." And I agree with that.

Now, I could go on and explain whey we are in recession, whether Alan Greenspan acted too slowly or did not act sufficiently. We are very close to a defined recession. This Senator is not that believes we are going to come out very quickly. I join with some, who know much more than I, that say it is going to be slow, we are not going to come out of it very quickly. And so I am very concerned about what we should do to make sure that we come out of it as fast as we can, put thousands of our working people back to work, get rid of the atmosphere that is around that is worrying Americans about their jobs and their future.

So right now I think we ought to go to work on the appropriation bills. We ought to decide whether we are going to pass them or not or whether we are going to play games with them over a few billion dollars.

I close by saying there was one President who thought, when we were in a deep recession, that it was imperative that we balance the budget. There was one President, the same President, who thought when we were in a deep recession, we ought to cut Federal expenditures. We did both and we had the biggest recession in the history of America and a worldwide depression, for that man was

President Hoover. Most of us have learned since, do not cut spending during a downturn and do not increase taxes.

Thank you very much, Mr. Chairman.

Chairman CONRAD. Well, let me just take a moment to respond because the Senator said a number of things that deserve a response. I do not know anybody that is saying raise taxes during a slowdown. I certainly am not. In fact, the Senator is absolutely correct that this Senator proposed greater fiscal stimulus this year, far greater than the President. The President had virtually no fiscal stimulus this year. I proposed $60 billion of fiscal stimulus when we had a projection that we had nearly $100 billion of room for fiscal stimulus.

But I think that really misses the point. There is no question we have got economic slowdown now. The President is forecasting for next year, strong economic growth, as is the Congressional Budget Office. And not just next year, but every year for the next 9 years. And in that context we see the President's plan taking $500 billion of Social Security and Medicare Trust Fund money to pay for other programs. So it is not just at a time of economic downturn. That I think would be more forgivable. What is of deep concern to this Senator, and I think what ought to be of concern to everyone, is that the President's budget plan and the budget plan that passed Congress, has us on course to take $500 billion out of the trust funds of Medicare and Social Security, when the President and the Congressional Budget Office are forecasting strong economic growth. Is that really the course we want to be on? I do not think so. I do not think it makes sense to take Social Security and Medicare Trust Fund to pay for other government programs at times of strong economic growth.

So there seems to be a disconnect here, and the truth is, our plan had greater fiscal stimulus this year. It is also true we did not support shifting $33 billion out of this year by a 2-week delay in corporate receipts into next year, which made the situation much worse. We did not favor that. That was done in the conference committee. And it is also true that over the 10 years our tax cut was about half as big as the President's, and as a result, we would have avoided much of the problem that we see.

With that, Mr. Crippen, again, welcome.

Senator DOMENICI. Senator, might I just say a comment? It will be very brief.

Chairman CONRAD. Sure, absolutely.

Senator DOMENICI. If you want to make changes to 2003, 4, 5 and 6, you will be chairman, I assume—at least people think you will for a little while longer—and you can produce a budget that does that, why don't we get on with doing what we ought to do this year? You have a chance next year. There will be no changes, and I will not be chairman. Following that there will be somebody different on our side because I have reached my—I cannot serve any longer. It is probably a righteous decision, full wisdom. In any event, you would have ample time to do that. I think we are talking about this year and next year at this point with reference to the recession. And I thank you for giving a minute to me.

Chairman CONRAD. No question. We have got really two sets of problems, if I can just conclude. We have got a short-term problem,

one in which we find ourselves in an economic slowdown, and we have got a longer-term problem. I think we need to focus on both of them, because both have consequences for the country, and both of them have consequences for the economy.

Again, Mr. Crippen, welcome.

STATEMENT OF DAN L. CRIPPEN, DIRECTOR OF THE CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. Thank you, Mr. Chairman.

I am most pleased to be here today. As you said, last time around I was not able to be, to represent CBO and present our latest report on the status of the Federal budget.

Before I turn to some of the details of our report, I would like to take a look at the nature of budget forecast for just a moment, including a slight detour through the past. I will conclude with a few comments about where we might be headed after this decade, a period that the Chairman has in particular focused on before.

We at CBO have been taken to task by some observers of the budget debate for the inaccuracy of our forecast, and I might say, with some justification. But it is also fortunate for our critics that they do not have to do what we do, which is make economic forecasts for the next 10 years, incorporate likely demographic changes into Federal spending, and work through all the interactions of the Federal budget, to produce a single number for each year, the surplus or the deficit, and to do all of this very publicly.

It is important to remember that what we do is dictated in part by the Budget Act, long-established precedents, many of them derived from the 1967 Commission on Budget Concepts, and guidance from the Budget Committees in Congress, to—and let me highlight this—produce a baseline against which to measure changes in law. These are not predictions of budgetary outcomes. They do not include actions yet to be taken by the government, no matter how obvious these actions might seem. But the single biggest unknown in all of this is the performance of the economy, not necessarily the performance of policymakers. No one has mastered economic modeling and forecasts, and I frankly suspect they never will. CBO is as good as most, in part because we have some of the best in the country helping us, and better than many, but we miss it sometimes. And economists are notoriously bad at picking turning points in the economy. It is certainly cold comfort to the Committee that it has always been thus. Slightly more comforting, I hope, is the knowledge that there is not a deliberate or systematic bias in our estimates.

Returning a brief bit to the past, in 1981 Dr. Rivlin presented the Congress with a CBO report on the Reagan budget, a report that did not foresee the coming recession or the development of large and persistent deficits. In retrospect, the single biggest mistake in the forecast was the failure to get the economy right. Revenues declined precipitously because of a declining economy, and the rapid falloff in inflation, both likely caused by extremely tight monetary policy at the time.

As recently as 1997, CBO projected continuing deficits, projections that fortunately turned out to be wrong. Here too, as our cover of last year's mid-year update showed, the biggest factor in

the change of these forecasts was the unforeseen, in this case, the positive developments in the economy. The economy performed better than we or anyone else predicted, and threw off sufficient tax revenue to completely reverse the fiscal outlook. The likely reason for the change was an increase in productivity and perhaps some unmeasured growth in the work force because of immigration.

Which brings us to the present. The economy slowed significantly this year. It barely grew at all in the second quarter. We certainly missed it. We did not see it as recently as January, we did not understand the magnitude of this slowdown. Again, it is cold comfort that we were closer to reality than many more optimistic forecasters. One of my colleagues put it: when you are collectively miles away from reality, the fact that we were a few blocks closer did not help much.

But the result of our changes in the economic forecast and associated technical adjustments is a surplus forecast for this year that is 40 billion lower than that of a few months ago. To this shortfall, as the Chairman has noted, is added the 80 billion in legislative changes, tax rebates, shift in corporate taxes and some additional spending. For next year the single largest factor in the changed forecast is the performance of the economy again and the associated technical adjustments. And over the next few years, the single largest difference between our estimates and those of OMB is how quickly the economy recovers over the 10-year period, to be sure, the biggest changes obviously the legislation passed since January, mostly the tax cut with some additional spending thrown in. But current economic weakness, nonetheless, contributes 20 percent, as the Chairman said, I guess 21 percent, to the reduced 10-year projections. Nonetheless, we still expect, when the fiscal year closes just 1 month from now, to have a fiscal 2001 surplus of over 150 billion. And even with the economic slowdown we are in and the passage of legislation, CBO forecasts continuing surpluses, albeit largely from the off-budget accounts. Where we estimated in January that total available debt held by the public would be eliminated in 2006, we now estimate that event to occur in 2010.

But the decade we have under examination in this report does not reveal what is likely to be the biggest change in fiscal outlook in our Nation's history, from 2011 to 2030, my generation and yours, Mr. Chairman, will retire, virtually doubling the number of retirees served by Federal programs.

As you can see from this poor chart I keep dragging around, the changes will be profound. Proportion of the economy necessary to fund just the Federal programs for Social Security, Medicare, Medicaid, will more than double from something like 7 percent of GDP in 2000 to 15 or 16 percent of GDP in 2030. That rise is the equivalent of $800 billion in today's economy, and puts in perspective the size of the tax increase or additional borrowing that could ultimately be required to finance elderly retirements and other spending if those programs are not changed.[14]

To maintain government as we know it today, and to fund programs for retirees in the future, we would have to raise taxes or increase borrowing by the equivalent of $800 billion a year in to-

[14] CHART NOT AVAILABLE AT PRESS TIME.

day's dollars. Viewed in this light, there are only two things that make a difference, grow the economy more, and/or reduce benefits for future retirees. The attention given to what is in the trust funds come 2015 or even if the trust fund exists at that point, is misplaced. What will matter are these two facts: the size of the economy and the amount of transfers to retirees.

All of this is to say that changes in the performance of the economy, whatever their cause, are the proximate cause of unanticipated changes in our forecast. It has been that way since CBO has been in business. It is the economy that generates tax revenues in greater or lesser amounts than our forecasts, and ultimately it is the size of the economy that will determine the ability of my children to fund my retirement.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Mr. Crippen. And, again, we appreciate your being here today, and we appreciate your testimony.

I especially appreciate your look to the long term because I think we have obviously a short-term responsibility, and economic performance is a key part of that. Also, our budget choices and decisions are a key part of it because they have an impact on what the economy of the future will look like. Clearly, we have a special responsibility when it comes to keeping our promises to future generations. When you look at the long-term trend, you can see that everything changes when we get to the next decade because of the retirement of the baby boom generation, which, as you indicated, quickly doubles the number of people eligible for the programs.

Let me go back, if I could, to your projections. We have gone from a projection of a surplus of $5.6 trillion over the next 10 years to a projection of roughly $3.4 trillion, a substantial reduction. I think it is very important for people to understand what is behind those assumptions. Those projections assume no changes in current policies; is that correct?

Mr. CRIPPEN. That is correct, Mr. Chairman.

Chairman CONRAD. And those are the rules that govern your making these estimates, is that not correct?

Mr. CRIPPEN. That is correct, yes.

Chairman CONRAD. It is not as though CBO just goes out and says, well, we do not think any changes are going to happen. You do not do that. You base your estimates based on what the current policy is. That is your responsibility and that is what you do. So that means that the projections do not include the President's request for some $200 billion more in defense spending over the next 10 years; is that correct?

Mr. CRIPPEN. That is correct, Mr. Chairman. The only thing that is included at this point is the current year appropriation bills, including the supplemental, inflated over the next 10 years.

Chairman CONRAD. So that additional defense request by the President would mean we would be even further into the trust funds of Social Security and Medicare if it were adopted; is that correct?

Mr. CRIPPEN. Presumably, yes.

Chairman CONRAD. The second is there is no increase here, other than inflationary increase, for education.

Mr. CRIPPEN. Correct.

Chairman CONRAD. You have just taken the baseline amount, what was done last year. There is no so-called new money for education here, and to the extent that were done, that would mean going even further into the trust funds of Medicare and Social Security. The projections do not include the cost of a new prescription drug coverage, even though that was in the budget that was passed by the Republicans in their budget resolution, that is not included in your estimates, is it?

Mr. CRIPPEN. No, none of the reserve funds are included as part of our baseline.

Chairman CONRAD. And, of course, what was passed in the resolution, passed when the Republicans controlled both houses, was $533 billion for a prescription drug benefit over the next 10 years, but that is not included because that is not part of current policy; is that correct?

Mr. CRIPPEN. Correct.

Chairman CONRAD. And the projections do not include the cost of extending the popular expiring tax credits. Some have said, gee, why does CBO not include that in their projection?

But you do not include it because those expiring tax provisions, including the very popular research and development tax credit end, and so you do not include them because they are not part of a future year's law; is that correct?

Mr. CRIPPEN. That is correct.

Chairman CONRAD. And that, as I understand it, that is about a $140-billion cost if that is put in place.

Let me go to, and just put up a couple charts quickly, the deal with the question of the change in the estimates of debt.

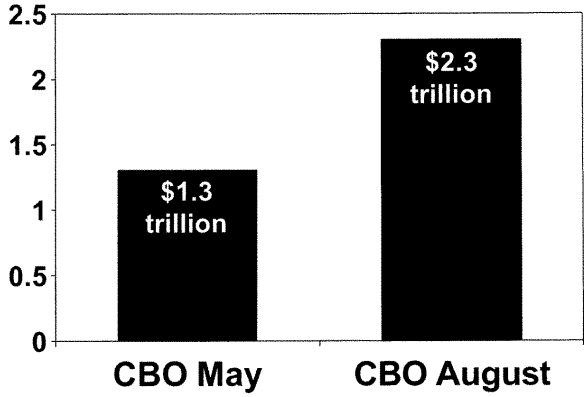
Do we have the first chart there that shows the increase in—yes, that one, that Sue has her hands on.

Mr. CRIPPEN. Senator Hollings probably has it in his pocket, sir. [Laughter.]

Chairman CONRAD. In your report, you indicate that by the end of the year 2006, instead of a publicly held debt of $1.3 trillion, we are going to have a publicly held debt of $2.3 trillion; is that correct?

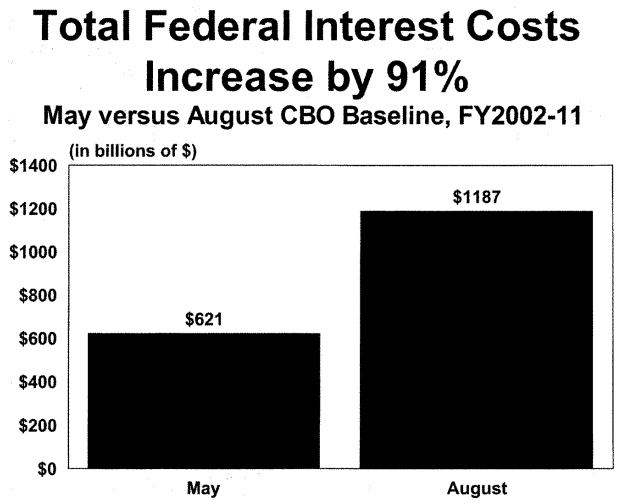
Mr. CRIPPEN. Yes.

Chairman CONRAD. So, you know, the Senator from New Mexico says it is just a short-term thing and just caused by the economy. No, it is not. This is much bigger than a short-term thing. This is a long-term thing, and it has got enormous implications for the United States. Instead of having at the end of 2006 a $1.3 trillion national debt, publicly held debt, we have a $2.3 trillion publicly held debt. What difference does that make? Let us go to the chart that shows what happens to the interest earnings, the chart that you have.



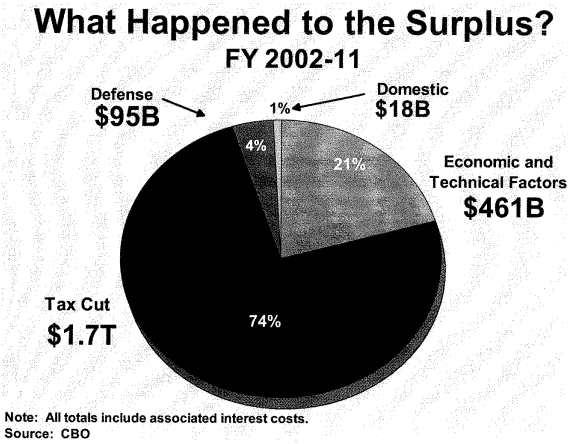
Source: CBO

Federal interest costs go up dramatically. By our calculation, they go up by 91 percent. We go from an interest cost that we were told in May would be $621 billion to an interest cost now of approaching $1.2 trillion. So there are real consequences to the fiscal choices that have been made.



Let us put up the chart that shows what is the cause of the changes. What happened to the surplus, right there. What happened to the surplus? Over the 10 years, what happened to the surplus is largely the tax cut. Seventy-four percent of the reduction is the tax cut and the interest costs associated with that tax cut. We have the economic slowdown is responsible for about 21 percent. Spending, spending as most people would think about it, the new

spending that has been done, not the tax cut that is considered spending, not the interest cost associated with the tax cut, but the spending initiatives that have been passed for defense and for agriculture, which is, by and large, where the money has gone, account for about 5 percent of the reduction in the surplus.



So those who have gone around saying the problem is spending, no, it is not. That is not factually correct. The problem is the size of the tax cut. It is too big. the problem is the economic slowdown. Those are primary problems that we face here. And, you know, it was not that hard to predict because some people were counting on every penny of a 10-year forecast coming true. It was highly unlikely to ever happen. I warned of that repeatedly during our budget discussions, during the debates on the floor, and in fact you warned of it, Mr. Crippen, did you not? Did you not warn us of the uncertainty of a 10-year forecast?

Mr. CRIPPEN. Yes. In fact, we dedicated an entire chapter of our January report to the uncertainty of these kinds of forecasts.

Chairman CONRAD. And very frankly, one of the problems we have got is people did not pay sufficient attention to your warning. You alerted us very clearly. You went out of your way to say to us, "Be careful. Be cautious because, yes, this is the best, most professional forecast we can make at this point, but the truth is these things are unpredictable."

Well, I thank you for your answers to that.

Senator Domenici?

Senator DOMENICI. Director Crippen, I said in my opening remarks I was going to ask you three or four rather pointed and brief questions. Might I ask the first one and ask you did President Bush cause the slowdown?

Mr. CRIPPEN. No. Not in our judgment, no.

Senator DOMENICI. Did anything the Congress do cause the slowdown?

Mr. CRIPPEN. No.

Senator DOMENICI. Will the slowdown have any effect on Social Security benefits now or in the future?

Mr. CRIPPEN. No, it should not.

Senator DOMENICI. What impact will the slowdown have on Social Security's future?

Mr. CRIPPEN. The trust funds will be as the trust funds were. The impact in the long term is that, when my generation retires, if the economy is lower, smaller, slower, it will be harder for my children to pay my benefits.

Senator DOMENICI. I am gathering from what you are saying, the most important thing is that we have a growing economy——

Mr. CRIPPEN. Yes.

Senator DOMENICI [continuing]. In terms of whether or not there will be checks for the Social Security recipients and whether there will have to be any changes in their benefits; is that correct?

Mr. CRIPPEN. Yes. Shall I say it is a fairly widespread understanding, that the more the economy grows, the easier it will be to fund these future benefits.

Senator DOMENICI. On the question of debt reduction, under the revised Congressional Budget Office estimate, what happens to the projection of debt held by the public? Is it true that even with the reestimates, the maximum amount of debt that can be retired still is retired?

Mr. CRIPPEN. Yes. During this decade, the period of this report, as we said, and the chairman's chart showed, we originally said in January we thought it could be retired by around 2006, now it is sometime in 2010. So it is a few years longer. But in this 10-year period, all debt that can be retired will be from these projections.

Senator DOMENICI. So, if we are talking about debt reduction, taxes and the like here today, you are suggesting that, with what you have reestimated with the downturn and with tax policy in place, that we will nonetheless be paying the debt down as much as we can by 2011; is that correct?

Mr. CRIPPEN. Yes.

Senator DOMENICI. Just for the record, I wanted to say the total amount of the tax cut that is being implicitly attacked by the chairman was $1.3 trillion spread out over that number of years. I think that the Carnahan-Daschle-Conrad tax proposal was also $1.2 trillion. In fact, I believe it was. So it equals—it takes as much out, if you are talking about what it costs for a tax cut, as this, as what we passed. Would there be any difference, in any event, as to the Social Security recipients and whether they will get their money or not?

Mr. CRIPPEN. No, there would not be.

Senator DOMENICI. Can you explain one more time to those who are interested why will it have no impact on Social Security benefits and the recipients.

Mr. CRIPPEN. Payroll taxes have been unchanged, either by the President's tax bill or, indeed, the economy, largely. There is some slight change in payroll tax receipts, but not much. Those receipts will be credited to the trust funds. Those trust funds, as has been the case forever, will invest in U.S. securities, and therefore be used any number of ways by the U.S. Government, including paying down the debt, it could be, as it has been in the past, to fund other Government programs, but the point is the trust funds will still hold the same amount of Federal bonds, Treasury bonds, that

it did before the tax bill, before the economy deteriorated, before any of these things we are now talking about.

So the trust fund balances remain roughly unchanged, and of course the benefits remain totally unchanged for current recipients and even those in the near term.

Senator DOMENICI. My last observation, as well as a question, has to do with what should we do now. Actually, by policy, you are not supposed to make recommendations, maybe by past precedent. Might I ask you, if we are looking out there at our country, and we are beginning to get worried about the people that are unemployed, about the people who are getting frightened about others being unemployed by some of our major high-tech industries, including Intel and others, beginning to talk about the fact that this turnaround is not going to be so quick, and it has an international flavor to it, and that, as a matter of fact, it is going to cost us a lot more before we get out of it, what recommendation would you have as to what we should do?

Mr. CRIPPEN. Maybe I can——

Senator DOMENICI. Maybe I should put it this way——

Mr. CRIPPEN. Maybe I can duck your question this way.

Senator DOMENICI. All right. [Laughter.]

Mr. CRIPPEN. For much of what we are talking about here today, that is, the diminishment of the forecasts, particularly the long-term ability to fund the baby boom retirement, clearly, one of the more important things is paying attention to our economy and making sure that we take whatever actions we can, as limited as they may be, to have a robust economy. At that point, we will have more Federal tax revenues, as well as a larger pie to share retirees and working folks. In that vein, any policy that would promote economic growth would seem to be appropriate at this time.

Senator DOMENICI. Is it standard assumption on the part of economists that cutting taxes and increasing spending would have more of a positive impact on the economy than their twin brothers going in the opposite direction, raising taxes or cutting spending?

Mr. CRIPPEN. Certainly, in times of a weakened economy, as we are seeing now, the Keynesian view of the world of increasing demand would be one that would say cut taxes and probably increase Federal spending. This economy has been kept above, and just above, a negative growth rate or a recession because of consumers.

We are seeing a slightly different kind of slowdown here, in which corporations are pulling back on capital investment, but consumers have more than kept their end up. So the tax rebates and anything you can do to help consumer demand, along with the Federal Reserve's obviously active policy in reducing interest rates in the short term, should help sustain the economy.

Senator DOMENICI. I thank you very much.

Chairman CONRAD. We will go now to Senator Corzine who is next and will have 7 minutes—questions, comments, any way you choose to your time.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Director Crippen, I appreciate your testimony and candor about some of these very important issues.

I have tried to study this book that you passed out on the mid-year review, and it is full of charts and all of the other things, but I guess my conclusion is that, if I read it right, there is not a lot of money around for the kinds of things that we have talked about on both sides of the aisle with regard to investing in our future.

It is pretty clear to me that if you look at that 10-year period, that chart that Senator Conrad, the chairman, put up, 74 percent of that is because of the tax cut. There is certainly this issue of a weakening economy which I think needs to be addressed, as Senator Dominici has talked about. It really lays the basis for a series of questions I have.

Do you think, in a weakening economy, since you talked about potential Keynesian kinds of approaches, not that everybody believes they are the appropriate force, that the 8 percent of this so-called tax cut that is put in 2001 and 2002, relative to the overall size of it and relative to the overall size of the economy, really is a meaningful stimulant going forward? I think let us put it in frank terms, $38 billion in rebates, looks like a small pebble in a very large pond, when you are looking at the overall size of this economy. I would just note that only one-third of this tax cut, not taking into consideration the interest expenses, are plowed into the first 5 years.

Does this meet the real test of stimulation? I am sure at the margin it moves around GDP a tenth or two-tenths or three-tenths, but is this a meaningful package for stimulating the economy?

I guess I will stop there, and I will come back.

Mr. CRIPPEN. I think you have obviously framed the question the way that I would answer, which is, indeed, relative to the size of the economy, any 1 year, in fact, of this tax reduction may not be all that significant. Over the 10-year period, we hope and expect the economy will generate something like $150 trillion in economic output. In that context, the whole tax cut, $1 trillion or $1.5 trillion, whatever number you want to use, and so even in that context, the entire amount is pretty small. As we get to the front end of this, as you point out, $38 billion in a $10-trillion economy, in a $2-trillion budget is not much.

I cannot tell you that we have or anybody else has definition of what would or would not move the economy. As you say, marginal effects can help. All I would suggest is that, given that consumers are keeping what is going today alive, anything that is done to help that part probably is useful.

Senator CORZINE. Let me move to some of the assumptions that are built in. One of the more troubling assumptions I have, and a lot of people have expressed concern about, which there is an enormous debate going on, are productivity numbers.

First of all, what is sort of the rule of thumb of looking at 1-percent changes in productivity relative—I think you all have those. I want to make sure that I am using the right metric. I think it is about $800 billion per 1 percent, if I am not mistaken. You can encourage me on that—but there are huge, huge debates about where we stand with regard to new economies and whether productivity growth numbers are real. It is almost the same as we were debating about whether growth was in good stead when we passed this tax cut.

Do you have any—I'd love to know the metric—and then why are you all a little shorter than where we are in Office of Management and Budget and where a number of others might be, which is actually lower, and what are the risks for that over the next 10 years?

Mr. CRIPPEN. Senator, I think you have highlighted the single biggest risk in the forecast; that is, economic growth is a function of roughly two pieces. One is the growth in the work force and one in productivity. We have been a little on the low side on work force, as we see in the census is catching up with some immigrants and others who are working that we did not count before, and so we have increased our estimate of the work force slightly over the next 10 years. We have reduced our estimate of productivity equally slightly, but because we are having less capital investment now, we expect that productivity cannot perform quite as well as we had hoped.

In the larger issue, and my colleagues will look up the metric for us here, but the larger issue surely is that if productivity does not perform the way we hope and anticipate here, then, clearly, the Federal budget will not look nearly as good, nor the economy. I would say we have adopted some, perhaps not all, of what some new-economy proponents would advocate; that is, we are going to be at about 2.5 percent of labor productivity over the next 10 years, and they would say 3 or 3.5 may be more like it, but the truth is that we waited several years as an institution to kind of let productivity hit us over the head, and we kept saying deficits, deficits, and the economy said surpluses. After 3 or 4 years of, frankly, underestimating productivity by pretty big amounts, we decided that we would adopt some of the last 4 years of history.

I would say, and I think, actually, I brought that chart because I thought about this a little bit in anticipation of the hearing, what we have adopted for productivity is not so out of line of some of the better times, of course, that the U.S. had, but it is not, if you will, wildly optimistic relative to history or the recent past.

So, as I started out saying, and as you I think suggested, the rate of productivity growth is critical to these forecasts and probably the most unknown piece, in some ways, and certainly highly debated of our entire forecast.

Senator CORZINE. So, if we go back to the baseline that economic growth is the most important issue to deal with in resolving a lot of these long-run problems, it seems like we are potentially misplaced in the structure of our tax cut for stimulative purposes, and we are making a big bet on productivity growth, which is, at least by some comparisons to other points in history, fairly substantially outside the range of what is expected or what has been our recent history.

Does that give you pause that we ought to think about restructuring in some form, not repealing, but restructuring of tax cuts that would be more stimulative to the economy, and therefore economic growth and the size of the economy might be in better shape to meet some of these both priorities that have been talked about by both sides of the aisle and also our long-term needs in Social Security and Medicare?

Mr. CRIPPEN. You are going to tempt me to say things I should not, and therefore will not.

Let me return to a safer harbor where I was before, which is, in many ways, whether we are talking about Social Security Trust Funds or the future over the next 10 years and our outlooks, what is most important to those is continuing economy. In most ways, the only real trust fund for my generation's retirement is the size of the economy. We cannot stuff the money away. We cannot invest it in a way that would do anything other than make the economy perform better or worse.

So I think that the real debate that you see up here, Senator, is that what we need to talk about are policies that promote growth, whether it is stimulus in the short run or productivity in the long run, and that, at least from the point of view of growing the economy, is the debate we need to have. Now whether that means restructuring the tax code, I leave to you, at least for the moment.

Senator CORZINE. Thank you.

Chairman CONRAD. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

I want to direct your attention to something I am sure you already know, but a couple charts. One that reminds all of us that before the tax bill was passed, taxes were at the highest level in the history of our country, at least for the period of time since World War II, with 20.6 percent of GDP. And the only other times that they were much higher is during the Vietnam War—not much higher, but higher than the normal 18.5 to 19.5 percent of GDP was during the Vietnam War and during the inflations of the late 1970's.[15]

And then a second chart, I want to show you to remind everybody that if you take all sources of income into the Federal Treasury, you find, over the last 10 years, a very steady rate of income to the Federal Treasury, with hardly any growth of all levels of taxation except for the income tax. Since 1995/1996, we have seen a 50-percent rise in income tax coming into the Federal Treasury, from about 7.5 percent of GDP to about 10.5 percent of GDP.[16]

Now, getting to some questions on the issue of taxes and tax cuts, I want to say that I disagree with those critics that think, in fact, the tax cut was wrong. I think it was needed to correct the problem of overtaxation. You can get taxes so high that it does economic harm.

I would like to get from you a little bit of historical perspective on this recently enacted bipartisan tax relief legislation, and I would refer to Page 3 of the August CBO budget outlook document. In that table, CBO provided projections of individual income taxes as a percentage of GDP. According to CBO, over the next 10 years, individual income taxes will still average very high at 9.5 percent of GDP.

Now, if you turn to Table F–7, Page 145 of the January 2001 baseline, when we look back over the period of 1962 through 2000, individual income taxes exceeded 9.5 percent only in those late years that I have just referred to. As a matter of fact, in addition to those years, over the 38-year period, individual income taxes

[15] CHART NOT AVAILABLE AT PRESS TIME.
[16] CHART NOT AVAILABLE AT PRESS TIME.

took 9 percent or more of GDP only in the years 1969, 1981, and 1982.

So, Director Crippen, is it not true that, even after the largest tax cut in a generation, the level of individual income taxes as a percentage of GDP, in terms of the last 40 years, will remain at a relatively high level?

Mr. CRIPPEN. It would appear, Senator, both individual income taxes and then, in turn, the total tax revenue of the Federal Government will remain at high levels.

Senator GRASSLEY. On another point, and referring to the critics of the recently enacted bipartisan tax relief passed and charging that it constitutes fiscal mismanagement, I, for one, believe that if you are going to accuse someone of mismanagement, then I would like to refer to the records of the people saying that.

So I would take a look at the record for the fiscal year and for fiscal year 2002. On March 27, 2001, the Senate Democratic leadership introduced legislation entitled, "The Economic Stimulus Tax Act of 2001." That leadership argued that this measure should be expedited and President Bush sign it. This tax relief package was scored as losing about $100 billion by the Joint Committee on Taxation. That revenue loss compares with a revenue loss of $112 billion for the bipartisan tax relief package.

Furthermore, 48 out of 49 people on the other side of the aisle, including all of the Democratic members of this committee, voted for the Democratic alternative tax package, which scored at roughly $100 billion when tax relief was considered by the Senate.

Now, Director Crippen, when we are considering the record of competing tax relief proposals and the fiscal management of the fiscal years 2001 and 2002, is it not fair to say that there was not much of a difference between the Senate Democratic leadership position and the bipartisan tax relief package that was enacted—$12 billion, to be exact?

Mr. CRIPPEN. I have to confess, Senator—I will rely on your numbers—we did not ever estimate or score the Democratic, at that time, amendment to the floor bill. The numbers that I am aware of are similar to those that you have stated, but we did not independently score it. So it is entirely likely—I will rely on your numbers—and the chairman knows what his proposal was as well.

Senator GRASSLEY. I assume, though, you would accept the judgment of the Joint Committee on Taxation on issues like that.

Mr. CRIPPEN. We do, and we must.

Senator GRASSLEY. OK. Director Crippen, now that we have seen that most of the members of this committee agreed on the size of a tax cut stimulus for the fiscal year 2001 and 2002, I would like to look at where they disagree, that is, over the long term. As I stated before, those who oppose the bipartisan tax relief package seemed concerned about the long-term impact of the across-the-board rate reductions, even though individual taxes as a percentage of GDP remain at high levels. There is opposition to long-term tax reduction because of the effect on the Federal tax base.

In the August update, the one you just gave last month, Boxes 2 and 3, Pages 34 and 35, CBO discusses the stimulative impact of the bipartisan tax relief legislation. CBO, albeit with some caveats, concludes that if left in place, the tax cuts, especially the mar-

ginal rate reduction, can provide long-term incentive for work and savings. The Finance Committee heard much of the same thing from witnesses during the spring.

So, Dr. Crippen, considering the stimulative effect, both short term and long term of the lower marginal income tax rates, can you see any reason why we should reverse course and repeal those marginal rate reductions? Would not repeal of those rate reductions result in slowing in an already slowly growing economy?

Mr. CRIPPEN. If I could, I would like to answer about three questions. That will make it easier for me, at least.

Senator GRASSLEY. OK.

Mr. CRIPPEN. One of them is that the current economic slowdown is not affected, I think, one way or another by the marginal rate reductions. They are very small in these first few years. In fact, I think the marginal rate reductions amount to something like $3- or $4 billion in 2002, as I recall. So it is really in the last half of this decade that those come into play, and so whether you change them now will probably have not much effect on either revenues or, therefore, the economy.

In the long run, as you have cited from our box, there are parts of the tax bill that most economists would think would help stimulate economic growth—the marginal rate reductions being one of them. There are other pieces, however, likewise cited here, that might deter economic growth as a result of the tax bill. It really depends critically upon your assumptions about where does the money come from.

If the tax cut comes from assumed more Government spending in ways that are not productive, then it could be, on net, a boon to economic growth over the long run. If, however, those tax cuts are coming from or have to be replaced later on, it could be, in net, a small deterrent to economic growth. So there are some big assumptions one has to make that we are not in a position to make to come to an ultimate conclusion, but clearly taken piece-by-piece, there are some parts of the tax bill most economists would agree could help economic growth, others that might deter it.

On net, though, I would say, Senator, in part because just the size of the whole tax package is relatively small, it is 1 percent of GDP over the 10 years, any effects we see on the economy, plus, minus or otherwise, would be quite small.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and thank you for holding this very, very important hearing.

If I might first respond to our esteemed leader on the Finance Committee concerning the tax cut for just a moment. As one person who supported a version of a tax cut of $1.2 billion, I would just like to indicate why I did, and I know many of my colleagues did.

No. 1, it was additional stimulus that the chairman talked about;

No. 2, it cut every marginal rate, including the one that 70 percent of the people are in, which is the 15-percent rate. So our tax cut focused more for middle-class Americans, which I would gladly do again as we focus on tax-cut policy;

But, third, and in my mind most important, what I supported had a trigger in it. It would not mean that we would be here today

talking about the possibility of dipping into Social Security and Medicare because the trigger, which was originally put forward by Senator Bayh, Senator Snowe, and myself, and others indicated that the policy of the Congress would be that any phased-in tax cut, any next step would be held in abeyance, if it touched Medicare or Social Security, until enough revenue was there for us to be able to make the next step.

So there were substantial differences, although the numbers may have sounded fairly close. I would argue yet today that it is time to revisit, Mr. Chairman, the idea of a trigger to guarantee that we do not touch Medicare and Social Security.

On the point of the big surplus, Mr. Crippen, and thank you so much for the work of you and your staff, you have a thankless job, and we appreciate, whether we at any given point like what you say, it is important that you are providing us accurate information from a professional staff. So we very much appreciate that.

We have heard a lot, I hear a lot of numbers about the largest surpluses in many, many years and so on. Is it not true that we are talking about large Social Security and Medicare Trust Fund surpluses; is that correct, Mr. Crippen?

Mr. CRIPPEN. Yes, and over the next 5 years, it is almost exclusively Social Security Trust Fund surpluses. It is only in the latter half of the decade that we see on-budget surpluses redeveloping of any amount.

Senator STABENOW. So what we are seeing right now is hard-working efforts of Americans who have been paying Social Security taxes, paying into Medicare Trust Fund, and those are being counted as large surpluses right now when, in fact, those are Social Security funds and Medicare funds.

Mr. CRIPPEN. Yes, that is true on both scores. We have traditionally, both in terms of the budget and the economy, of course, added everything together. The Federal Government's activities at large, how much we take in, how much we spend. So the distinctions between trust fund revenues and others are less important to us, certainly, than they are to you, ultimately.

Senator STABENOW. Sure. Well, I understand that a number of years ago the unified budget approach was put together and that there was an effort to put together non-Social Security and Medicare spending along with the dollars coming in from Medicare and Social Security. But, in fact, as you have indicated in your report, we will be, in fact, dipping into or however we choose to say it, we will be spending $9 billion of Social Security Trust Funds in order to be able to balance this budget. And, in fact, if we were to go further, if we did not include Medicare, it would be even more; is that not correct?

Mr. CRIPPEN. Yes.

Senator STABENOW. So we are spending Medicare to the tune of over $30 billion, and we are spending $9 billion of Social Security, at this point.

Mr. CRIPPEN. Yes. Using your terms, yes, that is correct.

Senator STABENOW. Is it not also true, and I appreciated in your report you have indicated that about two-thirds of the loss in surpluses, about two-thirds of the decrease in surplus results from new legislation, primarily the tax cuts.

Mr. CRIPPEN. Correct.

Senator STABENOW. One-third comes from a weaker economy and other factors. Would you agree that the legislative decisions that the Congress has made has made it more difficult in the future to pay Social Security and Medicare to those of us who are baby boomers that are going to be retiring beyond 10 years?

Mr. CRIPPEN. It is not at all clear, Senator, because what in the main will make it easier or harder for our kids to pay our retirement is going to be the size of the economy. We will be consuming what our children produce at the time, and there is no good way to really save, in the way that you and I might think of it, to save money at the Federal level for that purpose; rather, the economy is going to be largely the trust fund.

So however these fund are used, if they are thought about as being down the debt, for example, that may help national savings, which might grow the economy. That could be a good thing and would help ultimately our children in their obligation to us.

Senator STABENOW. So, if we are using it to pay down the debt, we have more capacity then, we potentially can help interest rates continue to go down, we have more capacity to stimulate savings and so on. If we are spending it on other purposes, as, in fact, we are, and it appears that there is support to continue to do, we are making it then more difficult.

Mr. CRIPPEN. It would depend, Senator, on what you were spending it for and how you viewed those programs, obviously. For example, if you were spending it on, say, education, which might make it easier for our children both to produce a better economy and to support us, that might be something that would be a pro-growth policy you would deem appropriate. I am making that up, and it is not my opinion, but it would depend largely on how you use those funds.

Senator STABENOW. Sure, and I would agree that——

Mr. CRIPPEN. You may have programs that you would like and that would help economic growth.

Senator STABENOW. And I would agree that education certainly is an important part of the investment to increase labor productivity and increase the economy. But, clearly, we are in a situation where we are not adding to the strength of Social Security and Medicare during the current situation, certainly, it would appear from everything that is seen in your report and your numbers.

If I might just go now specifically to Medicare. There has been a lot of debate about is there a Medicare Trust Fund, where are the dollars going on and so on. Your report indicates that Medicare is being spent, in fact, at a faster rate than Social Security in the current baseline, as we look at the situation.

When we look at the fact that on Page 1 of Chapter 1, in Table 1.1, you list a Medicare Hospital Insurance Surplus of $206 billion from 2002 to 2006. Is it not true that the Federal Government will spend much of this on other programs as it currently appears?

Mr. CRIPPEN. Let me take 10 seconds back and say that for this trust fund and others as well, the terms used are correct, certainly, that this money will be used openly to fund other programs. But I want to note again that the trust fund itself will look the same; that is to say, the payroll taxes dedicated to the HI fund will be

accounted for and attributed to that trust fund. The trust fund will invest in U.S. securities. That money will go into the U.S. Treasury and will be used for other things. What for is, of course, not clear. It is all mixed together.

So I want to say, on behalf of certainly current beneficiaries, but even those who are paying in, the trust fund looks the same no matter what happens with this accounting system.

Senator STABENOW. And I agree that we certainly do not want to cause concern of current recipients, that there is the trust fund. Although I have to say that when your counterpart, the director of OMB was sitting there, he indicated there was not a Medicare Trust Fund. So it is a very different view. For the first time in 30 years, they are using a whole new accounting system which concerns me because is it not true that while the receipts are going into the trust fund, there is a trust fund that the solvency of the trust fund, as you report it, is affected by whether or not we are using it for other spending programs?

Mr. CRIPPEN. The solvency itself would not be affected because we will record, as the Treasury and the rest of Government will, these receipts as coming into the trust fund whether or not on the other side it looks like they might be used for other programs. So that the solvency itself, solvency dates will stay the same.

Again, the question becomes, Senator, more importantly, what shape is the economy in, in the future, so that when those obligations are due in the form, in the first instance, of Treasury bonds and debt, how easy it is to cash those in. How much do our children have to give us, literally speaking, when what they are producing, either through the tax system or elsewhere?

Senator STABENOW. That is really another way of saying—what I am referring to, in terms of solvency, is the fact that if those receipts, if those dollars are not credited, they are unavailable, we create debt in order to meet those obligations.

Mr. CRIPPEN. Yes.

Senator STABENOW. Or there are other policy changes that have to be made.

Mr. CRIPPEN. Correct.

Chairman CONRAD. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you. Dr. Crippen, thank you.

Would you explain Part B of Medicare to this committee. My question is based partly on the Senator from Michigan's line of questioning, but we seem to act like there is no such thing as Part B to Medicare. Would you explain how Part B is financed.

Mr. CRIPPEN. I will certainly try. Senator Frist probably has a better idea, since he was on the other end of this.

Senator HAGEL. We may ask him.

Mr. CRIPPEN. Good.

Senator HAGEL. But right now we are asking you.

Mr. CRIPPEN. OK. There are, as you suggested, at least two parts to Medicare. There is also a Part C, as well, but in point here, Parts A and B. A is the hospital trust fund or hospital part of the program that pays for those admissions. Part B pays largely for physician costs and visits. In one of the grand compromises, when

Medicare was passed in 1965, these two pieces were established with a little different financing.

Part A, in the main, is financed by payroll taxes, a small amount on everybody's income, payroll, wage income; and Part B is supported 25 percent now by the recipients. They pay a premium equal to 25 percent. That, originally, by the way, in the history of the program, was 50 percent. It was designed to be half of the program paid by beneficiaries. The other half, and now three-quarters, is paid by the general fund, by taxpayers, you and I, and anyone else who happens to be working in general funds.

Senator HAGEL. Thank you. How much money is coming out of the general funds to cover that three-quarters of the amount for Part B?

Mr. CRIPPEN. I am going to rely on my colleagues to make sure I get that right. It is a significant amount. They will give me a number here in a moment. One thing I wanted——

Senator HAGEL. It is in the tens of billions.

Mr. CRIPPEN. Yes.

Senator HAGEL. If you took that amount and applied that to Part A so we had a complete accounting, would there, in fact, be a Part A surplus?

Mr. CRIPPEN. If you add Part A and B together, no, the income is not enough on payroll taxes to cover the total of the spending.

Senator HAGEL. So, in fact, the total for Medicare, there is no surplus, if you take all three.

Mr. CRIPPEN. If you add those pieces together. One thing I would say, I mean, there are separate trust funds, and we do account for them separately.

A change that was made in 1997 may be suggestive of the kind of thing that you are thinking about, and that is the home health care provisions were generally funded by hospital insurance by Part A. They were transferred, in 1997, to Part B. So it shows, and therefore of course the expenditures with them became more on-budget or became more general-revenue financed, only one-quarter by beneficiaries, and not out of the payroll tax. So the benefits are roughly the same, but were transferred from one part of the system to the other.

Senator HAGEL. So now we are taking Part B to pay for what previously had been paid for in the so-called trust fund of Medicare Part A.

Mr. CRIPPEN. Right.

Senator HAGEL. And you have a number in front of you. I understand your colleagues just gave you a number.

Mr. CRIPPEN. Federal contributions, $70 billion in 2001.

Senator HAGEL. That is a significant amount of money. I think most of the American public may not be aware of the fact that that amount of money comes out of the general Treasury to finance that part of Medicare. I just want to make sure we had that on the record and it was clear. Thank you.

Your report, Dr. Crippen, talks about estimating growth revenue over the next 10 years, and I believe at about 3 percent. Now that is below the 3.8-percent trend from 1961 through 2001. I know we are not in a particularly stimulating time economically, but can you

explain why your revenue growth would not match what we have seen over the last 40 years.

Mr. CRIPPEN. There are probably two major reasons: One, of course, it gets back into baselines and how you measure them, but there were a lot of changes in legislation over that period of time—some tax increases, some reductions. Probably the single biggest change, however, that factors into the two numbers you cite, was that in the 1980's the marginal tax brackets became indexed. Prior to then they were not. And so that would give you, on the natural, as you know, more bracket creep before the indexation occurred, and therefore higher rates of taxation, in some ways, and growth, especially with high inflation as we had in the 1970's.

So, prior to indexation, the growth rate was probably greater than 3.8. It was 4-something—I am making it up, but somewhere like that—and since indexation has been lower. So the biggest single change in that time period that would suggest 3 percent is closer than 3.8 is the indexation that occurred in the 1980's.

Senator HAGEL. Thank you. May I ask a question about defense spending?

I noted in your figures that defense spending, since I think 1985, has been reduced, and in some cases rather dramatically, when almost all other civilian programs' spending has increased, in some cases dramatically. As you know, we are going to have a very stimulating debate up here over the next 2 months about defense spending. Would you care to offer any observation on those numbers, especially coming from your perspective on projections and what can be sustained and anything that you would like to add?

Mr. CRIPPEN. We have, Senator, on the record, if you will, from the past year or so, a number of studies that we have done that are partly responsive to your question; that is, for example, last September, we estimated that in order to maintain today's force structure as it exists, it would take approximately another $50 billion a year every year for the next 10 years to sustain it.

That begs the larger question, however, and presumably part of your upcoming debate, in what is the appropriate force structure. One has to start first in a place that we are certainly not qualified to, which is what is the correct national security strategy? How much of that is defense? How much is diplomacy? Given the defense portion of that strategy, what is the force structure necessary to support it and sustain it, and then what does that force structure cost?

It is only in the latter question that we are probably capable of helping give you some insight as to what inputs cost. But until you answer those important first questions, it is almost impossible to say what is the appropriate level of defense spending, one way or another.

Senator HAGEL. It is a bit dramatic to look at those numbers as you have laid them out because I am not sure most of the people in this country have any appreciation how dramatically we have cut defense, and at the same time, to your point, ask our armed forces and force structure to do more. That will be something that you will be involved in as well.

My time is up, Dr. Crippen. I appreciate your answers very much. Thank you.

Chairman CONRAD. Senator Nelson.

Senator NELSON. It is exactly the reason that I would like to help Senator Hagel on defense spending for 2002, 2003 and years beyond that I find myself in a quandary. And we discussed this in this committee in January, and February and March, and we said that the figures on the he projection of the surplus was too robust, that we ought to be more conservative in our estimations of what the surplus was going to be in figuring how much, over the 10-year period, we were going to use of that surplus in a tax cut.

What I had argued at the time, because there were certain things that we were going to need to invest more heavily in, such as defense, such as education, that we ought to be conservative in our approach and do not use up all of the surplus that was going to diminish, and surely it did, with the tax cut, but rather be more conservative in our approach and set aside not only amounts for new investment, such as in defense and education, but set aside some for what you might call a rainy day fund and let that pour over into the Social Security Trust Fund for the ultimate day when the baby boomers start retiring and there is more of a demand on that trust fund, given what is coming in, in tax revenue.

So there have been a lot of points scored around this table today on various things like partisan points, and budgetary points and so forth, but the truth is, and this would be a question I would ask the CBO director, if we had taken part of that projected surplus and set it aside so that let us say it was an amount in the range of $750 billion over the 10-year period to, say, a trillion, set that aside so that it would enure to the benefit of the Social Security Trust Fund, over that 10-year period, as compared to where we find ourselves today, what would our budgetary outlook look like?

Mr. CRIPPEN. I do not think I can answer that, Senator, to your satisfaction. Let me give it a try, and then maybe we can work back and forth a bit.

It depend, obviously, on what years you took it from and lots of things like that, but just in the main we have seen the economic downturn, if you will, in these forecasts take about $480- or $490 billion out. So your $750 billion would certainly leave a positive amount if you took all of the economic changes in it.

It would not do anything, at least from, I think, budgetary and economic point of view for, say, Social Security or Medicare because those trust funds are, will, and still be counted, both for the financing they are getting, as well as the bonds that are created for them, and so on. Indeed, much of, I mean, this forecasts suggests that, in the next fiscal year, we will be a few dollars on one side of this line or another, relatively speaking, so that the Social Security surpluses, in the main, are still going to go to debt reduction in our forecast.

As I told a group not long ago, I get lost in all of the zeroes on these numbers, but if you cut a bunch of the zeroes off, we are talking here, at least the next year, about $8 out of $2,000. Again, these are, both the line and which side you are on, are estimates on our part. So that, in and of itself, is probably not something to be overly concerned about from a budgetary or economic point of view. It is, as the chairman and others have said, what you think the future looks like and the implications for the future.

So I guess part of my answer to your question is that even with a set-aside, we probably would not change the outlook much for certainly the trust funds of Social Security and Medicare. It would have been a sufficient amount that you cite to absorb the reduction, certainly, from the economy that we have just talked about, and in that sense would make the future look better.

Senator NELSON. As well as accelerating the paying down of the national debt.

Mr. CRIPPEN. Yes.

Senator NELSON. OK. Then that leads me then to ponder, Mr. Chairman, what we are going to do about the 2002 budget. Mr. Chairman, we are facing the fact that we now have a request by the President for an additional $18 billion in budget over and above what is projected on defense into the year 2002, and that is going to have to come from somewhere if we grant that.

As I read your figures, there is just about a balance, with regard to the Social Security Trust Fund, some maybe $2 billion plus——

Mr. CRIPPEN. Correct.

Senator NELSON. So, forgetting education, forgetting all of these other things that we are going to have to confront about investment, if we just increase the Defense Department budget in the year 2002, the net result in the projections is that it is going to have to dip into the Social Security Trust Fund.

Mr. CRIPPEN. Yes. By your terms, that is right.

Senator NELSON. Well, that puts a whole bunch of us, as we say in the South, in a heck of a fix because we have promised not to invade the Social Security Trust Fund, and yet we clearly have the Nation's needs, with regard to defense, education, et cetera, and so forth.

Mr. Chairman, do you have any guidance?

Chairman CONRAD. We are in a heck of a fix, all of us.

No question about it.

Senator NELSON. Thank you, Mr. Chairman. We will contemplate the fix together, all of us.

Chairman CONRAD. Senator Frist.

Senator FRIST. Thank you, Mr. Chairman. Dr. Crippen, thank you for joining us. The debate is clearly focused a lot on the budget and the economy, and having this hearing early on, Mr. Chairman, I think is a big help, so we can get some of the basic questions outlined and continue the discussion in a way that will allow us to address the important priorities of this Nation, one of which is prescription drugs and Medicare, and we talked a little bit about that today. Let me ask a brief question. It is the solvency of the Part A Trust Fund in any way affected by the tax relief package of the President of the United States?

Mr. CRIPPEN. No.

Senator FRIST. Is the solvency of the Social Security Trust Fund affected by the tax relief package of the President of the United States?

Mr. CRIPPEN. No.

Senator FRIST. When we say solvency, we very quickly—you can extend that further. Can we extend it? The solvency is not affected and thus the benefits, the obligation for benefits—I am thinking of Medicare to reassure the American people in part, but also to help

us all understand the difference between the tax relief package and the budgeting process and the economy. Does that mean that the benefits that seniors and individuals with disabilities can expect under Medicare and Social Security are unaffected by the tax relief package?

Mr. CRIPPEN. That is correct, Senator.

Senator FRIST. The issue of the $533 billion that the Chairman mentioned is one that, again, I appreciate him mentioning, because it is something we have to understand. The budgeting process is very different, and the resolutions we pass are very different than what we have to translate in terms of appropriation and in terms of policy, and we so need to understand that. Everybody needs to understand that as we go forward.

I think the presentation here made things a lot clearer to me. But looking through some of the numbers and comparing CBO to OMB, one of the major differences between the baseline, which, again, I think your remarks made very clear as to what the baseline really means, between CBO and OMB, is the Medicare program if you actually look at the numbers. Over the next 10 years, the CBO estimates total Medicare spending to be nearly $229 billion higher than the amount estimated by OMB.

The numbers—just looking at it, both CBO and OMB projected mandatory Medicare spending in 2001 will total approximately $214 billion, but OMB projects a slower rate of growth over the following 10 years. OMB projects an annual rate of growth of 6.1 percent and I believe that you, or CBO, projected growth of 7.5 percent. Because policies, which when we enter prescription drugs, will and should, I believe, affect overall growth. Could you, just as background, explain the difference between your assumptions, or the CBO assumptions and the OMB assumptions, because it is very dramatic when you look at that it amounts to over $200 billion over a 10-year period?

Mr. CRIPPEN. As you noted, Senator, the differences are not dramatic when you look at just the two growth rates. There does not appear to be, but over 10 years one-and-a-half points make a lot difference in a $200 billion program. The difference is an assumption, and that is, we look a ways back in history and note that Medicare has grown much more quickly than the economy for much of its history. We have had a couple of recent years were that is not true, but in the main it is. So we are assuming that Medicare will grow faster than the economy on a per capita basis for the foreseeable future, certainly is 10 years.

OMB assumes the same thing. They assume about 1 percent faster than the economy. We assume, as you pointed out, one-and-a-half points more than that, between two and 3 percent. The HCFA actuaries used to not assume any. They now assume 1 percent. So we are a little higher than both the HCFA actuaries and OMB, but certainly lower than much of history. I do not know if that has been responsive, but we are assuming that Medicare is going to grow a little faster, two-to-three percent faster, than the economy grows.

Senator FRIST. I think it is important for us to understand the assumptions, which in one ear, all of these do not look like very much, but cumulatively, they have a huge impact. I would also like

to say, because there are a lot of people on this committee who had been in the private sector before coming to the U.S. Senate, that the relationship between what is going on in the private sector in health care and Medicare, we do not all fully understand, but there is a relationship there.

If there is one thing that I learned over the recess, it is that the decade of the 1990's is gone in terms of a slower growth in health care today, and that we, for whatever reason, and I cannot explain it, are entering a period of time when all the underlying dynamics are pushing cost up. I do not know what the right—I have not really studied it—the right assumption is, but there is something different now in health care than it was 2 years ago, 4 years ago, 6 years ago and 10 years ago, that is driving, internally, these costs of health care as they go forward.

I say all that as a little bit of a preface to say that to do prescription drugs right, I have always argued in the past that we do have to modernize Medicare at the same time, that that linkage is critically important as we go forward for all sorts of reasons, really just because prescription drugs are a part of health care. But in addition to that, in your assumptions as you predict these baselines, the modernization component, or do you score things in such a way with your staff, that modernization can give the same benefits, but over a period of time have less growth—and, again, it is important to me, because we know that one of the problems of Medicare is this assumption of growth, internally driven in many ways by the elements of modernization that would not affect the benefits in a negative way—that you would use and your staff would score in order to lower that baseline overtime?

Mr. CRIPPEN. We do not make, Senator, as you know, policy proposals. We do, however, as you and I have discussed before and others of our staff, have to make some assumptions as we score real legislation. So the most immediate example I can give you is how we look at pharmaceutical benefit outside of Medicare, but you might assume some of those same assumptions would apply to the program at-large. And that is, if there is some element of more than one group offering a benefit, competition of some sense. It does not necessarily have to be purely private as we think about it, but certainly private competition, and how much that competition can adjust benefits up or down to match patient needs and requirements, how they can adjust, therefore, premiums as well.

Utilization controls and other things are very important as to how much a drug benefit would cost, not only in the first instance, but more importantly how fast its cost might grow. So those same kinds of elements could be brought to bear, presumably in the Medicare program, but it is a very complicated—I do not need to tell you—system of how we try to pay for these procedures. As you and I have also discussed, we have not spent enough time really focusing on where these dollars are going and what they are buying.

We know they are going to hospitals and doctors. Presumably they are buying good health care, but we do not know for what conditions. We do not know what the diseases are, the profiles. We do not know what the protocols are that are being applied in different parts of the country—there is a lot we do not know that you, as

a physician, would certainly want to know when you are thinking about a major reform of this program. Hopefully, we can begin to find some of those things out that would suggest ways not only to save money, but, perhaps, to better offer the benefit or in a way that gives you a better health outcome.

These things are not mutually exclusive, and I think that is what you were asking. Your question of can we provide the same benefit and spend less? Probably, but one needs to know a lot more about what we are buying now, not the benefit structure, not the 50 percent co-pay, not the hospitalization plus or minus 3 days. What we need to know is what we are buying for health care and that I think we do not know.

Senator FRIST. Mr. Chairman, thank you. I do not want to merge policy with budgeting and further discussions now, but as you look at what the big differences are in OMB and CBO, which we keep coming back to, very much is in the Medicare, which again explains a lot of the effect overall and those assumptions of growth over time. We may have an opportunity in all of this to address that head on.

Chairman CONRAD. Senator Clinton.

Senator CLINTON. Thank you, Mr. Chairman. Thank you for holding this hearing and thank you very much with your entire team for being here with us. I was particularly interested in the last exchange with Senator Frist about the costs of health care, something that I have given a lot of thought to over the years. I think it is absolutely appropriate to view what is happening now as—both in the private and public systems—as posing increasing stresses to the financial capacity of both businesses and government to afford health care.

I was interested particularly in your comment that we do not have enough information. I certainly, for one, believe, Mr. Chairman, we ought to do whatever we can to acquire the information that CBO and others would need to advise us, so that we were making decisions that were based on the best possible information. I would hope that is something that we could look to in the future.

I also wanted to just make sure I understood the other point that Senator Frist was making with you about solvency, because I do think that the public and all of us need to understand what it is we are concerned about. Is it fair to say that even though the existing system, as you described in your response to those questions with respect to Medicare and Social Security are solvent at this time, that the potential of any Social Security reform that would cause us to incur transitional costs would be an additional expense that you have not yet taken into account? I have heard some of the Social Security reform proposals with the transition costs ranging from $1 to $3 trillion, depending upon the shape of the proposal. Are those in your 10-year projections?

Mr. CRIPPEN. None of the transition costs you referred to would be in our projections. In the main, it is current law and the solvency of the Social Security Trust Funds are estimated by the actuaries, which I believe now is to 2038 for Social Security, much closer for health insurance. What we were addressing before was, has anything affected them this year, and the answer is no. Those solvency dates remain roughly where they were.

Senator CLINTON. The concern that many of us on this committee have spoken about in previous hearings really is focused on the impending demographic effects of the retirement and increasing medical demands of the so-called baby boomer generation, and those are expected to begin making claims on the system, I think, in 2011; so that the projections that we are talking about really have more to do with whether or not our country is going to be in strong fiscal condition to deal with future demands that we believe, in a responsible way, we should be prepared for.

Similarly, with respect to the solvency of Medicare, that does not include a prescription drug benefit because that is not part of the Medicare program at this time; is that correct?

Mr. CRIPPEN. That is correct.

Senator CLINTON. I am also very interested in Senator Hagel's concerns about defense, which I think all of us share, and Senator Nelson also spoke to that. I have not seen the projections that CBO made about the $50 billion annual spending with respect to maintaining existing force levels, and could I get a copy of that? I would like to see what that is based on and how it is derived.

Mr. CRIPPEN. Certainly.

Senator CLINTON. But with respect to defense, the request that the administration has made, the $18 billion request, that is also not in your existing analysis; is that right?

Mr. CRIPPEN. That is right.

Senator CLINTON. Nor is the very important piece of legislation known as the education bill, and the potential costs going forward, also included; is that right?

Mr. CRIPPEN. It is not included.

Senator CLINTON. I, for one, am a very strong supporter of Senator Hagel's, I think, brilliant idea to make the Federal Government do what it said it would do, which was to pay for special education, which is something that I hear about everywhere that I travel in New York, because of the increasing cost. But forward-looking special education payments that would be part of the Federal Government assuming the responsibility for special ed, which we should have when we started this program 25 years ago, that is not in your assessment?

Mr. CRIPPEN. It is not.

Senator CLINTON. Similarly, the bill that is working its way through the House and will someday, I suppose, come to the floor of the Senate, with respect to energy, the kind of tax credits and other issues that will be addressed in meeting the energy crisis, that may have abated some, but not disappeared; those figures are not in your projections?

Mr. CRIPPEN. They are not.

Senator CLINTON. Also, with respect to additional tax reform measures, many of us are concerned about the alternative minimum tax, which we know will drive many millions of taxpayers into a higher bracket, thereby wiping away whatever rate reform they might have enjoyed. Those are not in your figures; are they?

Senator CLINTON. No. Beyond what was provided for in the tax bill, no.

Senator CLINTON. Many of the tax bill's provisions do not kick in until next year at the earliest and 2010 at the latest; is that right?

Mr. CRIPPEN. Yes, some of them do not—for example, estate tax repeal does not occur until the end of the period—and then everything is set in legislation to expire in 2011.

Senator CLINTON. You have referred several times in your testimony to the need for the economy to continue growing. Has the CBO done any work over the last 15 to 20 years about those factors which contribute to a strong economy?

Mr. CRIPPEN. Not quite the way I suspect would be useful for you. We are better looking at the past than we are looking at the future, so we have, of course, done some examination of what has happened. Most recently, in these last four or 5 years, the rapid economic growth, the good economy, was due to unforeseen increases in productivity, and as Senator Corzine suggested earlier today, the question for us is will those productivity increases continue? Clearly, at the moment they are not, but then always in a downturn, they diminish. The question is will they come back with the economy, and we think they will, at least some.

So what has caused, certainly in the recent past, good economic growth has been good productivity. There are other things that you might think help that, whether it is tax policy, as Senator Corzine was suggesting, whether it is education or other things, but there are really, when it comes down to it, Senator, only two pieces to economic growth, in a simplistic way; one is the growth in labor force and the other is growth in productivity. So those are the two policies or the two ultimate goals you want to pursue with policies.

Senator CLINTON. Well, that is right. What I am concerned about is, given where we are right now, whether there are steps that could do either of those effectively, with respect to labor force growth and participation in productivity increases, and I know that is not your province. That is more of a policy issue. But I think many of us are concerned that we do not have an economic plan. We have had a tax cut plan, but we do not have an economic plan; and looking at what factors could be enhanced or motivated, in order to increase labor and productivity numbers, is something that, obviously, we take very seriously.

There are many of us who think that if you are looking at the government budget situation right now, we should go back and revisit the idea that was in the Democratic alternative, about some kind of trigger, to send a message to the market that we are not going to go into a backward-looking posture, where we begin to slide back into uncontrolled deficits, the triumph of politics on both sides of the aisle takes hold again. So I am wondering whether you have any thoughts about the trigger idea, after having, I am sure, talked about it with your staff because of the previous questions that we have addressed to the CBO?

Mr. CRIPPEN. I think the only thing we have concluded, Senator, is that we do not know; that is to say trigger mechanisms do not give anybody much comfort in both how they would be constructed and how they would work. As you are suggesting, perhaps capital markets would look at them more robustly than we have. Again, one has to be careful, of course, and one of the big arguments against a constitutional amendment for a balanced budget or something like that is the straitjacket it might put the country in, in

times just as this or worse, whether we are in a recession or a weak economy or a war or some other things.

So one has to think about triggers look awfully good on one side of an economy and maybe not on another, or on one side of a debate and not another. But, ultimately, I think it comes down to policymakers to take action, and whether you can foresee what those actions should be five or 10 years from now and put a trigger in place, I do not know.

Senator CLINTON. Something to be considered.

Chairman CONRAD. Thank the Senator. Reflecting on what I have heard here, a casual viewer at home might conclude it just does not make any difference, does not make any difference if you take trust fund money, once it has been credited to the trust fund, and use it for some other purpose. Does it make any difference?

Mr. CRIPPEN. It does not make any difference to the programs or to the benefits or to the trust fund. It can make a difference to the economy, depending upon how——

Chairman CONRAD. And how can it make a difference to the economy?

Mr. CRIPPEN. Well, in the case of trust funds, as we have been talking about here—Social Security, for example—one might think about policies, whether it is an amount of money equal to or different than that does not really matter. One can think about policies, however, that would help economic growth. One of them, as we have discussed today and elsewhere, is paying down debt might help economic growth by making capital more readily available and cheaper; others might be spending for education or other programs. I do not have a list or a policy recommendation, obviously, but one has to think about policies that grow the economy, and not just in the confines of a given amount of money that might be attributed to a trust fund, because as I have suggested, in my view, ultimately the trust fund is the economy and the size of the economy, and it is the totality of the Federal budget that may affect that, not just the dollars that are involved in the trust fund.

Chairman CONRAD. I agree with that. Let me just say, from my perspective, it makes a difference in the following ways: No. 1, the economy. To the extent you do not pay down the debt as much, that means less savings, less investment, less economic growth. Second, to the extent you do not pay down debt, you have more debt for longer. That means higher interest cost. We are seeing that in the current circumstance. We are seeing more debt for longer. Instead of having $1.3 trillion of publicly held debt by the end of 2006, we are going to have 2.3 trillion of debt. It matters a lot, because that means additional interest cost to the Federal Government, and we have indicated—in your report, you show us the difference it makes.

Instead of $600 billion of interest cost, we are going to have $1.2 trillion of interest cost. So it matters a lot. Further, what is going on now, in part, is that people's payroll taxes are being taken. The vast majority of Americans pay more in payroll taxes than they pay in income taxes. We are taking some of people's payroll taxes and using it to give an income tax increase that goes disproportionately to the wealthiest among us. To some of us, that strikes us as incredibly unfair. But, more than that, looking ahead, as you have

pointed out on many occasions, we are faced with a circumstance in the future where delivering the benefits that we give now with these programs, Social Security and Medicare, are in jeopardy.

They are in jeopardy because of the hard reality the baby boomers are going to retire, and as the President of the Social Security Commission has pointed out, we are going to face either deep cuts in benefits, big tax increases or massive debt. Some of us believe that it is important—it is necessary, but not sufficient, to use these trust fund surpluses to help prepare for that day. The second thing I wanted to point out, and that is the Medicare Trust Fund. Senator Hagel raised the question, on page 20 of this report, you indicate the Medicare hospital insurance, Part A, is in surplus by $404 billion; is that correct?

Mr. CRIPPEN. Yes.

Chairman CONRAD. You indicate that supplementary medical insurance, Part B, is in rough balance over the period, in fact, a slight surplus of $14 billion.

Mr. CRIPPEN. That is because it essentially has to be. The general fund contribution makes it be about zero balance every year.

[The prepared statement of Mr. Crippen follows:]

CBO TESTIMONY

Statement of
Dan L. Crippen
Director

The Budget and Economic Outlook: An Update

before the
Committee on the Budget
United States Senate

September 4, 2001

This document is embargoed until 2:00 p.m. (EDT), Tuesday, September 4, 2001. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, Senator Domenici, and Members of the Committee, I am pleased to be here today to discuss the current outlook for the budget and the economy. Last week, the Congressional Budget Office (CBO) released *The Budget and Economic Outlook: An Update*, which I will summarize today.

Recently enacted legislation and the continued sluggish behavior of the U.S. economy have reduced the projected federal budget surpluses for fiscal year 2001 and future years. CBO projects that the total budget surplus in 2001 will be $153 billion—$122 billion lower than CBO estimated in May. About two-thirds of the decrease results from new legislation; one-third comes from a weaker economy and other factors. Despite that drop, if the $153 billion surplus materializes in 2001, it will equal 1.5 percent of gross domestic product (GDP), the second largest surplus as a share of the economy since 1951.

Because of the smaller total surplus, CBO now projects a small on-budget deficit for this year. (The on-budget accounts exclude the spending and revenues of Social Security and the Postal Service.) If current tax and spending policies are maintained and the economy performs as estimated, CBO projects small deficits or surpluses in on-budget accounts for the next four years; however, steadily increasing on-budget surpluses reemerge by the middle of the decade. The projected surpluses would allow all public debt that is available for redemption to be retired by 2010.

The Budget Outlook

For the five years from 2002 through 2006, CBO projects surpluses totaling $1.1 trillion, which come almost entirely from off-budget accounts (see Table 1). For the 10-year period through 2011, CBO estimates that under current policies, surpluses

will total $3.4 trillion. Social Security makes up about three-quarters of that total. In 2010, the on-budget surplus reaches 1 percent of GDP, and the total surplus grows to 3 percent of GDP. Those estimates should be viewed cautiously, however, because future economic developments, technical estimating errors, and future legislative actions could produce substantial deviations—a point that CBO discussed in detail in its January report on the budget and economic outlook.

Total surpluses for the 2002-2011 period are $2.2 trillion less than CBO projected in May, when it last published its budget baseline (see Table 2). New legislation accounts for $1.8 trillion of that decrease, and changes in the economic forecast account for another $0.3 trillion; the remainder stems from other changes (technical ones not directly driven by new legislation or by changes in the components of CBO's economic forecast).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) is estimated to reduce revenues by $70 billion in 2001 and nearly $1.2 trillion over the 2002-2011 period. That law changed numerous tax provisions, including lowering income tax rates, establishing a 10 percent tax bracket, increasing tax credits for children, repealing the estate tax, lessening the so-called marriage penalty, raising the limits on contributions to retirement accounts, and enhancing education incentives. In addition, the law increases outlays for refundable tax credits by $4 billion in 2001 and $88 billion between 2002 and 2011.

Many of the provisions of P.L. 107-16, especially the ones with the greatest impact on the budget, phase in over time. Moreover, most of the provisions expire at the end of

calendar year 2010. Extending all provisions through 2011 would reduce revenues by an additional $255 billion over the 2002-2011 period.

Other legislation will also increase projected outlays through 2011. Providing additional assistance to farmers will increase spending by $5.5 billion in 2001, and the 2001 Supplemental Appropriations Act is projected to boost spending by $83 billion from 2002 through 2011. Because legislative changes will leave less money available to reduce outstanding federal debt, interest payments will increase by $413 billion over the next 10 years, CBO estimates.

Lower projections of economic growth over the next few years, along with other revisions to the economic forecast, will diminish surpluses by $283 billion between 2002 and 2011, according to CBO's projections. (Those revisions reflect changes in the economic outlook since January, when CBO last updated its economic assumptions.) In addition, technical changes will reduce surpluses by $177 billion.

In the Administration's *Mid-Session Review*, the Office of Management and Budget's (OMB's) baseline budget projections are similar, though not identical, to those presented by CBO. For 2001, OMB estimates a small on-budget surplus, whereas CBO estimates a small on-budget deficit. In each year of the projection period, CBO's estimates are lower than OMB's—overall, CBO's figure for total surpluses from 2002 through 2011 is $445 billion less. Although that discrepancy may seem large, it results from differences of just 1.0 percent in total projected revenues for the period and 0.7 percent in total projected outlays.

The Economic Outlook

CBO has revised its economic forecast to reflect the weakness in the U.S. economy during the first half of 2001. Although economic activity has slowed to a crawl, CBO believes that the economy will narrowly avoid recession and recover gradually next year. CBO now expects that the levels of both nominal and real (inflation-adjusted) GDP will be lower in 2001 and 2002 than it anticipated in January. CBO also has raised its estimates of the unemployment rate and long-term interest rates for the next few years and lowered its estimate of short-term interest rates.

CBO's current forecast assumes that growth of real GDP will average 1.7 percent this calendar year and 2.6 percent next year—for both years, those rates are about three-quarters of a percentage point lower than CBO estimated in January (see Table 3). CBO's projections do not incorporate the annual revisions to the national income and product accounts published by the Commerce Department's Bureau of Economic Analysis at the end of July, which were released after CBO's forecast was completed. Incorporating those revisions could move budget projections in either direction but probably not by very much.

Inflation, as measured by growth in the consumer price index for all urban consumers, is 0.4 percentage points higher for 2001 and 0.2 percentage points lower for 2002 than the estimates in the January forecast.

Short-term interest rates are projected to be lower in the next few years than CBO previously anticipated, but long-term rates are expected to be slightly higher. Interest rates on three-month Treasury bills are forecast to be about a full percentage point

lower for both 2001 and 2002 than the levels estimated in January. However, the interest rates paid on 10-year Treasury notes are projected to be between 0.3 and 0.4 percentage points higher than previously anticipated.

CBO does not forecast fluctuations of the economy beyond two years. Instead, it extends historical patterns in the factors—increases in the labor force, rising productivity, and the rate of national saving—that underlie the growth of potential GDP. After incorporating those patterns, CBO makes economic projections that extend three to 10 years out.

For 2003 through 2011, CBO projects that growth of nominal GDP will average more than 5.2 percent a year and that growth of real GDP will average 3.2 percent— levels slightly above those estimated in January. According to CBO's projections, inflation in the 2003-2011 period will average 2.5 percent, which is similar to the rate that was anticipated last winter. Interest rates over the period will average 4.9 percent for three-month Treasury bills and 5.8 percent for 10-year Treasury notes, CBO projects—figures that are also similar to January's projections.

CBO's economic projections incorporate the effects of the recently enacted tax legislation. In the short run, the rebate of taxes payable on income earned in 2001 may help counter the economic slowdown by encouraging consumer spending. In the long run, the impact of the new tax law on GDP is uncertain, but any effect is likely to be small. Analysis of the law's economic effects is complicated by the sunset mechanism built into it, which establishes expiration dates for all of its provisions. People's expectations about the law's expiration in 2011 could affect their decisions about consumption, work, and saving over the next 10 years. For the purposes of its

economic projections—but not for its budget calculations—CBO has ignored the expiration.

Like all forecasts, CBO's forecast is very uncertain, and economic activity could be significantly slower—or faster—than CBO currently expects. Indeed, economic indicators released since CBO's forecast was completed in July suggest a weaker economy than assumed in the projections, though the nature of economic activity (weak business investment offset by moderate consumer spending and spending on residential structures) is close to CBO's expectation. In light of additional weakness in construction spending and in the manufacturing sector, the latest estimate for the second quarter of this year indicates that output growth was only 0.2 percent, rather than the 0.7 percent first estimated. And indicators for July, the first month of the current quarter, suggest that growth may be less than CBO assumed because of much weaker business investment. Short-term interest rates in the current quarter are also likely to be lower than assumed in July because the Federal Reserve cut its intended federal funds interest rate another 25 basis points in August.

Much of the uncertainty about medium-term growth involves the pace of investment in information technologies. The increase in the growth rate of overall productivity in the late 1990s resulted both from greater amounts of capital per worker, mainly in the information technology sector, and from more rapid growth in total factor productivity (reflecting both labor productivity and capital), probably in large part the result of innovative uses of information technologies throughout the economy. The question now is what the pace of investment in information technologies will be over the medium term and the extent to which those investments will lead to significant cost savings in other sectors of the economy.

The economic perspectives of OMB and CBO are generally quite similar, but the differences in those outlooks still account for a large part of the difference between the two agencies' budget projections. The Administration's current economic projections anticipate stronger near-term growth than CBO's projections do, with a sharp improvement in economic conditions by the end of this year. As a result, corporate profits in the Administration's forecast return to recent levels almost immediately, and the unemployment rate remains below 5 percent (see Table 4). By contrast, in CBO's forecast, profits remain weak in the near term, and the unemployment rate rises to 5.2 percent by the end of 2002. After 2002, the Administration's projections of nominal GDP and of tax bases (such as corporate profits and wages and salaries) remain slightly stronger than CBO's. Throughout most of the period, the Administration anticipates significantly lower interest rates on Treasury securities than CBO does, although the implications of that difference for the budget are limited at a time when publicly held debt is being paid down.

Table 1.
CBO's Baseline Budget Projections (By fiscal year)

	Actual 2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002-2011
						In Billions of Dollars							
Revenues													
Individual income taxes	1,004	1,015	1,039	1,079	1,123	1,175	1,223	1,286	1,360	1,440	1,528	1,717	12,970
Corporate income taxes	207	149	210	195	215	247	253	265	278	292	307	321	2,584
Social insurance taxes	653	694	727	761	794	838	880	923	967	1,016	1,066	1,119	9,092
Other	161	152	158	160	175	178	187	189	196	204	203	185	1,833
Total	2,025	2,011	2,134	2,196	2,307	2,438	2,543	2,663	2,801	2,952	3,103	3,341	26,479
On-budget	1,545	1,503	1,602	1,638	1,723	1,822	1,897	1,985	2,089	2,204	2,319	2,518	19,795
Off-budget	481	507	532	558	584	616	647	679	712	748	785	823	6,684
Outlays													
Discretionary spending	615	647	689	717	737	759	774	789	812	833	853	878	7,842
Mandatory spending	1,032	1,092	1,181	1,243	1,313	1,387	1,454	1,531	1,625	1,724	1,831	1,961	15,249
Offsetting receipts	-81	-89	-92	-109	-112	-107	-112	-119	-125	-132	-139	-148	-1,196
Net interest	223	207	179	174	168	155	139	121	101	78	58	50	1,223
Proceeds earned on the balance of uncommitted funds[a]	0	0	0	0	0	0	0	0	0	0	-7	-29	-36
Total	1,789	1,858	1,958	2,024	2,106	2,194	2,254	2,323	2,413	2,502	2,596	2,713	23,083
On-budget	1,458	1,512	1,600	1,656	1,726	1,802	1,850	1,906	1,983	2,057	2,134	2,235	18,948
Off-budget	331	346	358	369	380	392	405	417	430	445	462	478	4,135
Surplus or Deficit (-)	236	153	176	172	201	244	289	340	389	450	507	628	3,397
On-budget	87	-9	2	-18	-3	21	47	78	106	147	184	283	847
Off-budget	150	162	174	190	204	224	242	262	283	303	323	345	2,549

SOURCE: Congressional Budget Office.

a. "Uncommitted funds" is CBO's term for the surpluses that remain each year after paying down publicly held debt available for redemption. CBO assumes that those funds, which accumulate from one year to the next, earn proceeds at a rate equal to the average interest rate projected for Treasury bills and notes.

Table 2.
Changes in CBO's Projections of the Surplus Since May 2001 (By fiscal year, in billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002-2006	Total, 2002-2011
Total Surplus as Projected in May 2001	275	304	353	400	437	508	578	641	718	806	883	2,002	5,629
Changes													
Legislative													
Tax act[a]	-74	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130	-479	-1,275
Other[b]	-7	-10	-8	-7	-8	-8	-8	-8	-8	-9	-9	-41	-83
Debt service[c]	*	-4	-9	-16	-23	-31	-41	-53	-65	-79	-92	-84	-413
Subtotal	-81	-52	-107	-131	-138	-174	-201	-221	-241	-274	-230	-603	-1,771
Economic	-25	-48	-54	-50	-40	-31	-23	-16	-9	-6	-5	-224	-283
Technical[d]	-16	-27	-20	-18	-15	-13	-13	-16	-17	-18	-19	-93	-177
Total	-122	-128	-182	-198	-192	-219	-238	-253	-268	-299	-254	-920	-2,232
Total Surplus as Projected in August 2001	153	176	172	201	244	289	340	389	450	507	628	1,082	3,397

SOURCE: Congressional Budget Office.

NOTE: * = less than $500 million.

a. The Economic Growth and Tax Relief Reconciliation Act of 2001 will reduce revenues by $1,186 billion and increase outlays by $88 billion between 2002 and 2011.

b. Mostly the 2001 Supplemental Appropriations Act, along with recent legislation that provides additional funds in 2001 for agricultural producers.

c. Reflects only the change in debt-service costs resulting from legislative actions. Other effects on debt-service costs are included under economic and technical changes.

d. Changes not directly driven by new legislation or by changes in the components of CBO's economic forecast.

Table 3.
CBO's Current and Previous Economic Projections for Calendar Years 2001 Through 2011

	Forecast		Projected Annual Average	
	2001	2002	2003-2006	2007-2011
Nominal GDP (Billions of dollars)				
August 2001	10,366	10,876	13,355[a]	17,145[b]
January 2001	10,446	11,029	13,439[a]	17,132[b]
Nominal GDP (Percentage change)				
August 2001	4.0	4.9	5.3	5.1
January 2001	4.7	5.6	5.1	5.0
Real GDP (Percentage change)				
August 2001	1.7	2.6	3.2	3.2
January 2001	2.4	3.4	3.1	3.1
GDP Price Index (Percentage change)				
August 2001	2.3	2.3	2.0	1.9
January 2001	2.3	2.1	1.9	1.9
Consumer Price Index[c] (Percentage change)				
August 2001	3.2	2.6	2.5	2.5
January 2001	2.8	2.8	2.6	2.5
Unemployment Rate (Percent)				
August 2001	4.6	5.2	5.2	5.2
January 2001	4.4	4.5	4.7	5.2
Three-Month Treasury Bill Rate (Percent)				
August 2001	3.9	3.8	4.9	4.9
January 2001	4.8	4.9	4.9	4.9
Ten-Year Treasury Note Rate (Percent)				
August 2001	5.3	5.6	5.8	5.8
January 2001	4.9	5.3	5.6	5.8

SOURCE: Congressional Budget Office.

NOTES: The August 2001 values for GDP and its components are based on data from the Bureau of Economic Analysis' national income and product accounts before the annual revision in July. Incorporating those revisions, which occurred after CBO had completed its forecast, could move budget projections in either direction but probably not by very much.

Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2011.

c. The consumer price index for all urban consumers.

Tabl 4.
Comparison of CBO's and the Administration's Economic Pr jections for Cal ndar Years 2001 Through 2011

	Forecast		Projected Annual Average	
	2001	2002	2003-2006	2007-2011
Nominal GDP (Billions of dollars)				
CBO	10,366	10,876	13,355[a]	17,145[b]
Administration	10,364	10,937	13,553[a]	17,488[b]
Nominal GDP (Percentage change)				
CBO	4.0	4.9	5.3	5.1
Administration	4.0	5.5	5.5	5.2
Real GDP (Percentage change)				
CBO	1.7	2.6	3.2	3.2
Administration	1.7	3.2	3.3	3.1
GDP Price Index (Percentage change)				
CBO	2.3	2.3	2.0	1.9
Administration	2.3	2.2	2.1	2.1
Consumer Price Index[c] (Percentage change)				
CBO	3.2	2.6	2.5	2.5
Administration	3.3	2.7	2.5	2.5
Unemployment Rate (Percent)				
CBO	4.6	5.2	5.2	5.2
Administration	4.6	4.8	4.6	4.6
Three-Month Treasury Bill Rate (Percent)				
CBO	3.9	3.8	4.9	4.9
Administration	3.8	3.9	4.3	4.3
Ten-Year Treasury Note Rate (Percent)				
CBO	5.3	5.6	5.8	5.8
Administration	5.2	5.2	5.2	5.2
Tax Bases (Percentage of GDP)				
Corporate book profits				
CBO	7.9	7.5	8.0	8.1
Administration	7.7	8.9	8.9	8.0
Wages and salaries				
CBO	48.6	48.9	48.4	48.1
Administration	48.1	48.2	48.6	48.1

SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTES: CBO's values for GDP and its components are based on data from the national income and product accounts before the July 2001 revision.

Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2011.

c The consumer price index for all urban consumers.

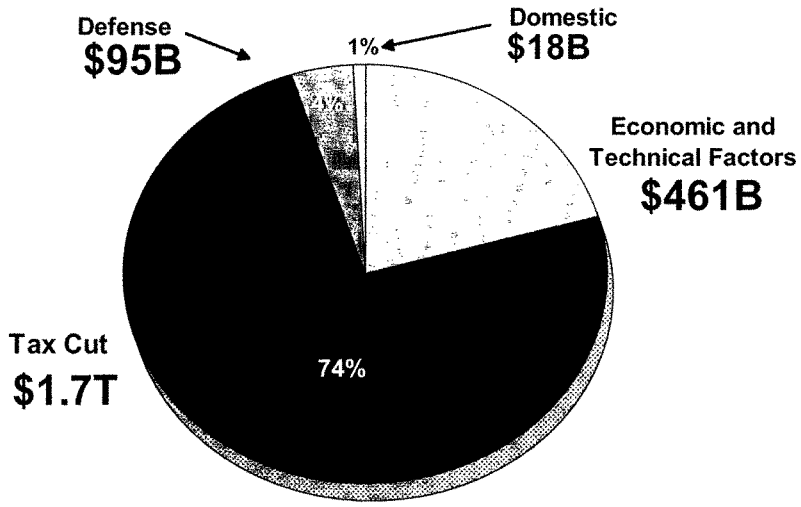
CBO Surplus and Deficit Estimates - August Update
(Adjusted to include Bush Defense Request and Budget Resolution Policies)

($ billi ns)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-11
CBO August total surplus	153	176	172	201	244	289	340	389	450	507	628	3,397
Social Security trust fund surplus	163	176	190	204	224	242	262	283	303	323	345	2,551
Postal Service deficit	-2	-1	-(*)	-(*)	0	0	0	0	0	0	0	-1
Medicare HI trust fund surplus	29	38	41	42	42	45	43	43	42	39	31	404
CBO surplus/deficit without Social Security and Medicare surpluses 1/	-37	-36	-59	-45	-21	2	35	63	106	146	252	443
Bush defense request	0	12	14	15	17	18	19	21	22	24	25	187
Other budget resolution policies 2/	-0	17	24	29	34	38	52	56	60	65	71	447
Interest	-0	1	2	5	8	11	15	20	26	32	38	158
Revised surplus/deficit without Social Security and Medicare surpluses 1/	-37	-65	-99	-94	-80	-65	-52	-34	-2	26	117	-349
Raid on Medicare	-29	-38	-41	-42	-42	-45	-43	-34	-2	0	0	-286
Raid on Social Security	-8	-28	-58	-52	-38	-20	-9	0	0	0	0	-205
Total raid on trust funds	-37	-65	-99	-94	-80	-65	-52	-34	-2	0	0	-491

(*) Less than $500 million deficit
1/ Also excludes Postal Service deficit.
2/ Includes amounts allocated for a prescription drug benefit, expanded health care coverage, veterans programs, agriculture and other policies.

05-Sep

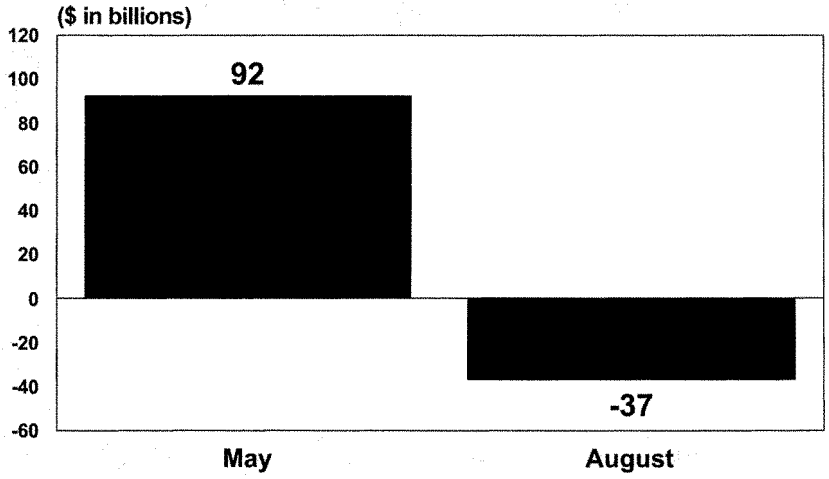
What Happened to the Surplus?
FY 2002-11



Note: All totals include associated interest costs.
Source: CBO

What Happened to the Surplus?

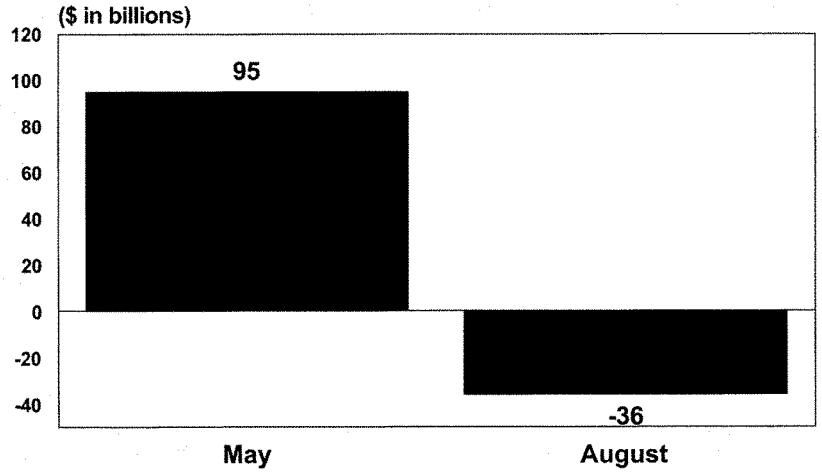
Change in 2001 Surplus without Counting Social Security and Medicare



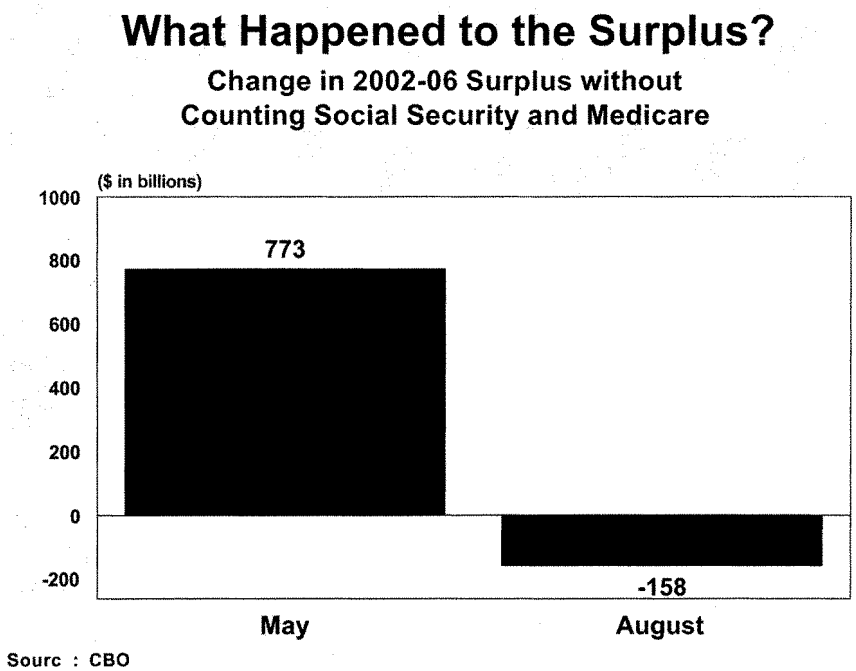
Source: CBO

What Happened to the Surplus?

Change in 2002 Surplus without Counting Social Security and Medicare



Source: CBO



Chairman CONRAD. General funds, that is the way we pay for government programs. That is the way we pay for defense. We do not say defense is in deficit, because it receives general fund moneys. The anomaly here is that Medicare Part B—Part A is in surplus because there are more payroll taxes coming in than expenses going out. Part B is an anomaly in the sense that it has a separate income source. It has premium income. We decide—we, right here, decide how much comes from premiums, how much comes from general fund transfers, just like we do with defense, where we have decided all of it comes from general funds, just as we have with education and other funds.

To suggest, I think, that it just does not matter whether we take these moneys and use them for other purposes, I think, is flatly wrong, and I want the record to reflect that is at least the view of this member. With respect to both the Social Security and Medicare Trust Funds, I think if you take the money and use it to pay for other programs, that means you pay down less debt. That means you do not have the funds available to prefund liability, as other countries are doing who face this same circumstance that we do.

Finally, I want to put up this chart to talk about looking at just a little bit more than what Congressional Budget Office is able to look at, and I want to make it very clear to anybody watching, I am not faulting you. You operate under certain rules. You have got to look at current policy, but the President is not saying stick with current policy on defense. He is saying we are going have a $200 billion increase. The Congress passed a budget resolution that had certain spending in it. It was passed when our friends on the other

side controlled the Congress. What this tells us is that when you put all of that together, the Republican spending plan, the tax cut, the President's proposal for increased defense, that we are not just talking about a short-term, small problem. We are not talking about $8 billion out of Social Security this year. We are talking about $500 billion out of the trust fund of Social Security and Medicare over the next 10 years; this not at a time the administration is forecasting economic slowdown, this at a time the administration is forecasting strong economic growth. They are forecasting 3.2 percent economic growth next year. They are not forecasting recession. They are not forecasting slowdown. They are forecasting strong economic growth, and every year thereafter.[17]

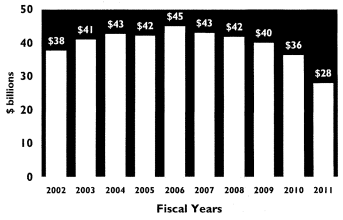
In that content, we see their budget plan as taking $500 billion out of the trust funds of Medicare and Social Security to pay for something else. I think that is a mistake. I also think it is terribly unfair, because we levied those payroll taxes on people for the purpose of supporting those programs, not to pay for a tax cut for the wealthiest among us, not to build bridges, not to construct tanks. That was not the basis on which those payroll taxes were levied. So this will be an interesting debate as we go forward. I, again, want to thank you, Mr. Crippen, for being here today. We are especially happy that you are back up and able to walk under your own steam, and we wish you very well as you go through this next process of rehabilitation. Thank you so much.

[Whereupon, at 3:54 p.m., the hearing was adjourned.]

Medicare Part A

- **Expenditures: hospital services, home health, skilled nursing facilities and hospice care for the aged and disabled.**
- **Income: Payroll tax on covered earnings (employees and their employers pay 1.45% of earnings; self-employed workers pay 2.9% of their net income); interest income paid on securities held by the trust fund; taxation of Social Security benefits; other revenues.**

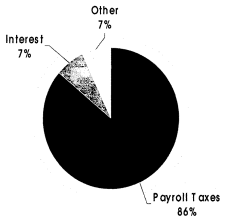
The Part A Trust Fund Surplus FY 2002-11



Source: Congressional Budget Office, May 2001

[17] CHART NOT AVAILABLE AT PRESS TIME.

Medicare Part A: Income



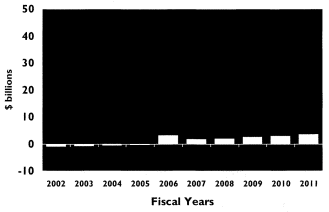
Source: 2001 Annual report of the Board of Trustees
CY 2000 Data

Medicare Part B

<u>Expenditures</u>: Payments to physicians and for other professional services; facility payments, payments for managed care, administration.

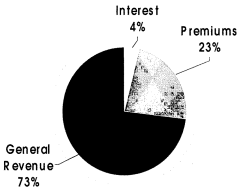
<u>Income</u>: General revenue, premiums, interest.

The Part B Trust Fund Surplus FY 2002-11



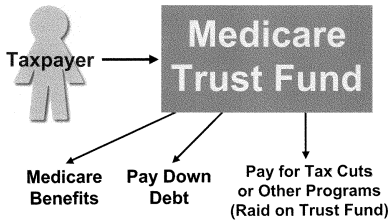
Source: Congressional Budget Office, May 2001

Medicare Part B: Income



Source: 2001 Annual report of the Board of Trustees
CY 2000 Data

Following Your Medicare Money



If Medicare is in "Deficit" How About…

- Department of Defense ($310 billion)
- NIH and other health programs ($180 billion)
- Education programs ($77 billion)
- Veterans programs ($47 billion)
- Space and science programs ($21 billion)

OMB'S MID-SESSION REVIEW AND THE BUDGET AND ECONOMIC OUTLOOK

THURSDAY, SEPTEMBER 6, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SH–216, Hart Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Wyden, Feingold, Byrd, Stabenow, Clinton, Corzine, Domenici, Grassley, Bond, Snowe and Hagel.

Staff present: Mary Ann Naylor, Majority Staff Director; William Hoagland, Minority Staff Director.

OPENING STATEMENT CHAIRMAN CONRAD

Chairman CONRAD. We bring the committee to order. We thank Mr. Daniels for being here this morning and all members of the committee. We are going to proceed. We know that there is a joint session, and we intend to continue so that members have a chance to get their questions answered, but if we are done in time, obviously, members are free to go as they choose.

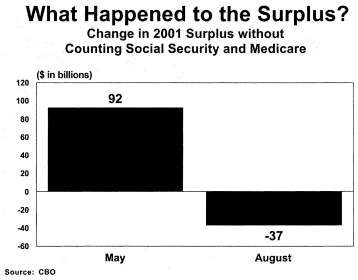
Let me just begin by, again, welcoming Director Daniels to the committee. We appreciate you being here. This has been an interesting morning already because in the middle of all this, the committee staffs are moving because of renovation that is going on in the Dirksen building. So that has delayed us a little bit, and we are glad that you have got the easel and we are ready to go.

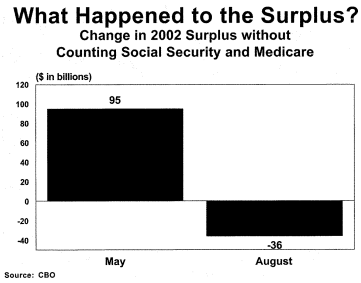
Let me just begin with an opening statement, and then we will go to Senator Domenici's opening statement. I think one of the things that is most striking to many of us is that the President said very clearly to us that he had a budget plan that added up. He told us that we could have a significant tax cut and, at the same time, accommodate a very large increase in defense spending. We could have more money for education, and at the same time, he told us we could also protect Social Security and Medicare Trust Funds, and that we could have maximum pay-down of the debt. With the latest numbers from the Congressional Budget Office, it is clear that his analysis was simply not accurate, not correct.

He told us during the campaign and afterwards that: Social Security and Medicare will get every dollar they need, and every dollar of Social Security and Medicare tax revenue will be reserved for Social Security and Medicare. He was not alone in representing that position. We also had his top people telling us that everything was fine and would all work out, including the Secretary of the

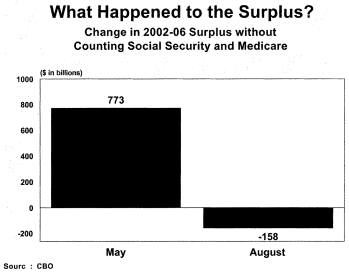
Treasury, who told us that we have dedicated every dollar of Social Security and Medicare money to come in to pay down the public debt, so that we are honoring the idea that Social Security and Medicare money should only be used for those purposes, and we can well afford this tax reduction and still take care of Social Security and Medicare.

Well, with the new numbers that have come out from the Congressional Budget Office, we see a different set of facts. According to CBO, in May, we were told that not counting Social Security and Medicare, we had a $92 billion surplus for 2001. Now they tell us in their August numbers that, no, there is no surplus. In fact, there is a $37 billion deficit. That means, of course, that that $37 billion will be coming out of the Medicare and Social Security Trust Funds.



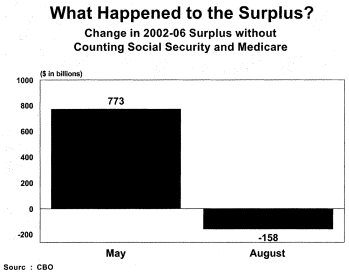


Let's go to 2002, because we see an almost identical picture for 2002. In May, the Congressional Budget Office told us that if we were going to keep the President's promise and not use Social Security and Medicare for other purposes, we had a $95 billion surplus. Now in August, they tell us, no, there is no surplus. Instead, there is a $36 billion deficit.



Of course, the Congressional Budget Office's numbers are based on current policy. They do not have any additional money for education. They do not have the President's defense buildup. They do not have money for the expiring tax provisions. They do not have money for prescription drugs. They have none of that in there.

Let's go to the next chart. From 2002 to 2006, just the first 5 years of this budget plan, we see an even more dramatic difference. It is not just a matter of the economic slowdown this year. In the first 5 years, instead of a $773 billion, non-Social Security, non-Medicare surplus, we have, according to CBO, a $158 billion deficit.



Let's go to the next chart. One of the things that concerns me a good deal is, that although we have a problem in 2001 and 2002, we have a much bigger problem than that. As this chart shows, looking at the 10 years from 2002 to 2011, and just taking the tax cut, the Republican spending plan that is in the budget resolution and the President's request for increased expenditure for national defense, what we see is not just a little bit of a hole, not just a few billion dollars of deficit, but $500 billion of shortfalls—$500 billion coming out of the Medicare and Social Security Trust Funds from 2002 to 2011. If we include this year, it is even more than that. It is over $520 billion being taken from the Medicare and Social Security Trust Fund to pay for other government programs.

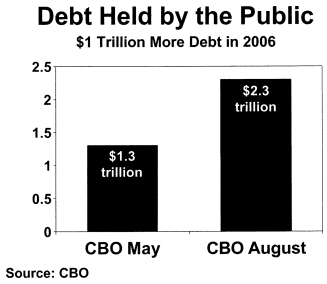
Changes in the Total Budget Surplus - FY 2002-11
(Assumes Senate Democratic Stimulus Package)

($ billions)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-11	%
Total Surplus (CBO May)	**304**	**353**	**400**	**437**	**508**	**578**	**641**	**718**	**806**	**883**	**5,629**	
Changes since May:												
Tax Cuts:												
Tax bill	-39	-91	-108	-107	-135	-152	-160	-168	-187	-130	-1275	
Tax stimulus	-37	-4	4	3	2	1	1	0	-0	-0	-31	
Debt service	-3	-10	-18	-23	-31	-40	-51	-63	-78	-89	-404	
Subtotal, tax cuts	-80	-105	-120	-128	-164	-191	-210	-230	-263	-219	-1,710	45%
Other Legislation:												
FY 2001 supplemental	-10	-9	-7	-8	-8	-8	-8	-8	-9	-9	-83	
FY 2002 discretionary spending agreement	-10	-14	-16	-17	-17	-18	-18	-19	-19	-20	-167	
$40 billion emergency anti-terrorism supplemental 1/	-25	-22	-21	-21	-22	-22	-23	-23	-24	-25	-229	
Airline assistance 1/	-6	-4	-6	-2	0	0	0	0	0	0	-17	
Other legislation enacted to date	-0	0	0	-0	-0	-0	-0	-0	-0	-0	-1	
Senate Democratic Stimulus	-36	-13	-2	-1	-0	-0	0	0	0	0	-53	
Debt service	-2	-8	-10	-14	-17	-20	-24	-28	-33	-37	-192	
Subtotal, other legislation	-89	-67	-62	-62	-65	-69	-74	-79	-85	-91	-743	19%
Economic and technical changes 2/	-167	-184	-172	-158	-138	-119	-99	-102	-111	-122	-1,374	36%
Total changes since May	-336	-357	-355	-348	-367	-379	-384	-411	-459	-432	-3,826	
Resulting surplus/deficit	**-32**	**-3**	**45**	**89**	**141**	**198**	**258**	**307**	**347**	**451**	**1,802**	

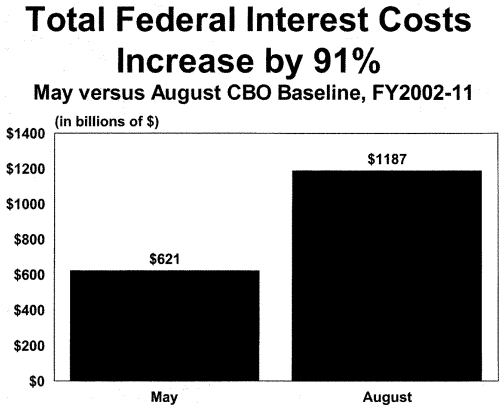
1/ Preliminary estimates.
2/ Senate Budget Committee estimates.

SD-Nov

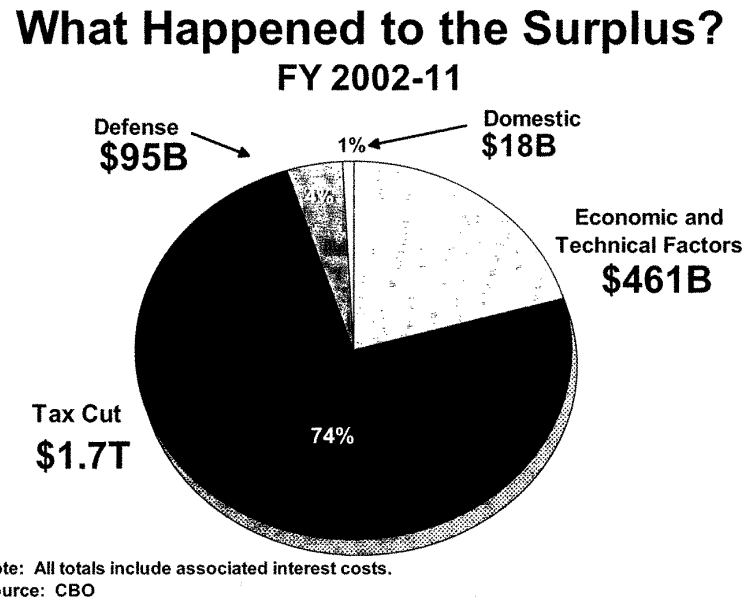
Let's go to the next chart. Some say, well, it does not really matter, this is just a small deal. It is a little blip on the screen. I think CBO's numbers show something quite different. In May, they told us that publicly held debt, that portion of the national debt that is publicly held, would be down to $1.3 trillion in 2006. Now they tell us four or 5 months later that the publicly held debt is not going to be $1.3 trillion. It is going to be $2.3 trillion, $1 trillion more of debt at the end of the first 5 years of the President's plan. That has real consequences.



Let's go to the next chart, which shows what that means to the interest costs of the United States. The interest costs go up 91 percent, from $621 billion dollars, that CBO told us in May, to now $1,187 million of interest costs to the Federal Government, because we have got more debt for a longer period of time than we were told just 5 months ago. Some have asked us, well, where did it go? What happened to all that surplus? How did we go from a projection of $5.6 trillion of surplus down to $3.4 trillion in just 4 months or 5 months?



This shows what CBO is telling us: $1.7 trillion of that $2.2 trillion reduction in the surplus is from the tax cut. The tax cut and the associated interest costs are $1.7 trillion. 74 percent of the reduction in the surplus is from the tax cut. Something over $400 billion or 21 percent is because of the economic slowdown; only 5 percent is from spending. Those are the supplemental appropriations bills that have the strong support of the President. Most of that money, of course, went for national defense. So for those who have asserted that this is spending that has done this, I just do not think they can make that case, at least not with a straight face.



Let's go to the next chart on the question of spending. I was on a show over the weekend with one of our colleagues from the committee who said we had this incredible spending binge. He said spending went up last year 14 percent. It did not sound right to me. I did not remember spending going up 14 percent last year. So I went and looked at overall Federal spending from 2000 to 2001, and indeed, it did not go up 14 percent. It went up 3.9 percent. That is what happened to Federal spending.[18]

Let's go to the next chart, because it shows that, in fact, Federal spending as a share of our national income, which is the way most economists say is the best way to measure it so we are not including inflation, we have gone from 22 percent of the national income going to the Federal Government in 1992, to 18.1 percent today, and we are headed to 16.1 percent of GDP at the end of this budget period, which will be the lowest since 1951. I do not think we have got a situation where spending is out of control.[19]

Now, at our last hearing, some of our colleagues said, "But you, Senator Conrad, were for more stimulus this year than the President," and that is exactly right. I certainly was. I was for substantially more stimulus this year because I thought we needed it to give lift to the economy. In fact, there is the comparison. In President Bush's February budget he had virtually no fiscal stimulus, virtually none. I proposed $60 billion this year. The President came back in his April budget, he still had no fiscal stimulus or virtually none, and what passed was $40 billion of a tax rebate, but there was more than that. There was another thing included, a gimmick, which I opposed, which shifted $33 billion out of this year by delaying corporate receipts for 2 weeks. It put the money into next fiscal

[18] CHART NOT AVAILABLE AT PRESS TIME.
[19] CHART NOT AVAILABLE AT PRESS TIME.

year, to make the President's tax cut look more affordable in the next fiscal year.

So, in the interest of full disclosure, absolutely, I supported more of a fiscal stimulus this year, more of a tax cut, far more than the President did, because I thought it was necessary to give lift to the economy, but I did not support the gimmick of transferring money from this year into next by delaying corporate receipts for 2 weeks in order to make the tax cut look more affordable.

The larger truth is that the tax cut I advocated over the 11-year period was far smaller than what the President proposed, about half as much, because I could see, and I warned at the time that his plan was going to inevitably lead us back into deficits and was going to take money from the Social Security and Medicare Trust Funds to pay for other programs and to pay for his tax cut. I thought it was a mistake at the time, and I think now these new numbers confirm the warning.

With that, I will turn to Senator Domenici for his statement. Senator Domenici, I think we should indicate, is part of the welcoming committee and the committee that will accompany President Fox and President Bush, and so he will need to leave for that joint session. We are certainly pleased he is here now.

Senator DOMENICI. I will have time to do my opening statement and listen to some others, if others are going to give them. First, I am very pleased to see the chairman of the Appropriations Committee, Senator Byrd, here today. We have had a very good lesson in what one Senator thinks the budget of the United States ought to look like and what the tax cuts ought to look like for the next 10 years, but one Senator only has views. I had views. The budget I proposed did not get passed. I am sure many of you had views on the tax cut. If I recall, some of you, on your side, in the end, were not very energetic about a tax cut, but it got passed.

The truth of the matter is we have a very short-term problem that we ought to solve, and it involves mostly the appropriations process of the United States for this year. There are actually only 12 working days left in this fiscal year, and Senator Byrd and others are trying to put together the Appropriations Committee package. I guess they are anxiously waiting to see what the House wants to do, and one waits on the other, and here we sit. From this Senator's standpoint, if the distinguished Senator, Senator Conrad, and even 10, 15 or 20 of his Democratic colleagues would like to redo years five, six, seven, eight, nine and 10, they have ample time to do that.

They will be before this committee with a budget resolution unless lightning strikes, and God forbid that it would, he will be the chairman, he will have a one-vote margin and if he wants to undo the tax bill in the outer years, he can do that. But the point is for this year, let's talk about the real issue that has been raised and what we ought to do about it.

First of all, let me say for a few Senators and a few people who are listening, let me start by saying we had a leader in the U.S. Senate once named Bob Dole. Bob Dole and I, joined by others, worked for years to try to get a balanced budget for the U.S. Government. A few years ago we sat down with the President. We got a balanced budget. It looked like if we handled things rather well,

we would have a balanced budget for a long, long time. But let me remind everybody, if you look at that chart even before it has been put before us—would you mind me using it? Would you put your finger right there where the green starts up and the green goes down, just right there?

Mr. DANIELS. Would a finger be OK?

Senator DOMENICI. Yes, a finger would be OK, whichever finger you would like, right there. Thank you very much. Now, what has happened to our government, because of 10-and-a-half years of sustained economic growth, this balanced budget that Senator Dole and everybody worked—and we tried a constitutional amendment on a balanced budget—we have gone way beyond it, such that all of that green on this side of 1996, 1997, 1998—all of that green on this side is excess surplus over and above a balanced budget. Never, never, never did we contemplate such an event. It happened not because Congress was terribly wise, perhaps we had something to do with it, but it happened because the American economy, with all the things that happened to it, began to flourish and, Senator Byrd, when the economy grows at 5 percent, 4 percent, 7 percent, 6 percent, the taxes come rumbling in.

Now, it is a truism that when they come rumbling in in large quantities, when you have a growth in the economy, I regret to tell everyone, they go rumbling out when you have a recessionary-type economy. What has now happened is that $41 billion to $46 billion of the surplus predicted for next year, that is, this kind of surplus, not the zero surplus, the surplus with all of these extra surplus dollars—what happened in our next year's budget is that the economist do a mid-year review. You have probably read it. It is a very, very complicated document, unless you have been around here for a long time, and they said the economy started falling 13 months ago. It is now in its fourteenth month of falling down.

It has not reached zero, but it is so close to zero in growth that I choose for simplicity of words to call it a recessionary environment, and we have now been there—this is the 14th month. That means it started well before George Bush was in office. We have already put on the record that President Bush had nothing whatsoever to do with the economy faltering, nor did Congress. It is something that happens, where we fix up the economy through this kind of activity about every 5 years in the past. This time, it is 10-and-a-half or 11.

Now, what is being talked about is plain and simple. In a time when the economy is falling, even though we have huge surpluses—let me summarize the surpluses. The surplus, with a faltering economy, will be the second-largest in the history of America, the second-largest. That means we will be taking in extra dollars versus current policies, amounting to about $165 billion. We are arguing today, and the distinguished Chairman is trying to make a case—trying to make a case that we should not use any of that surplus for anything other than Medicare or Social Security.

Frankly, I have now talked to at least 15 economists. None of them—none of them—believe that that is good economic policy for America, to say that we cannot touch those in an era of declining growth. I wish I would have brought the last lockbox I introduced. You know, we have not passed a lockbox in the Senate. Did you

know that, Senator Hagel? We have not passed it. There is no lockbox. We did not send it to the President. But the lockbox that we have seriously discovered has in it provisions that say you unlock this impediment of 60 votes called a lockbox. You unlock it when you have a recessionary economy—you unlock it when you have a recessionary economy.

I am glad we were already—eight and 10 years ago, we understood this. It is perhaps a simple rule we all should have known then and we should know now; that when you have a surplus and a recessionary economy, it is the recession that is the problem, not the budget. We have a fantastic budget. We have a budget—no country in the free industrial world comes close. We have a huge, huge surplus with a declining growth pattern, and would that the countries suffering great depressions have anything like that during their recessionary times. Plain and simple, plain and simple, it appears to me—it appears to me that the reduction in the surplus is caused by two things: one—I am talking in the year 2002, which I would like to get on with completing this year, 2002.

The reduction in the surplus is caused by two things: one, a recession, about $41 to $46 billion; second, a tax cut in that year. If somebody wants to talk about a tax cut 8 years from now, that is fine. But in the year 2002, the second ingredient is a tax cut. I say to all of you Senators the tax cut is almost more like a Democratic tax cut for this year and next year than it is Republican, for when we went to conference, we and the House, we came out with heavy funding for this year and next year, because some thought we were already in a recession. I was not sure, but I thought we ought to proceed in that manner anyway.

So here we are with two things that have caused our surplus to get reduced, a recession over which we have no control and a tax cut which almost everybody says, for this year and next year, could not have been more timely and could not have been more welcome. I would conclude today that, had I known that this economy would tank as bad as it has and stayed where it is, I would ask for a bigger tax cut. I might have joined you, Kent, in saying in the first year it ought to be 60 or 70 or 80, but I would not then be up here and say that we cannot spend any money, we cannot do appropriations, we cannot pay for an increase in defense, we cannot pay for an increase in education, because the surplus has come down, and, therefore, we ought to be worried about applying that whole surplus to the debt—to the debt of the Nation.

Now, I want to conclude, when you have a surplus of this magnitude, and it will be the second-largest in the history of the country, there is no reason in the world that you should look at that debt (sic) for only one purpose, that is, to pay the debt down. What is wrong with looking at it for education if you need education now? What is wrong with looking at it if you need defense now? This would be the right time to do that, but it is not a big thing. The amount of money that is at issue in the Appropriations Committee over the budget resolution is very small. It is very small.

I would guess, Senator Byrd, it is 10 or 15 or $20 billion that is at issue in all the appropriation bills, in outlays, including the defense appropriations bill. This one Senator is suggesting that to say we must cut those bills back because the current surplus was de-

creased by a downturn in the economy does not make any sense at all.

Thank you.

Chairman CONRAD. Mr. Chairman, Mr. Former Chairman and ranking member, let me just go to this point, because you have raised a critically important point. I think it is something we all need to focus on. If we look at 2002, the Senator has just said that, during a time of recession economists tell him that it is all right to take Social Security and Medicare Trust Fund money to use for other purposes. But that is not what we are looking at in 2002. This administration is not forecasting recession. This administration is forecasting strong economic growth. This administration is forecasting 3.2 percent economic growth.

Yet if we look at their budget for 2002 what do we see? We see that if we include the President's defense request and the spending included in the budget resolution that our Republican friends authored coupled with their tax cut, coupled with the President's request for increased spending for defense, for 2002 there is no surplus. They are going to be taking $38 billion of the Medicare Trust Fund money and $28 billion of Social Security Trust Fund money to pay for the other operations of government. That is not at a time of recession. That is a time when the administration is forecasting 3.2 percent economic growth. The Congressional Budget Office is forecasting 2.6 percent economic growth.

So what troubles this Senator is that the President's budget plan, are slated to take all this money, $65 billion, out of the trust funds of Social Security and Medicare next year, when they are forecasting strong economic growth, to pay for other government programs. Finally, on the tax cut, whether it is Democrat or Republican, I would say this to my dear friend. All of you were out waving those rebate checks on the Capitol steps right before the break.

I know that you would not be out there taking credit for the Democrats' idea. I am sure that would not be the case. But, look, Democrats did support a big package of fiscal stimulus in 2001, bigger than what was passed. We did not support the gimmick of transferring $33 billion to make next year look better. But we, over the 10 years, supported a tax cut about half as big because we could see that it was going to be taking Social Security and Medicare Trust Fund money to pay for other government programs, and we thought that unwise.

Does the Senator——

Senator DOMENICI. Well, I would make two comments, if you would then permit me to be excused for my functions—there will be some Senators here. First, Senators, the statements made by the Chairman are right, but for this year and next year, we lose $100 billion in surplus attributable to the recession. Whatever numbers you are going to use, the tax take is down $100 billion for this year and next year, the total taxes that are coming in are down $100 billion. That precipitates the issue that is being confronted, as to what do you do when you have a $161 billion surplus instead of a larger one? Do you indeed restrain spending? Do you impose taxes to pay for the new spending? It seems to me you have only one alternative. You have to pay the budget that we passed, pay it in full, and if there are a few other things that Congress and

the White House says we ought to do, do them and get on with waiting three or 4 months to see if we must do more to stimulate the American economy. I think that those are the issues. I hope we do them. I hope the distinguished chairman and the leadership on his side will be ready to confront this issue.

Let's have some votes on whether or not, if you need for appropriations, if you need for defense and education $15 billion more than were in the budget, are we going to deny them to you because we have less of a surplus? I do not think so, because the surplus is big, it is gigantic. It is the second-largest in history. So, Senator, I would just say you were right, but imposed on those numbers, regardless of what you are going to assume, is a loss of revenue due mostly to business loss, corporate loss, lack of profits by corporations, of $100 billion for this year and next year.

You did not spend it, Senator, for anybody who says this problem is spending. George Bush did not ask to spend it. His tax cut did not do that. This is the income tax reduction because of the downward trend in this economy. I think that should make it easy, because the surplus is so big, for us to get our work done. The conclusion that my friend is trying to—and he is my friend—trying to suggest to us and to the American people is that every bit of that surplus should be used to pay down the debt, every bit of it. None of it should be used for spending, none of it should be used to pay for the Defense Department if they need $5 billion or $7 billion more in outlays. That is essentially the issue, as I see it. Thank you for listening.

Senator BYRD. Mr. Chairman, before the Senator leaves, he has addressed some of his comments to me because he was talking about appropriations and about my being Appropriations Chairman. A number of times, the distinguished Senator has spoken about the huge surplus that we have on hand. That surplus is a surplus, not in the non-budget items, but in the Social Security budget. There is the surplus. That is the huge surplus which is referred to as the second-largest surplus in the Nation's history. That is the Social Security surplus.

At the same time, we have a President who says we will not cut one dollar out of—we are not going to lower Social Security; we are not going to cut a dollar into Social Security, not one dollar. How are we going to deal with both of these manifested situations that confront us? We have a huge budget surplus in Social Security. We are, right down to the dollar almost, $1 billion. Until we dip into the Social Security surplus, that is where we are. And the President says we are not going to dip into that surplus. How do we do that? How do we avoid dipping into that surplus? The President says we are not going to do it. He says we have got the biggest surplus on record, consequently we can afford all these things; we can afford more money for defense; we can afford more money for education. How are we going to do it? I just do not get it. I do not get it.

It seems to me we are either going to go into Social Security or we are not. Which are we going to do? We cannot continue to claim victory on both sides. I am not seeking a controversy with the distinguished Senator from New Mexico, but he knows as much, if not more, than any other Senator in the Senate about this budget and

about the process. What concerns me is how can we stand before the American people and say we have a tremendous budget surplus, we have the second-largest in history, we can afford all these things, and then at the same time say we are not going to dip into Social Security?

Senator DOMENICI. Mr. Chairman, Appropriations Chairman, if, in fact, the appropriators in the U.S. Senate want to live within the budget that was passed and not touch the fiction of the Social Security Trust Fund, you can do it. You can do it. There will not be an awful lot of new money for education. There will be about 8.1 or 11.1 growth, and you will have to use the outlays on the defense spending, if you give the President the 18.3, use the outlays, and you will be accomplishing the miraculous. You will have 13 appropriation bills and you will have not touched the Social Security part of the surplus.

But, Mr. Chairman, the Social Security part of the surplus does not mean that people are going to get their Social Security checks. What is going to get the checks to future generations of American citizens is a full-growing American economy. If it fumbles around, growing at one-and-a-half percent, 2 percent, then comes down to zero and goes back to three, this trust fund will do nothing to protect Social Security recipients in 15, 20, 30 years from now. As a matter of fact, the IOUs go into the box regardless of whether you spend the money, save the money, or pay down the debt.

Senator BYRD. Would the Senator yield?

Senator DOMENICI. Sure.

Senator BYRD. I know the Senator has to go, and I do not want to impose on your time. How can we maintain that the Social Security Trust Fund is a fiction, on the one hand, and then on the other hand—do you see where I am going—on the other hand say that it is not a fiction, that we can use that surplus, we can get into it? We have got the second-largest—the second-largest budget surplus on record. How can we maintain that there is such a fiction as the second-largest budget surplus on record? How can we say that and then say, on the other hand, but the budget trust fund is a fiction? Now, which is true? Is it a fiction or is it not?

Senator DOMENICI. Mr. Chairman, with reference to what you use it for, you do not have to use that money entirely for Social Security. That is the point. The answer to your question is you do not have to use all of it to protect Social Security. You do not have to leave all of it there. What you will do with it, if you leave it there, is pay down the debt. That is all you would do with it. If you spend some of it, the IOUs go to the Social Security system from the government of the United States in the same manner as if you had not spent the money.

Senator BYRD. What I cannot understand is how we maintain that the Social Security Trust Fund is purely a fiction, on one hand, and on the other hand say that we have got the second-largest budget surplus in history.

Senator DOMENICI. The surplus comes from collecting taxes. We are collecting more taxes than we are going to spend out now. The Social Security checks are going to get taken care of, it looks like, till 2037, regardless of what we do with this account here today or next week, till about 2037, and the issue comes what do you do in

a recession when you have that much money accumulated? Is it a drag on the American economy? Should you put taxes on to pay for the add-ons that you might want? I think the answer to the latter is no. The answer to the former is yes.

Chairman CONRAD. Maybe I can just reach closure on this by saying my own judgment is talking about surpluses here is totally misleading to the American public. The only way anybody can claim surpluses is to jackpot all Federal funds, the trust fund and the general fund, put it all together, do not differentiate them. That is the real fiction. The real fiction is to talk about surpluses, because I think that leaves the American people to conclude there is extra money, there is more money for more spending, there is more money for more tax cuts. The truth is those surpluses are all committed. That is the truth of the matter. That money is all committed to keeping promises that have already been made.

So I think all this talk about surpluses has totally misled the American people. There are no surpluses. All the money has been committed, and if we go to the year 2002, the numbers do not lie. The numbers do not lie. You go down the list and if you put in what our friends across the aisle put in their spending plan for the budget, and if you put in the President's defense request, what you see is at a time when they are projecting strong economic growth—they are not projecting recession—projecting strong economic growth, they are going to use every dime of the Medicare Trust Fund money, and $28 billion of Social Security Trust Fund money, in that year alone.

Senator BOND. Mr. Chairman.

Chairman CONRAD. That does not add up. Let me just say this. We are going to end this dialog and go to our witness, and then everybody will have a chance for their questions.

Again, Mr. Daniels, just your appearance has triggered this conversation, and it is a healthy conversation. But we are going to go to the witness.

Senator BOND. Thank you, Mr. Chairman. That was going to be my suggestion. It has been very enlightening to hear the discussion. I was kind of interested to hear what Director Daniels wanted to say.

Chairman CONRAD. That is what we are going to hear right now.

Director Daniels, please proceed.

STATEMENT OF MITCHELL E. DANIELS, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DANIELS. Thank you, Mr. Chairman. Let me just say I think it has been a very successful hearing so far, and I have yet to make my first mistake. [Laughter.]

Chairman CONRAD. Please proceed.

Mr. DANIELS. I will just be very brief. I did want to draw a couple of, perhaps, just technical matters to the committee's attention, and then draw what I think are the obvious conclusions, and then welcome your questions. You had here, I think 2 days ago, Dr. Dan Crippen from CBO, and I know he did his usual excellent job. I would draw to the committee's attention really the remarkable coincidence, similarities, as Dan pointed out on several occasions in his testimony, between the two reports.

You have two entirely consistent reports here, and I am struck by that. Looking back, historically, there probably has rarely, if ever, been two independent reports from these two agencies that look more like. A few just for instances: The 2002 surplus is estimated within one-third of 1 percent in the two reports, debt outstanding within a fifth of a percent. Over the 10-year time period, receipts are within less than a percent; mandatory spending, discretionary spending and the total of those two, all within 1 percent. The Social Security surplus, the part of the surplus attributable to payroll taxes, is within a tenth of a percent over that time period, and many of the underlying assumptions, inflation and long-term GDP and several others, happen to be identical.

Perhaps most important for the immediate deliberations of the Congress, particularly the leadership of the Appropriations Committee, is that the receipts forecast for 2002 is identical between the two agencies. I think this has escaped some folks' notice because they only looked at sort of the first order or first level of detail. There is a difference in the first-year growth numbers, but that, of course, is just one of several variables that go together to help us understand how much money the Congress will have to work with, because they are more cautious about growth. We are more cautious about the revenue composition, the revenue derived from a given amount of growth.

It turns out that we have exactly the same number, twenty-one thirty-five—theirs rounds to 34—those are billions, I am sorry—for revenue next year. I just mention this to indicate that I do think the Congress can take some confidence, and both forecasts can be wrong, of course, but some confidence that two independently arrived at analyses are that consistent and that close together. We can start from the same facts, and as the previous discussion illustrated, come to different conclusion. Mine, you will not be surprised to know, are about as follows: This is, by any rational definition, an enormous surplus.

If it is wrong to call it a surplus, then we were wrong for all of American history until the last couple of years, and no one else outside of Washington I know has any trouble identifying the current term to apply to a situation where revenues exceed all expenditures by hundreds of billions of dollars. That surplus, both analyses agree, will get bigger, not smaller, in 2002. It will be in excess of $3 trillion over the 10-year time period.

The second conclusion I would draw is that the essential work of the Congress the balance of this fall is very straightforward now. Within the budget resolution as amended by the President's request for funds to rebuild national defense, we can honor all of the commitments, including that common commitment to set aside and use—I stress use for debt reduction—the surplus attributable to payroll taxes. Those moneys are always used, as we know. They are always tapped. We are only discussing for what purpose, all for debt reduction and how much more for debt reduction.

So my hope and my optimistic aspiration for the next few weeks is that, under Senator Byrd's leadership and others, we will have an orderly and cooperative appropriations process that, for the first time in awhile, produces—does the public's business, does the people's business, apportions the resources available and does so under

the framework of the budget resolution, which at least so far this year has not been tossed in the ash can, as so often in the recent past. The work of this committee and its House counterpart, ultimately the entire membership of Congress, has produced a budget resolution that will allow this to happen.

This is the President's first budget proposal. It does, as he intends to do, keep the promise, first of all, to reorder the Nation's priorities along the lines of about which he has spoken for years, and, as a part of that, to commit to debt reduction the amount of the surplus that comes from Social Security. The budget and the fiscal condition of the Federal Government of the United States is in astonishingly good shape. Senator Domenici made the important point we are running enormous surpluses, growing surpluses, in spite of a struggling economy. It is the economy that is not in adequate or acceptable condition, and I hope that that will be the focus and the increasing focus of this committee and all Members of Congress. Despite our temptation to imagine otherwise, the government of the United States—not the Congress, not the President—does not drive economic outcomes in this country, but it can have a lot to do with creating the conditions for growth, and it should do all it can, within its limitations inside a 10-plus trillion dollar economy, to foster that growth, which alone ensures this kind of positive fiscal future.

So we will be asking the Congress to proceed through within the rough framework of the budget resolution, lots of give and take—of course, the Congress finally deciding how to apportion those resources within a total that we think reflects a balanced policy of record debt reduction through the use of the surplus for that purpose, but coupled with a stimulus in the short-term, the growth-sustaining effects of rate reductions over time that the tax bill provided for, both short and longer-term economic growth, all enabled by the strength of spending, not through frozen levels and cut levels and that sort of thing, not to the kind of levels which the Congress, by the way, achieved or was forced to achieve in part in the 1990's, but to moderate growth of a few percent a year.

These are attainable goals, and we suggest we ought to be about the business now of achieving them. I need to make then just one other point, and it is an appeal to the Chairman to be much more careful about the use of words which are inaccurate. Virtually the rest of the world has come to understand how this all works, but phrases like, "coming out of trust funds; raid; taken from the trust fund," over and over and over again, this is not a matter of misinterpretation. This is a matter of fact. It is not true. No funds come out of the trust fund. The trust funds are not one dollar, one quarter, one nickel smaller than they would have been.

It is an easy misunderstanding, but now, with so much focus in recent months, there are very, very few people who talk about it that way. Even the media of the United States has caught on. And it is very important, I think, for people in leadership positions not inadvertently, let alone intentionally, to mislead the American people that there is one dollar less in the trust funds than there would have been, or if there is any question about paying every penny of benefits in Social Security and Medicare. We are paying every penny of benefits with 150–60–70 billion left over. There is not an

ounce of doubt, and there is not an ounce of truth in the perhaps casual comment that the trust funds in some way have been raided or reduced.

So I would appeal for caution and precision in the words we use, so that we can work constructively toward the outcomes we all seek. Thanks for the opportunity, and I am happy to take questions.

Chairman CONRAD. Thank you for your testimony, and I would like to start where you left off. I believe I have been precisely correct. It is true that when Social Security money comes in, it gets credited to the trust fund, no matter how the dollars are used. But how the dollars are used really matters to the ultimate disposition of the promises that have been made. You know, if you think about the private sector, there is no private sector entity in America that could take the retirement funds of its employees and use it to pay the operating expenses of the company. We should apply the same principle here.

We should not take payroll taxes that have been paid on the promise that people will, in the future, get Social Security benefits, take the money, credit it to the trust fund, and then go take the dollars and use them for something else, because when you do that, then you do not pay down the debt to the extent the President has promised. We already see that in the CBO numbers, and you have less ability to keep the promises that have been made when the baby boomers retire. In fact, one of the great disconnects I see going on in this town is you sitting there, Mr. Daniels, saying, "Everything is fine with Social Security, everybody is going to get paid," but the President's own Social Security Commission has quite a different take on it.

Let's put up what they said. This is the interim report from the President's own Social Security Commission. That is not Kent Conrad's commission. It is the President's commission. What did they say? "If the current system's financing is left in place, future workers and beneficiaries will experience one or more of the following: one, large tax increases; two, significant benefit cuts; three, widespread reductions in other government programs or, four, unprecedented accumulations of debt."

Mr. Daniels, you cannot have it all ways here. It is not going to work. At least it is not going to work with me. To say on the one hand that everything is fine with Social Security, and on the other hand to have the President's own commission say you are facing large tax increases, significant benefit cuts, widespread reductions in other government programs or unprecedented accumulations of public debt, and you at the very same time are here with a budget that takes $500 billion of Social Security and Medicare Trust Fund money, based on your tax cut, based on the Republican spending plan, based on the President's request for increased defense expenditure, it does not add up.

How do you reconcile the conflict between what the Social Security Commission says and what you are saying?

Mr. DANIELS. If there was one, I would reconcile it for you, Senator. Something I said apparently mislead you. All is not fine with Social Security. In fact, Social Security long-term does face these problems. That is why the President has proposed major reform,

the first President to do so, and all those statements made by the commission are roughly accurate. So all I said was that in the context we were discussing, the budget this year, next year and so forth, sometimes loose talk, untrue statements about the state of the trust funds and so forth, could mislead people. One is sometimes tempted to think it is intended to mislead people, to believe that somehow their Social Security check is in jeopardy. No, that is not the issue. The issue is out there, as was correctly alluded to earlier, years ahead of us.

Chairman CONRAD. Well, that is exactly right. It is ahead of us. It is ahead of us, and your own commission has pointed out what is going to happen. In the future, people are going to face big tax increases, massive cuts in benefits, massive debt, because we have not prepared now for what is to come, what we all know is to come. We have not done what other countries are doing to prepare for the retirement of the baby boom generation, and frankly, when you come before this committee and say that we can honor all the commitments for 2002, I tell you I think it defies logic and defies truth.

We just put up 2002. These are CBO's numbers. It includes the budget resolution that our friends, the Republicans, crafted before we gained a majority in the Senate, and the President's request for additional defense spending, and the numbers do not lie. The numbers show that you are going to be taking $38 billion out of the Medicare Trust Fund this year, and $28 billion out of the Social Security Trust Fund this year. You are taking those moneys that are payroll taxes——

Mr. DANIELS. Excuse me, Senator. Not one dollar comes out—first of all, there are no dollars in the trust fund. There are never any dollars in the trust fund. I think you know this. There are only bonds, and not one nickel of those bonds ever comes out.

Chairman CONRAD. You will get your chance to respond. Let me make the point. You are taking $65 billion of payroll tax revenue and you are using it for another purpose in 2002, when you say there is going to be strong economic growth. You are taking payroll tax revenue, $38 billion of Medicare payroll tax money, $28 billion of Social Security payroll tax money, you are crediting it to the trust fund, I will grant you that. But then you are taking the money and you are spending it on something else. You are not paying down the debt with it. You are taking that money to pay for other government programs.

I tell you there is not a private sector firm in America that could get away with it. They would be on their way to a Federal institution, but it would not be the Congress of the United States and it would not be the White House. It would be a Federal prison, because that is fraud.

Mr. DANIELS. Well, now, Senator, first of all, if we had ever held Social Security to private-sector standards, we would have a jailfull of trustees somewhere right now. There are no assets, other than the future promises that future taxpayers will pay off the bonds in those trust funds. So there has never been a time when Social Security resembled a private sector system. The President has suggested that, at least partially, the fundamental reform which alone can head off future problems, would go in the direction

of making it more like a private sector system, giving retirees ownership, as a private-sector plan might.

Chairman CONRAD. Where you going to get the money to do that?

Mr. DANIELS. Of real assets.

Chairman CONRAD. Where are you going to get the money to do that when you have taken all of the Social Security and Medicare Trust Fund money and used it for something else? The surpluses that you describe, the only surpluses that are left, are Social Security funds. You have blown right through all the Medicare Trust Fund. You have taken it and used it for something else. So how are you going to fund this transition to the program the President wants? Where is that money going to come from?

Mr. DANIELS. I can ask you the same question, Senator. You have used it under your plan for something else. You have used it for incrementally more debt reduction, on top of the record debt reduction that the President intends.

Chairman CONRAD. No, you left out the other element of my plan. Not only did I have more debt reduction because I reserved all the money of the Social Security and Medicare Trust Fund for the purposes intended, but I also set aside $900 billion to strengthen Social Security for the long-term, which could have funded the accounts that you seek. Unfortunately, you did not. You did not provide a dime. So the result is you have an overall budget plan here that does not add up, and that is no longer just my prediction. I have been predicting this for months. Now we have the Congressional Budget Office telling us your budget plan does not add up; it does not come close to adding up. The result is that you are taking Medicare and Social Security Trust Fund money and using it to fund other operations of government right before the baby boom generation retires.

I tell you I think that is most unwise, and the answer has been, "Well, we are in a recession." Well, you are not forecasting recession next year. You are forecasting strong economic growth. You are forecasting 3.2 percent economic growth. The Treasury Secretary suggested this morning that economic growth could be considerably less than the Bush administration's official estimate for 2002. Can you tell us who is right with respect to what the administration's position is on economic growth for next year?

Mr. DANIELS. I checked with the Secretary, and he said, but someone misunderstood or misheard him, he said private sector forecasters are forecasting something somewhat lower. As I mentioned before, our forecast of revenue is just as conservative, if that is the right term, as CBO's, identical. So we are more cautious about other variables. Some people simplistically think that from the single number of GDP growth, that is sort of all you need to know to know how much money the government is likely to take in, but members of this committee know that is not right.

I guess, since we are still having trouble getting to the facts here, it is time for America's favorite game show. So may I have—I guess I am supposed to speak into this. In case members of the committee——

Chairman CONRAD. Actually, I do not think you need to hold it. I think it will pick you up if you just put it at the edge of the table,

so you would not have to—it is directional. So if you pull it up, it will pick you up, I think.

Mr. DANIELS. Well, I will not be here long. But just so everybody understands, here was the May estimate, before any decisions were made about any additional spending for agriculture or defense, or for any rebates and so forth, of $275 billion of projected surplus. Take the August estimates, all CBO's by the way, because that is what this committee prefers to use, and assume there had never been a Bush tax cut. You would have had 227. There would have been shrinkage due to the economy and the spending I referred to. After the tax cut, CBO is projecting 153.

The question is if, in fact, benefits are somehow threatened or trust funds have been raided, tapped, used in some way, then, of course, those numbers would change. So I am prepared to pay the entire amount of the unified Medicare surplus to those who get the answer right. Social Security benefits, under the original forecast, would have been $426 billion. If there had never been a Bush tax cut, we would pay exactly the same about of money—or if there had been only the recession—I'm sorry, the downturn Without the tax cut, the same amount of money, and perhaps most important, have the trust funds been dipped, tapped, raided? Well, the May estimate showed a trust fund balance at this point of 1.17 trillion. The August estimate, 1.17 trillion. The Bush tax cut, imposed on top of the spending and the economic effects, startlingly, 1.17 trillion.

This is why: Expert after expert, and now non-experts, have all come to understand what language is true and what is not. I would just take that one away. I have got a partial list here, because we only have a few hours. The Comptroller General: "trust funds will not be affected in any way;" Newsweek, a Pulitzer prize-winning economist, "The image of raids is false;" The Wall Street Journal, "Raid on Medicare, the idea is ridiculous;" Washington Post, "Aren't we raiding those programs? No."

I will just be selective here: The Social Security surplus can be put in a bank somewhere? Washington Post editorial, "It doesn't work that way;" former Clinton OMB official Matt Miller, "Raiding Social Security and Medicare, it is not true;" President Clinton's Labor Secretary, Dr. Reich, "It is a fiction. Democrats should stop their bellyaching about raids. It is irrelevant." Do we have one more? Detroit News, "No relationship between the budget surplus and the trust fund;" my CBO colleague, Dan Crippen, in front of this committee, "It does not make any difference to the programs or the benefits or the trust fund;" Time magazine, "It does not imperil current recipients. The fact is this, there is no box. There is no lock;" and advisor to many leading members of your party, Senator, Dr. Kuttner, "Stop equating the surplus with saving Social Security."

I am sorry to be tedious, but, in fact, I guess my point is what we are debating and what separates us, I think, has been exaggerated. The differences are very narrow, and we have a couple of honest debates. One is what is wise tax policy, and I know that debate will continue, and I respect the position of some who think particularly the extended policy of tax reduction was unwise. We have a second debate about how much debt reduction. Nobody is against

debt reduction. We are going to do it in a record amount. The question is what about that next 10 or 20 billion, whatever, in a given year?

I think the President's policy calls for one of balance. We can have this debate, but I would just urge us to get it onto that plane and out of an area in which it is all too easy for people to misunderstand what is really at stake. Finally, as we have that debate about the right mix of tax levels and debt reduction and spending levels, let's do it with an eye on economic growth. Surpluses, per se, cannot be the end and the sole end of our common endeavor here. They are a means to an end, and surpluses do not produce economic growth. Economic growth produces surpluses.

So I honestly think that although good, healthy political to-and-fro is part of the recreation of the town and good fun on occasion, but I think, especially as we move into the appropriations process, we ought to recognize that we have narrower differences than we sometimes act like, and that our end objective is less about the exact accounting of the Federal fiscal situation and more about how that can best optimize our economy over time. Sorry for a long answer.

Chairman CONRAD. No, that is fine, and this is a very healthy debate and an important one. Let me just tell you that you could put up a dozen quotes by people who say it does not matter. To me, common sense tells almost anyone that it does matter. You can credit money to the trust fund all day and night, but if you then take that money and do not use it to pay benefits, do not use it to pay down debt, which is what we use surpluses in the trust funds to do, instead you use it to pay the other operations of government, that has real consequences.

One of the consequences is exactly what the President of the Social Security Commission described. We are headed for choices that mean either large tax increases, significant benefit cuts, unprecedented accumulations of debt. It does not all add up. It does not all add up. When you take the Social Security Trust Fund money and the Medicare Trust Fund money——

Mr. DANIELS. Revenues, please—Social Security revenues.

Chairman CONRAD [continuing]. When you take those moneys that were credited to the trust fund, payroll taxes, and use them for another purpose, you dig the hole deeper in this Senator's judgment. To me, it is very clear. I believe that is a raid. I do not care if you credit it to the trust fund. What you do with it afterwards matters a lot; and, in addition to that, what you are saying that the President's promise not to use Medicare and Social Security Trust Fund money to pay for other purposes was a hollow promise, it meant nothing. I do not think it was a hollow promise. I think the American people have a pretty good understanding of what this is all about. I think it is why Senators and Congressman in large numbers have voted and promised not to take Social Security Trust Fund money, not to take Medicare Trust Funds, and use them for other purposes, because the American people are pretty smart, just like they know in a private-sector setting you cannot take the retirement funds of the employees and go use it to pay operating expenses of the company.

Mr. DANIELS. Well, you cannot use it to pay the interest cost of the company, either, which is your recommended policy here. So I think the private sector-public sector analogy will never be of any value, unless and until we fundamentally restructure Social Security and make it into a true asset-based system. Let me——

Chairman CONRAD. No, wait. I listened at length to your answer. I listened at length patiently. I did not interrupt, so I am going to ask the same from you. Look, it is abundantly clear the way Social Security works, and to the extent our trust funds are in surplus, that it is used to pay down the debt. Because you have more debt paid down, that means more savings, more investment, stronger economic growth; and so we are in a better position to meet the obligations in the future. To the extent that you take that money and spend it, you do not have that same positive effect on the economy. So, to me it is very clear; taking these funds, using them for other purposes what the President expressly promised not to do is being done.

Final point on honoring all the commitments, it just does not add up. It just does not add up. If we took at 2002—put up the 2002 budget—we just take the Republican spending plan, the Republican tax cut, and the President's defense request, and you are taking Social Security and Medicare money and using it for other purposes, something the President pledged not to do. It is just not accurate to come in here and tell the American people and tell this committee you can honor all of those commitments.

Mr. DANIELS. Thank you, Senator. Three things: First of all, I appreciate the first part of your last question, because I do think you frame the argument and the honest debate we have in the right way. It is the way that your counterpart, Congressman Spratt, for example, in the House is always careful to do. It is not a debate about raids and so forth. It is a debate about which way we use the extra funds. By the way, let me point out that the year 2000 is the first year, aside from a few very trivial exceptions in the 1950's, the first year in history that we had surplus—that we did not use any Social Security extra receipts for anything else, as you would say, for anything other than debt reduction. So this is a brand-new phenomenon, not some long-time practice.

Chairman CONRAD. But there is a reason for that.

Mr. DANIELS. The President's 2002 budget is the second in history, only the second, after the 2001 proposal, to ever propose setting aside all extra Social Security receipts for debt reduction. In 2000, when it happened, President Clinton did not propose it. It happened because of an enormous gust of revenues coming in from a strong economy, further proof that it is the economy that is the real driver and our first concern. But in any event——

Chairman CONRAD. Can we just say that one thing we agree on is that it is the economy? We need to keep our eye on the ball of the economy. Can we go to Senator Grassley?

Senator GRASSLEY. Mr. Daniels, I do not think you need to be at all embarrassed about the fact that something does not add up, because if you would superimpose on this chart the Democratic alternative budget—and you can get it right there, in front of Domenici, if you would like to have a copy of what I have got here—if you would superimpose the Democratic budget alternative on this and

if you would adjust it minus the Medicare health insurance surplus, adjust it minus the CBO economic and technical adjustments, take into consideration everything that the Democrats wanted to do this spring on defense, on taxes, on additional domestic spending, all of that, you would find only this difference for the year 2002, between what the Democrats propose and where we are right now. The difference would be—the $38 billion would be exactly the same. The only place that there would be any difference here would be $25 billion, instead of $28 billion.

Now, that is where they would have taken us, and I am going to give this to you so that you know that I got it from the web site for the Democratic alternative budget proposal. These are the adjustments that would have been made to your budget by the CBO adjustments that are made in August. So if it does not add up, for us as Republicans, if it does not add up for the President of the United States, then it does not add up for the Democratic alternative budget, either, and whatever you had said about the President's budget must also be said about—if we had gone your direction last March.

That includes what you wanted to have in your budget for Social Security. It has everything that you had, adjusted accordingly.

Chairman CONRAD. Let me just say that——

Senator GRASSLEY. So if it does not add up for us, it does not add up for you, either.

Chairman CONRAD. No, there is a very big difference here. We did not support shifting $33 billion out of this year into next year to make the President's tax cut look more affordable next year. That is not in your numbers. I specifically opposed it. I said it was a gimmick at the time. You delayed corporate receipts by 2 weeks to move them from this fiscal year into next fiscal year to make the next fiscal year look better. We did not engage in that gimmick.

Senator GRASSLEY. Well, you are wrong to this standpoint: The $33 billion you are talking about does not affect your alternative and it does not affect our numbers, either.

Chairman CONRAD. Well, but certainly it does.

Senator GRASSLEY. The numbers I have just given you.

Chairman CONRAD. No, certainly it does, because by transferring that money, you dodged right into the bullet. That is why you are going to take Social Security Trust Fund money this year and use it for another purpose. If you would not have shifted that money, you would not have that problem in 2001.

Senator GRASSLEY. Let me be clear. It does not affect the numbers that I have just given you, that shows if we had adopted your budget, you would have ended up just $3 billion short of where we are.

Chairman CONRAD. Look, for the overall period, trying to rewrite the history here is not going to work. I warned repeatedly that you could not rely on the 10-year forecast, that the tax cut that you proposed was twice as big as the tax cut that we proposed, and as a result, you have a circumstance in which, over this next 10 years, you are going to be taking $500 billion out of Social Security and Medicare Trust Fund money and using it to pay for other government expenses. That is not my budget. That is the budget that you all passed.

My budget was far different and would have avoided most of these problems for the long-term. Look, I have said very clearly we favored more fiscal stimulus this year to give lift to this economy. But we did not support this transfer of the $33 billion out of this year into next.

Senator GRASSLEY. Well, let me respond. First of all, you end up with a $237 billion raid on Social Security and Medicare. Now, those are your words, raid; they were your words that it does not add up. If we had done what you wanted to do, whether you are right or wrong on your interpretation, of your criticism of Mr. Daniels' message here, I think it is intellectually correct that you have to be saying the same thing about your budget, as well. And so what I am calling for is the intellectual honesty of it, as opposed to disagreeing with what you said, because in some respects I can agree with what you said. But the point is that whatever criticism you have of the President's approach, you have to have the same criticism of your approach, because when it is adjusted for the August changes that were brought about, you end up raiding Social Security, Medicare, $237 billion.

Chairman CONRAD. No, that is just not true. I think all of us remember exactly who took what positions on this committee and on the floor. I warned repeatedly not to count on a 10-year forecast. It was too uncertain. The tax cut that I proposed was half as big as the President's, and we restrained spending in almost the same way. We took spending down to 16.4 percent of GDP, the lowest level since 195, in the budget that I proposed. If we are going to be intellectually honest here, let's do it.

My proposal would have had lower deficits and would not have raided Social Security. It just would not have. Our budget was far more restrained because we had half-as-big a tax cut, because we could see that the President's plan did not add up.

We will go on this side to Senator Corzine.

Senator CORZINE. It is great to join the fray. Let me ask a big-picture question, and I want to get back to this $33 billion that was transferred from 1 year to the next, which is the ultimate gimmick. Do you agree with Senator Domenici's categorization of the trust fund fiction as being a fiction?

Mr. DANIELS. The trust fund is not a fiction. It has sometimes been said that the lock box is a fiction. The notion has certainly been written by people of all persuasions, including many who, as I illustrated, do not agree with the policies of the administration, that the idea of raids is a fiction, that sort of thing. But, no, the trust fund itself is real. It is only what it is. It is not a pile of cash, as some have imagined.

Senator CORZINE. Is it an asset?

Mr. DANIELS. It is an asset in the sense that it is a bond, secured in this case only by the ability of future taxpayers to pay it.

Senator CORZINE. Full faith and credit of the U.S.?

Mr. DANIELS. Yes, but as the chart the Senator has used a couple of times indicated, if the system trundles on without reform, the implications in order to pay the full faith and credit obligations are enormous, in terms of benefit cuts or massive tax increases.

Senator CORZINE. Let's just pursue that 1 second. The way you grow the ability to pay for future Social Security benefits is to grow

the economy, and one of the ways to have that done is through national savings, and what this debate is about is whether the moneys that go into the trust funds are actually contributing to national savings. If they are not and they are spent on current consumption, there is a difference. There is a huge difference and a huge long-term difference in what the size of the economy will be, and therefore the ability of the economy to produce the kind of payroll taxes that will support future Social Security benefits, and you get into these kinds of problems. That is one issue.

The other issue is that about sometime in the mid-1990's, society and politicians, in general, Republicans and Democrats, started making the case that ought to set aside these Social Security payroll taxes, which were intended for purposes of paying Social Security and Medicare benefits, and set them aside and use them as savings so that we would prepare for the demographic bubble that is rapidly approaching us. You do accept that if we save those assets and they grow, purportedly based on the recommendations of the administration, you believe that if you wanted to privatize accounts, there are different ways to do that, but there is a belief that you want to grow those assets that are in that trust fund, not unlike what I think the political argument has moved in the last four or 5 years. It seems like we are just denying that when we say we are using loose language about raids and invading and taking out of the trust fund. That is not where the debate with the American people has been, and I do not think that we are using tight language, to use the opposite of the term you are saying, when you say we are using loose language when we are talking about raiding the trust fund, because the political debate has changed.

People said we wanted to set aside these funds more in the pension fund kind of context, to grow them, and I think the kind of language that you saw the President use, that the Chairman cited and that most of us have used in our political campaigns, has moved to that position. I think it is very dangerous to try to say that we are not using payroll tax-generated trust fund moneys for general expenditure purposes, because that is going to confuse everyone's point of view. I think that is, unfortunately, I think, challenging what the Chairman has said here this morning, does just that.

I have a specific question. We moved $33 billion—I think it is actually maybe a larger number, according to CBO—from 2001 to 2002, from a September 17th payment to an October payment date. There was obviously a give-up in interest cost that the American public paid. Did corporate America get a revenue transfer from the American public to fund this $33 billion movement from one fiscal year to another?

Mr. DANIELS. I guess it depends on how many of them do wait the extra days or do not, and we do not know. We anticipate, based on history, that many will pay at the original date. This was the subject of some dispute in the last couple of weeks, the history, because Congress has done this before. In the previous administration, this same sort of thing was done with different tax, and some businesses went ahead and paid, either unknowingly or knowingly,

ahead of time. We will not know until next month how many chose to take advantage of the offer to wait.

Senator CORZINE. There is an implied cost, though, to the Federal Government of some substantial—at least some significant millions of dollars—in lost interest expense or, I guess you would put it that we paid interest on debt that would not have otherwise been paid because of that movement.

Mr. DANIELS. Yes, it would be very insubstantial in the grand context, but I agree with you.

Senator CORZINE. Would you have recommended that in the private sector?

Mr. DANIELS. No, and I did not recommend it this time, either. You know, the providence of this particular proposal was sort of lost to history. No one seems to want to claim it now, and I will not either, because it was not the President's proposal. I do not disagree with the Chairman that there was, in general, an artifice. There have been a lot of these, and I guess I just sort of view it sort of benignly in a way, because it was entirely a matter of this snapshot mentality into which the process has worked itself. No, in any commonsense business or other setting, you would not have done it.

Senator CORZINE. I would argue that, about using pension fund resources when you have made a commitment to use those for paying out long-term liabilities, and I think that is the kind of conversation we have had here with regard to the trust fund today, and I think the conversation with the American people has moved substantially with regard to that over the last 5 years.

Mr. DANIELS. I agree, Senator, and I think your comments were very helpful, as were the Chairman's some minutes ago, before the last exchange, during which I observed the wisdom of the African proverb, "When elephants collide, it is the ant who is in most danger." I sat that one out. No, I think there is an honest debate about, again, at the margin, how much debt reduction versus any other use of the money, of the extra Social Security revenues, is wise?

I believe the commission, on the slide that the Chairman used, expresses a view close to that of the administration about the long-term fundamental problems with Social Security, which we do not believe can be fixed by simply paying down debt even faster than we already will. As you know, it is the President's intention to pay off all the debt that can be practically retired well before the Social Security crisis arrives. But paying that off or more or even faster does not do anything to increase the asset value of the trust funds. It simply gives you more borrowing capacity when the day comes.

I think that most analysts would agree that we will not be able to borrow our way through that problem. If we drive the debt to zero and we leave the Social Security system as it is, pay-as-you-go, promises vastly exceeding the ability of the work force at the time to pay them, that the fact that we can borrow an extra couple, $533 billion, we will go through that in a heartbeat. So I think it takes you back to the issue of the need for fundamental reform. Again, there will be widely different viewpoints about how that ought to happen, but I hope we can all work together on it—again,

I think the true issue here—which is how much debt repayment how fast.

Chairman CONRAD. Let me just say Senator Grassley made a charge here with respect to my budget, and as I indicated, I did not support the artifice of transferring the money, but beyond that I supported the Snowe proposal to have a trigger, so that we would have protected Social Security and Medicare if we got into the circumstance like the one that we have now. I mean, he just left that out. So when somebody comes in here and presents a budget and suggests it was mine, and leaves out a key element, to protect Social Security and Medicare, which Senator Snowe and Senators on our side proposed, they are not being square here. They are not telling the whole story, and I think anybody who is honest, who has sat around this table, knows full well I predicted repeatedly that the tax cut the President was proposing was too big, that it endangered doing precisely what we see happening now; that is, the taking of Social Security and Medicare payroll taxes and using them to pay for other government operations.

I think that is unwise, and it is not just a matter of paying down debt, because it is true I reserved more money for paying down debt than did the President's budget, but I also reserved $900 billion to prefund the liability or to establish individual accounts. Look, we were shooting straight. We provided the resources to strengthen Social Security for the long-term, to address the problems that the President's commission has now described. The President's budget did not. Now, that is just a fact.

Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Director Daniels, thank you for appearing this morning. We have heard a lot this morning about all the downsides of tax cuts. Are there any positives to tax cuts? That is to you, sir.

Mr. DANIELS. I'm just not used to getting a question that friendly. I barely know how to react. Obviously, the President believes that there are, and I think so do an overwhelming number—unanimous, as far as I know—economists who have said—I could have brought an even more tedious set of quotations on that subject—who have said that a tax cut was very much in order now, even many people who disagree with the idea of sustained predictable tax cuts over time very much seem to be united about saying tax cuts in a time of economic weakness were a very smart thing to do. And then there is some division, although I think most economists would agree that predictable rate reductions, in the rates that are paid by so many small businesses, as well as individual workers, is also very positive for the economy.

Senator HAGEL. Meaning generally more revenues would flow into the Treasury as a result of tax cuts?

Mr. DANIELS. Well, we do not assume that.

Senator HAGEL. I know we do not. We budget, I think, in a way that the Stone Age budgeting crowd did, talking static versus dynamic, so what we essentially do is we penalize in the budget tax cuts. We see tax cuts as essentially deficits taking away from the numbers, as we heard this morning, when in fact, and I use the term "fact" very deliberately, because I am looking at a CBO report from 1987 that says all tax cuts, all tax cuts in the last 50 years

have resulted in a net increase in Federal revenues. Do you disagree with that, Mr. Director, or could you enlighten the panel more that issue?

Mr. DANIELS. I think both common sense and the data tells us that there is far more than a zero effect.

Senator HAGEL. A positive effect?

Mr. DANIELS. Positive effect.

Senator HAGEL. Bottom line, positive effect, more money coming into the Treasury as a result of tax cuts, revenues?

Mr. DANIELS. Yes, sir.

Senator HAGEL. Anything else you would like to say about that?

Mr. DANIELS. I believe in quitting when I am ahead—quitting when you are ahead.

Senator HAGEL. Well, I do not know about that. I am never ahead. But I have another point I would like to go to, because we brought this up with Dr. Crippen the other morning, and that is the so-called Medicare Trust Fund, the surplus that we are running. A couple of issues here. Dr. Crippen gave this panel and those listening a very good, explicit, factual representation of Medicare, the total, which I think is the only legitimate, fair way to look at this, and he said that there are essentially three parts to Medicare. There is a Part A, which is the so-called trust fund, which we hear a lot about, that we are running a surplus when, in fact, according to the CBO numbers, the surplus for the next 10 years, Medicare Part A will be about $404 billion, and, in fact, the Part B Medicare, which represents almost half of all spending in Medicare, will have a shortfall. Now we are looking at probably $992 billion. So hardly that represents a surplus for Medicare. Would you care to comment on that, Mr. Director?

Mr. DANIELS. I think that is the only fair and accurate way to look at it, and we have discussed this here before. Here is a representation, just for 2002, of the phenomenon that you just illustrated over the longer term, and I have often said that I think what is especially dangerous about talking about Medicare having a surplus, which it does not have; this year about $50 billion shortfall, which is then taken from general revenues, is—every penny of Medicare receipts, in other words, goes to Medicare, and then there is this shortfall you referred to.

I think that what is probably most dangerous about that is it could lead the system to delay in addressing Medicare reform. Medicare, probably more so than Social Security, is unsustainable in its current form. It needs to be updated, and no surprise after four decades, almost. So I think it would be very unfortunate if the misconception that Medicare has a surplus—and incidentally, to correct something in the historical record, the President has never talked about sequestering the Part A Trust Fund for debt reduction. Social Security, yes, but not Medicare, because of this, because it is not a true surplus. To set aside the argument about that, if it led the system to procrastinate, which the system is all too prone to do, this would be, I think, a really unfortunate consequence. So I think it is very valuable for you to illuminate those facts.

Senator HAGEL. You mentioned, I think your words, "snapshot mentality" of budgeting. Some of us around this panel were in busi-

ness before we had the great privilege of representing our States in the U.S. Senate, and I have been a bit amused at the budgeting process that government uses, in that I do not know of a business—Mr. Corzine might differ with me on this—but I do not know of one, and I have run some, where you budget based on quarterly numbers or you make long-term investment decisions on quarterly numbers, or you really do anything based on quarterly numbers. The Wall Street guys, I know, respond to quarterly numbers more than the rest of mainstream American business, and they have to and I understand that, and I am not critical of that.

But my question to you is this: Is there a better way to do this? We are responding and reacting to the immediacy of these quarterly numbers. We could go back two quarters and find that the CBO and OMB numbers were a bit off, and we were responding and reacting to quarters ago, and we were responding less than a year ago to these projected great surpluses that were going to be able to work with when, in fact, a different story now, as we go into the third quarter. Could you give us your thoughts on is there a better way to do this?

Mr. DANIELS. Senator, there has to be. I came from a business background, too, and I am amused by some of the same things that I think strike you. On the central question that we have spent a lot of time on here, I think some future conversations about this could be helpful. We are dealing with trillions of dollars over time, and the Chairman is very correct to keep us focused on the longer term and on the ultimate issues of Social Security solvency and so forth. It could be that we should be looking at this question of setting aside the surplus for debt reduction on a multi-year basis.

For instance, we elevate the matter to cosmic importance, what the snapshot says on 1 day at the end of September, over an amount that comes to a hundredth of a percent of all the Social Security surpluses that we are going to run, and this is somehow lifted up to, as I say, sort of a transcendent meaning and importance, when it really is not. So I do not have a specific proposal for you this morning, but I do agree that we might well talk about how this commitment that we all share, to one degree or another, ought to be more reasonably measured.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Chairman CONRAD. Thank you, Senator Hagel.

Mr. Daniels, I just have to say to you that, to me, the lack of logic in your position on Medicare was just revealed by this chart. You are saying on the one hand that there is a shortfall in Medicare. But under your budget plan, you are taking payroll taxes coming from Medicare and using them to pay for other government programs. What a bizarre position to take. Medicare is in shortfall, so the answer is to take Medicare payroll taxes and go pay other bills with it, go pay for a tax cut with it. It makes no sense at all.

Let me just say this to you. That strikes me like a person who has a bill coming due for $10,000 for college tuition, but they only have $2,500. So what do they do? Do they save more? No, under your proposal, you would take the $2,500 and go buy a car. It makes absolutely no sense, no earthly sense to me. You say there is a shortfall in Medicare, and so your answer is to take Medicare

payroll taxes and go use it to pay for a tax cut, go build a tank or construct a bridge. What earthly sense does that make?

Mr. DANIELS. Senator, I thought about asking the Secretary of the Treasury if he could start minting money in different colors, so that we could gave green for usual purposes, and yellow dollars could be Medicare and red ones could be payroll taxes, so that we could pretend that these are all different. But, in fact, all the dollars are green, and all this chart plainly shows and the Senator's comment plainly shows is that we take in, in Medicare payroll dollars, vastly less than it costs to run that system. If anybody doubts that this is a fiction, I ask you to think back just three or 4 years, when the alleged surplus was going away.

If you want to talk about a gimmick, somebody in Congress said, "Home health care is eating up a lot of it, let's get it out of there," It was moved, the yellow bar, from the left side—from Part A, I should say, over to Part B, and presto, the so-called surplus came back and got bigger. So I guess my answer would be, yes, any extra Part A dollars, we spend on Part B, and then we have to go get some of those green dollars from the general revenue to cover the rest of the difference. I am very careful not to call this a deficit or something like that. We fund most of government out of general revenues, absolutely. I just do not think it is right to call it a surplus, and that is, I think, the only point here, and again I come back to the thought we tell ourselves we have a surplus, we tell ourselves we do not have a problem, and we have a huge one, and it is probably closer.

Chairman CONRAD. You have been the one who has been here telling us all day that we have huge surpluses.

Mr. DANIELS. In fact, on the national scale, we do. As a matter of Medicare, we do not.

Chairman CONRAD. Yes, but unfortunately, at the national level, it is all payroll taxes. That is the surplus. It is payroll taxes that have been taken from people on the basis that it was going to be used to support the Social Security program or the Medicare program, and instead, in your budget plan, you are taking a chunk of it and using it to pay for other programs. To me, there is an inherent contradiction in your position.

Senator Stabenow.

Senator Stabenow? Thank you, Mr. Chairman. First, let me indicate that in your analogy, when you speak about $2,500 for a car, if it is American-made from Michigan, I think that would be a great idea.

Thank you, Mr. Daniels, for being here. Let me first say that, in stepping back on the whole debate and listening to Dr. Crippen and now yourself, Dr. Crippen indicated to us on Tuesday that the shortfall in surplus dollars now, the changes in the numbers, have come two-thirds from legislative policy changes, one-third from a weakening economy. Any it would be my position and that of many others that what we are seeing is dramatic change in economic and tax policy.

We have an analogy of the 1990's, focused on balancing the budget, fiscal restraint, slowing the growth of government, tax cuts more geared toward the middle-class, an effort to invest in those things that would grow the economy, and labor productivity, such

as education. In the 1980's, we saw what we see happening now. We see a switch coming to what is frequently called supply side economics, tax cuts geared to the top, ask the American public to wait, that it will trickle down, except for $533, it will trickle down to them, large increases in defense.

What unfortunately happened in the 1980's was massive buildup of national debt, which is of extreme concern to me and many, many others of us in the Congress, who see this dramatic change as it relates to economic and tax policy, to a process that unfortunately did not work in the 1980's. When we talk about where we are now, in terms of the numbers and the surpluses, I wonder if you might respond. You said that you agreed with Dr. Crippen. You were very close in your analysis. On Tuesday, I asked him, when we are talking about the largest surpluses in many, many years, frequently a characterization from yourself, as well, are not we talking about large Social Security and Medicare Trust Fund surpluses? Dr. Crippen: "Yes, over the next 5 years, it is almost exclusively Social Security Trust Fund surpluses."

Would you agree with that statement?

Mr. DANIELS. Yes, the differences between us are pretty minimal over that time period and across the whole 10 years.

Senator STABENOW. So when we are talking on the one hand about surpluses and the great economy and all the things that we can do with surpluses, at least over the next 5 years what we are talking about are payroll taxes paid into Social Security and Medicare, and I had asked Dr. Crippen several different ways. Each time, he answered in the very same way.

I would next ask you, just from a factual standpoint, are the excess revenues from the Medicare Part A Trust Fund being used solely to pay down the national debt over the next 5 years, in your budget?

Mr. DANIELS. They are being used to pay Medicare costs. Again, these dollars all come in one color, so we do not put a homing device on any one of them, and track it through the Federal Treasury. But it remains true, indisputably true, that the money that comes into Medicare payroll taxes covers only a fraction of Medicare's cost.

Senator STABENOW. What we are looking at really is a debate and a change in accounting for the first time in 30 years. I find it so amazing. In fact, I went to the Library of Congress and took a look at, since 1965, each year the reports regarding the Medicare Part A Trust Fund, and my good friend, Senator Hagel, and I have this back and forth discussion, I think, in every Budget Committee, as to how that is figured. But the reality is that, since 1965—there were too many to bring, so I brought a picture, to bring my own chart here.

If you look at this, and it is about 16 inches of reports on this desk, piled up, those are the reports that categorize a Medicare Part A Trust Fund, and every year they discuss its solvency and that it is, in fact, in surplus. Now we have a new administration who is coming in and saying there is no Part A surplus, there is no surplus in Medicare, and combining what our two programs, Part A, which is paid differently, and Part B, which was designed to be paid for out of general revenues. Part B was set up for people

to pay in, if they wanted to sign up. Part B, voluntary, you can sign up for it and you can pay premiums, and about 75 percent comes from general revenue.

So, traditionally, since 1965, we have had a Part A Trust Fund, and I know that those in our hospitals and nursing homes certainly are extremely concerned about what happens there, taking deep cuts in the last few years to balance the budget; in my State, services being affected to families that I represent, and Part B, which is a separate program—it was set up to be funded with general fund revenues. As our Chairman indicated, now we have a situation where you combine them, take the surpluses from Part A, combine them with Part B, which was usually general fund. So you are now supplementing the general fund by combining—collapsing-those, and you are taking money that otherwise would be used for Medicare and freeing it up for other purposes, which is of great concern to me, as much as Social Security, given the needs under Medicare and the need to be expanding Medicare, in terms of prescription drug coverage, as well as strengthening it for our teaching hospitals, for our nursing homes, for those providing care across this country.

That is the difference that I am extremely concerned about, and I would ask you, if you are saying that Medicare Part B, which was set up separately—it is a separate program, funded intentionally with general fund revenues—if you call that being in deficit, would you say national defense is a deficit because that was set up to be funded by general fund revenues?

Mr. DANIELS. Senator, I would be concerned, too, if what you said was true. But it is utterly untrue, so we can both be reassured. A minute ago, I very plainly said I never use the word "deficit" to refer to Medicare for the reason you gave. It is not accurate. It is simply another program, like most, that draws on general revenues. I have simply quarreled with what I think is an antique, very misleading and untrue, as Senator Hagel pointed out, notion that the Medicare program, as it exists in the year 2001, three-and-a-half decades after its founding in a very different era of health-care, which was dominated by hospital care, as today is not, is in some kind of surplus.

So please be careful about the notion that Medicare money has been taken away. The trust funds are exactly as big as if there had been any other set of policies, tax policies or otherwise. The little chart I showed for Social Security, there is exactly the same picture of things in the Medicare. In fact, we put that chart, a Medicare chart, in the mid-session review for this purpose. So absolutely share with you the concern about the solvency of Medicare, and nothing about the policies put in place so far has done anything about that. The future of Medicare depends on two things, two things only. Do we or do not we reform the system, because the current system is not sustainable?

By the way—interesting point—one of the biggest, and the very few, differences between our report and CBO's over a 10-year period, over half the difference—there is a difference in terms of the total 10-year surplus projection on the order of eight or 10 percent. Over half that difference is their belief that Medicare costs will go up faster, Medicare costs will go up faster. They might be right. We

believe Social Security costs will go up faster than they do, and Medicaid, for instance. So these are all subject to big error bars, but I just would say that Medicare must be reformed to become sustainable, and we have to have economic growth to pay the bills as they escalate and come due. There has been no accounting change whatsoever. The trust funds are still accounted for in exactly the same way as always. The amounts in the trust fund, the Part A Trust Fund, the amount of bonds there, is just exactly the same.

Senator STABENOW. Mr. Daniels, in conclusion, I might indicate that consistently, since the beginning of this year, the Medicare Trust Funds have been collapsed and counted as part of the budget, as you have come before us indicating how the tax cuts would affect the revenues and looking at the total picture. Clearly, it is not in dispute that you are using accounting—you are counting the revenues that are paid into Medicare as part of the balancing of the budget and the numbers that you are putting before us.

But I would say one other thing in conclusion. Again, to emphasize what the Chairman had indicated, your logic, your statements, make no sense. They are not logical. To say we believe there will be more pressure on Medicare, more spending on Medicare, and yet we are going to change the way that Medicare has been viewed since 1965, in terms of the Part A Trust Fund, instead of strengthening it, instead of putting more dollars aside for Medicare because you believe that there will be more expenditures in Medicare, you are taking those receipts that are counted toward Medicare and turning them around and using them for other budgetary purposes. I believe that it is wrong and that it is dangerous, and it is part of the deep concern that I have about the direction we are going.

The CHAIRMAN. Thank you.

Chairman CONRAD. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

Just to followup on that point on Home Health Care in Part B, but the fact is, talking about gimmicks, that was the greatest gimmick of all, by moving Home Health Care from Part A to Part B as a way of addressing the solvency question in Part A, obviously now having a tremendous impact as well on spending in Part B. And in fact, it would be interesting to note what the impact has been by shifting Home Health Care to Part B from Part A, and that actually would be a number that I certainly would be interested in having, Mr. Daniels. Do you have that offhand?

Mr. DANIELS. I have at one time or another. I want to say it was well over $100 billion, and it might be more than two, but I will have it for you maybe by the end of the hearing.

Senator SNOWE. Thank you.

Thank you, Mr. Chairman, for having this hearing. I do think it is instructive to review where we are and where we have been. I could not help but think of the beginning of this year and how we began with the first hearing with Chairman Greenspan. In fact, at that hearing, much to the surprise of everyone, he advocated a tax cut for the very reason that we are facing today economically, that in the event that this downturn proved more than an inventory correction, that the effects of the tax cut certainly could mitigate that decline.

He also did propose a trigger, which I hope the administration would consider, because I do think that that is very timely, frankly, as a mechanism. The very reasons why Chairman Greenspan proposed it was for the very reasons we are facing here today: you cannot precisely estimate revenues 1 year to 10 years. It is very difficult. There are many changes in our economy that ultimately have an impact on our estimate, so therefore, I do think this would be a worthwhile endeavor, and that is something, certainly, I hope to pursue again with my colleague—Senator Stabenow and I and Chairman—because I do think it is relevant, and I think this debate underscores that.

But the fact of the matter is, Mr. Chairman, this year we faced a Hobson's Choice. You know, do we do something to affect the economy through a tax cut or do we do nothing? Now, some people say, well, the reasons why we have a declining surplus is because of the tax cut. Others are saying for spending. Others because of the economic decline. Well, I say it is all of the above.

And when the proposal came forward, actually, it was a Democratic idea on the tax rebate. That was not a Republican idea, it was a Democratic idea. We thought it was a good idea. Why? Because it provided the stimulus that was necessary to try to rejuvenate this economic decline. The fact is, this is the first time, I understand, that we moved in a timely fashion to affect the current economic conditions by passing a tax cut. That was the concern. And many expressed it before this committee, that we would never pass a tax cut soon enough to have an effect. But we moved heaven and earth to do that, and it emanated from a Democratic idea. In fact, there were several votes on the floor that I went back to review because I was a little confused by a lot of the discussion that has taken place. You know, we had the Hollings Amendment that was adopted 94 to 6 that would have increased the tax cut to 85 billion, 12 billion more than was ultimately enacted. And Senator Graham's Amendment from Florida, which was supported by 35 members, in fact, many on this committee, that would have cost 60 billion next year, 22 billion more than ultimately was enacted.

But there was a reason for all that. There was criticism against the President's tax plan because it was all back loaded to the last 5 years of his 10-year plan. You all remember that. And in fact, in the Finance Committee, when we were marking up the tax bill, I said that there was a logical reason for that, that it had to reflect the surpluses that were accruing each and every year, and many of those surpluses were not accruing until the last 5 years. That is why it was back loaded.

But we changed that premise to the rebate because we saw what was happening with the economy, and rightfully so. I mean, consumer confidence is really the equivalent of where we would be in a recession today. Unemployment numbers, unemployment claims is the highest in 9 years. We have had a million job cuts announced for this year, a million job cuts over this last year, so obviously, we have to be concerned. So we might say, would things be better now if we had not done this tax rebate? Maybe so. Would it have been worse? We do not know. The X factor was the economy, and we took the risk by putting money in the hands of people. Why? Because two-thirds of consumer spending is what generates economic

growth in America, and that is reality. So, yes, we might not be precisely right, but who is to say that we were wrong?

The question is: what are we going to do about it? And I hope this whole political cacophony serves as an ultimate platform for solutions to where we are. You know, the beauty of the balanced budget has always been it is going to force us to make decisions and it is going to force us to make choices. And that is precisely where we are today.

We have to make choices. Just like every family is doing in America right now because of this current economic decline, every state legislature is making revisions in their budgets because of this economic decline, and so must we. I do not think there should be any question as to whether or not we are going to preserve the surpluses for Social Security or for Medicare. If we have to make adjustments, then we ought to honor that commitment, that we all pledged to do so on a bipartisan basis.

So that has been the backdrop as to where we are here today, Mr. Chairman, as I have seen it. You know, I look back on even how we began this year with spending increases. I mean, I was stunned by the $12 billion increase that occurred last year in discretionary spending in our budget, that has had an impact on our surpluses of $561 billion over the next 10 years. $12 billion increase has now yielded $561 billion effect on our surpluses over the next 10 years. So if you start looking at that, what was the impact this year? Well, this year it was $12 billion. We could have had $12 billion more in the surplus this year if that spending had not occurred, $40 billion more in the year 2002, $46 billion more in the year 2003, $51 billion more in 2004. So we would not even have any questions about where we are today in terms of declining surpluses or whether or not we are going to Social Security. That has all had an effect, and we all share in the responsibilities of what has happened.

The question is how we proceed now. And I hope we can find that bipartisan agreement, Mr. Chairman, for that. I really do. And I hope it comes in the form of a trigger mechanism and other issues, and making adjustments if it is necessary. But I do know this, even if half of the assumptions had not changed because of this economic decline—I would have you answer this question, Mr. Daniels, and it will be my only question, my time has run out—we still would not change where we are on the Social Security Trust Fund. Would it change the solvency question? Would it change the long-term issues that we will have to grapple with because the President's Commission on Social Security said if the current system of financing stays in place? Well, that current financing system has nothing to do with our surpluses. We still will have to grapple with that major challenge, even if we saved all the surpluses for the next 10 years for Social Security, whether it is on budget or off.

Mr. DANIELS. You are absolutely correct, Senator, as page after page after page of witnesses and observers and analysts now have all understood and recognized, today's surpluses do not have anything to do, either with the long-term problems of Social Security or Medicare, or the solvency or our ability to pay those bills as they come due. We are only talking about whether one level or another

of debt repayment, a great achievement of both parties that is going on right now, is enough, and whether even more would be the choice for the next increment of money or some other purpose. And I think you are very wise to redirect the committee's attention to the main question, which is: economic health, the economic growth, jobs and incomes in this country, vastly more important than honest differences at the margin about how much debt to repay.

Chairman CONRAD. Senator Byrd.

Senator SNOWE. Thank you.

Senator BYRD. Thank you, Mr. Chairman.

And thank you, Mr. Director, for your appearance here today and the testimony you have given.

Let me change the focus just a little here, as the chairman of the Appropriations Committee. The Budget Act requires the OMB to implement a sequester on mandatory programs, including Medicare, at the end of the year if the Congress has passed and the President has signed legislation that either increases mandatory spending or reduces revenues.

The latest OMB pay-go report estimates the pay-go balance to be $126 billion. Does the administration propose that Congress enact legislation to cancel the sequester and set the pay-go balance back to zero?

Mr. DANIELS. There will be a need, Senator, to bring the Budget Enforcement Act current as to its caps, which has occurred in the past, and we will need again to occur again. The cap, as it stands in the law, of course, is 550 odd billion dollars discretionary spending, and that was antiquated by the budgets of the last few years, in which Congress chose to move way beyond those caps, and yes, that will have to take an affirmative act of Congress to bring that to some new level, and the administration will support that, at least up to the level of the budget resolution as amended.

Senator BYRD. If we are to avoid diverting any more of the Social Security surplus to other government programs, the President and the Congress must pay for bills that increase mandatory spending or further cut revenue. Does the administration support eliminating pay-go, or do you believe that future mandatory and tax legislation should be paid for?

Mr. DANIELS. We certainly support some ongoing regime, either a renewal of the system we have or some modification of it. We think it has served well. It has helped to produce, first a balanced budget, now a very, very large surplus. And that some form of ongoing structural limitation like it is a good idea, and we want to work with the Congress. And we know there are differing views about what the best mechanism is, but we do think some mechanism is appropriate.

Senator BYRD. So the Budget Director is recommending that the administration does support that we continue with pay-go, that we renew pay-go, or do you believe that future mandatory and tax legislation should be paid for? Do I hear you saying you think it should be paid for?

Mr. DANIELS. Well, the President would say that it should be paid for in a way that ensures that we continue to run surpluses at the level, at least at the level, of those attributable to Social Se-

curity, and that some form of caps, some form of pay-go, some form of structural limitation be put in place or renewed to keep that pledge.

Senator BYRD. I was here and attended the meetings at Andrews Air Force Base in 1950 (sic) when President Bush the first was President and was there, who also prescribed to pay-go. It worked well. I discussed this in my office with one of your distinguished predecessors. It worked well, until we came to this period of surpluses. Now we have done away with pay-go. And that is the purpose of my question. Pay-go helped us to achieve those surpluses. And so as I understand it, you would support some form of pay-go again?

Mr. DANIELS. Yes, Mr. Chairman. Our budgets—each of our budget submissions, I think, has made reference to this. Take a note that the caps that are in place will need to be adjusted at some point and suggest that that was probably the right point at which to put some new system in place or renew the current one. My guess is that, just as you reminded us, pay-go was put in place in a very different era of true deficits, very large ones, and has served well, that perhaps some variation of it is better suited to this unprecedented era, unprecedented era of very large persistent in rising surpluses. But the idea of such a mechanism is a wise one.

Senator BYRD. The budget resolution includes $661.3 billion in budget authority for fiscal year 2002. Under the budget resolution, the Appropriations Committee can only have the additional $18.4 billion for the President's defense request if that additional spending does not result in reducing the Medicare surplus. Based on CBO's estimates the Medicare surplus is gone in fiscal year 2002, 2003 and 2004. Senator Conrad, the chairman of this committee, has said that he cannot provide the Appropriations Committee with the additional $18.4 billion. Is the President proposing that we bust the budget resolution in order to pay for his defense request?

Mr. DANIELS. We would not view it as busting the resolution, Senator, unless the totals ran beyond the total of the resolution plus the amendment, which was anticipated in that resolution. We would respect the Chairman's decision if he chose not to use his prerogative or decided that he could not use his prerogative. There is a similar situation, not identical, but similar, in the House, pertaining to the chairman of that Budget Committee. So in either case it will be necessary, and we think advisable, for each body to act to make available at amount up to the level of the budget resolution as amended. I would observe that that was—back to our previous discussion, there is going to be a need for each body to act extraordinarily anyway because of the antiquity of the caps that are in place, and that might be the moment at which to address this problem.

Senator BYRD. Well, if the Medicare surplus is not real, as the administration witnesses have maintained, what do you suppose the Budget Committee had in mind when it was under the leadership of Republican members, what did it have in mind when it put this provision into the budget resolution?

Mr. DANIELS. I think it clearly had in mind to aim at an even higher surplus than the one we have. When we say that these

funds will be saved or set aside or however we put it, what we really mean is they will be used in a specific way, they will be used for debt reduction. Now, actually, a fair amount of it gets used for direct loans. A very high amount this year, as just a matter of cash management, was taken away, not for debt reduction, taken not for debt reduction, but for the direct student loan program, be the biggest single consumer of those funds. But this is a matter of cash management at——

Senator BYRD. Mr. Director, the President is also proposing to bust the budget resolution on the tax side, is he not? How about the administration's proposals that more than $533 billion more in tax cuts, beyond the budget resolution ceiling on tax cuts, be made?

Mr. DANIELS. I am sorry, sir. The question again?

Senator BYRD. Well, you said that the Medicare surplus is not real, and yet the very august and illustrious members of your party, who were in control of this committee when the budget resolution was sent to the floor, without any participation by Democrats on this committee, had a provision to the effect that the additional $18.4 billion for the President's defense request could be provided only if that additional spending did not result in reducing the Medicare surplus. And what I have said to begin with is that Senator Conrad has said that his hands are tied, and I believe they are, as far as that provision is concerned.

That being the case, is the President proposing that the budget resolution to pay for this budget request be busted? I did not get exactly a clear answer, but I went on to say that the administration is—or at least some people are proposing that there be $533 billion in additional tax cuts beyond the budget resolution ceiling on tax cuts. So is the administration proposing to bust the budget resolution on the tax side?

Mr. DANIELS. With regard to Medicare, Senator, I do not have the language in front of me, but it says "by an amount not less than", or words to that effect, the trust funds, as we have discussed this morning, will be credited with an additional, we estimate, $34 billion this year, exactly as much as under any other surplus outcome, and so will be unaffected.

But what I take the committee's action or the Congress's action or the Senate's action to have meant here was that at that time, they were hoping to ensure a total surplus at least as large as that attributable to Social Security's excess revenues, and the excess revenues attributable to Part A.

Now, the economic downturn alone was substantially more than the excess revenues attributable to Part A, and that is a changed circumstance that maybe the Senate will take into account if and when it decides to legitimize a resolution limit of 679 for your committee to apportion, as opposed to 661.

Senator BYRD. So you are proposing to exceed the budget resolution on spending by $18 billion, and proposing to cut taxes $314 billion beyond the Republican budget resolution. I am in a quandary as to how this adds up.

Mr. DANIELS. Well, from the very beginning the resolution this year anticipated, and it was, I think, universally understood that there would be a subsequent request for defense, that the amount of that was not known or knowable at time of the submission in

April, that Secretary Rumsfeld would have been charged with an in-depth look at the nation's long-term defense needs and possibly transformation, and that an amendment would be forthcoming.

It was. I guess from the administration's standpoint we view that as part and parcel of the request for this year, and we hope it will be part and parcel of the budget resolution, not seen as breaking it in any way.

Senator BYRD. Out time is very limited. Let me take up at another juncture. You referred to an orderly process, the need for proceeding with an orderly process. We are rapidly approaching the beginning of a new fiscal year. The President is out making statements, according to the press, to the effect that we need to change the process on Capitol Hill, we need to get away from the old ways, quote, end quote, and Congress needs to send down to the President the appropriation bill for defense, and making appropriation bills for education, saying, quite clearly, according to the press, that the old ways are what is hindering the action on the defense appropriation bill, and that in recent years the defense appropriation bill has been held back to the last or the next to the last. And this puzzles me.

In recent years the Congress has been under the control of Republicans, and it seems to me this is poking a finger right in Ted Stevens's eye, because as the chairman of the Appropriations Committee in the Senate, he worked very hard and very effectively to move the appropriation bills, all of them, and last year the defense appropriation bill was No. 2. The year before it was No. 6. The year before it was No. 3, and the year before that it was No. 4. So it seems to me he did yeoman's work in getting the appropriation bill for defense down to the President's desk. Now, I do not what the President has reference to when he talks about the old ways.

Second, I cannot understand why he is urging that the defense appropriation bill be sent down ahead of the other bills. Could you comment on that?

Mr. DANIELS. Yes, Senator. I think the President's observation is a more general one, that the last few years have too often resulted in—have gone not just somewhere beyond, as we may well this year, but well beyond the end of the fiscal year, have dragged out sometimes almost till the end of the calendar year, that far too much acrimony about shutdowns and all the rest, that he would like to move beyond that. So I think when we speak of an orderly process, really, we are talking about restoration of the leadership direction of that process by the Appropriations Committees and the passage on whatever timetable is possible of each individual bill if that is practical. And I think his comments with regard to defense really resolve to a more general one also, that he does believe, particularly in this year—I think many would say the national defense is the first responsibility of the Federal Government, above and beyond all others, but particularly in this year when he believes, and I think most agree, that substantial rebuilding of that defense change of that defense is urgently needed, that first priorities ought to be agreed on, if not first, at least early, and this may or may not involve the final passage of the conference report, but I think he was simply asking that he would like to understand what the Congress's will is on the top priority, and not after everything

else has been dealt with, but early on. And so I would give you that in response.

Senator BYRD. Mr. Daniels——

Chairman CONRAD. Might I ask the Senator is he is close to ending, if we could get to Senator Wyden and the Senator from Wisconsin as well, and then we could come back?

Senator BYRD. But I cannot come back, Mr. Chairman.

Chairman CONRAD. OK. Go ahead.

Senator BYRD. And I sat here rather patiently, I think, and my questions deal with a matter that is facing this Appropriations Committee, right, very soon?

Chairman CONRAD. Absolutely, go ahead.

Senator BYRD. It seems to me that if the administration had been in all that hurry, it would have gotten its requests up here sooner. This budget did not come up until April. And it said that there was a hole in that budget, namely the defense amendment, that hole would be plugged soon, and it was plugged on June 27, and half the year was gone. So here was have the administration, for one reason or another, saying because of strategic review, it would be late sending up an amendment, but I expressed my support for a defense review, not necessarily for the results, because I do not know what the results are. But the administration, for one reason or another, did not get its request in until you might say half the year was gone.

And now the President is wanting to do things in an orderly way in his view, and get the defense appropriation bill down to him first. From my viewpoint, it does not matter what bill gets to the President first, so long as we get them all down by the beginning of the new fiscal year. That, it seems to me, is the important thing. And the administration does not seem to be helping us much along that line.

The House passed nine appropriation bills. My Appropriations Committee, due to fileting with the support of Ted Stevens and the other members on both sides of the aisle in that committee, reported out nine appropriation bills. The Senate passed five of those appropriation bills, the first one being the appropriation bill that comes out of my subcommittee on the Department of the Interior. That bill was reported out and was acted on in the Senate, and conferees were appointed by the Senate on July 12. That will soon be 2 months ago. So here are five bills, on four of which conferees were appointed by the Senate, and to date not a single one of those bills, not on a single one have the House conferees been appointed. And I am not criticizing the House. There may have been various and sundry reasons. But what I am saying is that the administration, instead of pointing the finger at the Congress and saying, "It ought to send me the defense appropriations bill first," ought to be saying, "Let's get all the bills down there." I say, let's get them all down. What is the big hurry in getting defense? We do not even have the results of the top-down review yet, and not likely to have any soon I don't guess.

It seems to me that the administration ought to look to the Republican-controlled House and ask questions, "Why don't we have conferees appointed? Why don't we get those bills down here?"

The President, as I understand it, won the election on two signature items, one, the tax cut, and changing the tone in Washington. And what I have been hearing out of the President, and I respect the President, but what I have been hearing out of the President is not a change of tone, but the same old finger pointing and making comments—used the phrase a little earlier about using words that were misleading, making words such as "if the Congress doesn't go hog wild overspending." We have kept every one of these appropriation bills that have been passed within to the allocations, we have kept them within the budgetary resolution limitations.

When the President's supplemental came up to the Congress, he asked for $6–1/2 billion supplemental appropriations. We did not add one thin dime to that bill. The House had $473 billion in emergency spending—$473 million in emergency spending item. And the administration stated that it was against the emergency spending item. We stood firm in the Senate, and we took out all the emergency items and we found offsets for them. So we have not spent one thin dime over what the President requested. We have not spent one thin dime over what has been the allocations that were given to us by the Budget Committee. We are trying to work, do our job, and do it right, and it does not change the tone for the President to make references about Congress going hog wild on spending.

The President is the biggest spender, hands down, in this town. The administration, with its tax cut, is the biggest spender, hands down. That is money that is being spent. It is going out of the Treasury. So you want to talk about spending, big spenders, perhaps the administration ought to look into a mirror.

Now, what is going to be done here? We are facing a crisis. The fiscal year is going to begin in short time, and we want to get our work done. We are going to pass four more appropriation bills in the Senate soon, and then we are going to get into those last four. Now, you talk about, Mr. Director, an orderly process. That is exactly what we are following here, is an orderly process. The orderly process is, with respect to defense, that the authorizing committees act first. When Sam Nunn was chairman of the authorizing committee, the Armed Services Committee of the Senate, he and I stood on the floor and debated this 1 day, and we both agreed that the authorizing bill should come first. Mr. Levin is trying to get that authorizing bill out and acted upon. That committee, on which I also sit, and with reference to which I have been absent this morning, is trying to get its work done. The House authorizing committee, the authorizing bill on defense will be taken up next week. The House appropriations bill on defense will be taken up the following week. And so where we are following a quote, "orderly process", close quote, namely, that the authorizing measure should come first, the Appropriations Committee should have some guidance from the authorizing committee. We are not dragging our feet in Appropriations on defense. We are waiting on the authorizing committee to act and the Senate to act and the House to act, so we will have the benefit of that guidance. So that is our reasons. That is our reasons.

I hope the President will understand that. That is why the defense appropriation bill is not coming down at the head of the line.

They are good reasons. Now, that being the case, we need some help. We need some help from the House side. As I said before, I want to preface my statement with this, that there may be good reasons for the House not having appointed conferees, not having gone to conference, but we need some help over there. We are going to have a real crunch, and it will not be far off. It is going to be soon. So I hope that the Budget Director can get the administration to give us some help in getting these bills to conference. We will get them all to—we ought to get them all down to the President by the first of the fiscal year. We got a late start on our side for reasons that are pretty well known, but we need to work together and get these bills done. We need to go to conference and get the conferences back. And the House needs to appoint conferees. The House needs to send its conferees to conference. We stand ready. We are waiting. We have been waiting.

Thank you, Mr. Chairman, for your tolerance, and thank you, Mr. Director.

Mr. DANIELS. May I respond quickly? Thank you, Mr. Chairman.

Senator those are very fair comments. It is certainly true that, for unusual circumstances, the original budget was somewhat delayed. We did the best we could to make up some lost time.

It is certainly true that the difficulties of the defense review made that amendment come in the middle of the year, as you said, and that is certainly no fault of the Congress's. Likewise, it is very fair of you to, and I think, in fairness, the President also has been very careful to talk about the Congress, House and Senate, calling, I hope, in a constructive way, not an adversarial way, for the kind of process that you have been trying to restore and implement here in the Senate.

In each of his comments about this, you will find compliments of the way the process has gone so far, and simply urging that we all work together to see it through. Obviously, the latter stages will be difficult. There are not that many business days left. There are holidays that further complicate the situation, and the administration understands that completely.

So the President is very clear in instructing all of us to strive for a tone that is constructive, that respects the leadership role of the Congress. And I think all that any of us are trying to say is that let us do see this through, despite the difficulties, let us try to have just the kind of outcome that you just outlined, and we will try to be scrupulous in both what we say and how we act.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Daniels, I want to ask you about several health care issues, and my reason for asking you is that I, and a number of colleagues, have tried very hard on a bipartisan basis to see if we can make some progress during very difficult times. Our colleague, Senator Snowe, is here. She and I have, for 3 years, worked on the prescription drug issue. Senator Smith and I have teamed up and were able to get $28 billion in the budget to address the concerns of the uninsured, which strike me as particularly pertinent right now, given all of the layoffs that we are seeing around the country and the need for some way to address this enormous pain.

My reason for asking you this morning questions in both of those areas is I am concerned that the administration is staking out some positions that are inconsistent with what we are trying to do up here on a bipartisan basis to make some progress on the health issue, and maybe I am incorrect.

I want you to set the record straight on it because I want to work with you on these issues.

Prescription drugs are a pretty clear example. I talked to a constituent last night who said that his mother spent $1,000 this month for 30 days of cancer medicine to deal with a serious cancer problem, 30 days, $1,000 for the cost of the medicine. We are trying to come up, Senator Snowe and I, with a market-oriented approach to this issue. The Congress set aside $533 billion over 10 years to try to help us address this. As far as I can tell in the midsession review, about a third of the money is gone.

Now maybe I am not reading that correctly and maybe I am missing something, but the reason that I am asking you about this is that we want to work with you. Senator Snowe and I think that we can come up with a common-ground sort of approach that uses marketplace principles, which Republicans have been supportive of, but also has a clearly defined benefit package that is part of Medicare that the Democrats have been for.

It will be very hard to do that, to get the bipartisan approach Senator Snowe and I want, if the midsession review is essentially where you all are and a third of the money is gone. Now maybe we are reading that incorrectly, and if that is the case, I want you to enlighten me, but I am concerned about it.

Mr. DANIELS. Thanks for the question, Senator. I think you are reading it incorrectly. Actually, I think our positions are coming closer together, and let me tell you why that is the case.

The number $533 billion I think is best described as a good-faith guess or estimate. It is sort of a placeholder number as we see it. It is not associated, to my knowledge, with any specific plan that anybody has fully fleshed out, but we take it as $533- over 10 years as a good guess by somebody about the kind of plan that you described.

The President has always supported strongly adding prescription drug coverage to Medicare, supports it in the context of Medicare reform that makes that program more sustainable over time, and believes it would be really a big mistake, a big mistake to bolt on prescription drugs to the current system without substantial reform—as some have said, dessert before dinner, and others have observed, it might preclude the kind of reform that is essential.

In the original budget, we had an estimate of $153 billion over 10 years to do that, and so there was a gap of almost 50 percent, sort of an average of 15 a year versus an average of 30 a year. In the midsession review, based on the elaboration of Medicare reform principles that the President released in July, we have recosted, and again these numbers do not proceed from sort of a macro guess or guesstimate, but from the principles of a fairly well-articulated plan, and we added $37 billion to the original estimate.

So the midsession review increases the amount proposed for Medicare/prescription drugs to $190-, and that is over 8 years. So, more or less, $24 billion a year, compared to $30-. So a lot of dis-

tance remains to be covered really, but I think that the boundaries of this are not impossible, not impossibly far apart, and they have narrowed, as opposed to widened.

Senator WYDEN. Let us do this because I want to ask about the uninsured. I would like to have you send to the subcommittee, the bipartisan group, in particular—Senator Snowe and I—this recosting exercise because I will tell you this is something the Congress passed. Yes, we are very much aware that you all wanted to spend $150 billion, and we wanted to spend, some of us, substantially more. We came together on a bipartisan basis and said $533- is where we are going to be.

Now you all may disagree with that, and you have got a right to any kind of recosting that you choose, but it does trouble me that when there is a bipartisan effort up here to try to come up with a bill that certainly meets you all halfway, in terms of marketplace kinds of approaches, that we have this sort of behind-the-scenes kind of recosting. That is what goes into the midsession review.

And I want the record to be clear on this, and especially because my friend from Maine is here, and she has been such a trooper to work with me on this, is I am very troubled with the fact that the administration is now saying we are going to look at $190 billion for a prescription drug program because we want to make sure that we go forward with at least a $533-billion program. On a bipartisan basis, I will look at what you are saying about 8 years versus 10 years and the like.

We want to work with you, but get us these numbers with respect to recosting the benefit because that is not going to be of much solace to the person last night in Oregon who spent $1,000 for 30 days of cancer medicine.

Mr. DANIELS. Why do we not exchange costing because, so far as I know, there is not any costing that leads to $533 billion. I think you have a good-faith attempt. Somebody said $533 billion. Now I do not think you mean to take a number and then form-fit a plan to fit it. The President has a plan, better articulated I think than any around, and we have a number that derives from it, and we will be glad to show you how we got there.

Senator WYDEN. Mr. Daniels, with all due respect, the President may have a plan, the Congress has a law. This was a budget law that said we were going to spend $533 billion. I want to move on to the uninsured, but the fact that you are recosting this program at a time when people all over this country are being shellacked with their medical bills, and you have got Members of Congress, on a bipartisan basis, who are trying to meet you halfway, it is pretty troubling to me. So send us the recosting data.

The second question with respect to the uninsured. Again, what we have tried to do is get both sides to put down their swords. We have got conservatives who would like to go with a tax-credit approach. We have got folks on the liberal side of the spectrum who would like to go with the public spending program. The administration has chosen to go with a tax credit approach. I want to ask you how this is going to actually work for a typical family.

The typical family may have monthly premiums of $5- to $600 a month. Now these are premiums, and I am at a loss to figure out

how they are going to be able to cover those premiums with your tax-credit approach, which under the administration's proposal seems to be about $2,000 per family per year. Now, if you could tell us how your tax- credit approach would work. Again, I want to make it clear, I am willing to meet you halfway. We have said from the very beginning that we would have tax credits as a portion of the program, but we also feel strongly that there is going to have to be some way to help people pay for premiums, and that is why there was a role for a public program as well.

How is your tax-credit approach going to get some meaningful relief to this growing number of uninsured, which was important when we, again, had a bipartisan plan, Senator Smith and I, and it is a heck of a lot more important now than it was back when we put that together?

Mr. DANIELS. Thank you, Senator. Just like prescription drug coverage in Medicare, this is a goal that the President strongly shares with you. His proposal, and I will suggest that beyond some general comments I will make, this is really a question for our colleagues at HHS, but the—and his proposal, we believe, would be as direct as any we could imagine. It would empower individual families to pick the coverage best for them, put the money directly at their discretion to get that question.

The question of whether it could completely cover all of the costs, all of the premium costs or not is a valid one, but $2,000 a year is certainly not to be dismissed as unimportant, in terms of at least protection against catastrophic losses and expenses, the things that I think worry most Americans the most. It would either do the job or come very, very close.

On both of these counts, by the way, let me say the President has not been prepared for us to wait for us to come to some common ground. He had proposed immediate action on prescription drugs. That proposal has not met with enthusiasm in Congress. So he has acted, as you know—this would be of value to the person you were talking to quite possibly in your State—to make available to senior citizens discounts that would begin to alleviate the costs they are experiencing.

And likewise, in the case of the uninsured, we have been working very hard with Secretary Thompson at HHS, first granting waivers, but more recently constructing a model waiver for Medicaid that will allow States, and is allowing States, to cover a lot more people. There are, by the Secretary's calculation, over a million Americans have been newly covered since this administration came to office because of this more flexible policy in using Medicaid resources.

So the administration is prepared to act on both fronts, to the extent it can, and definitely to work with you and thank you for your leadership on both counts.

Senator WYDEN. My time is up, and I want to leave it this way. First, with respect to the uninsured, I hope that you all will look at the actual language in the budget because the language in the budget envisaged both the tax credit and the public program part of it, and that was the clear bipartisan intent of the Congress.

And, second, given the fact that it is very significant to me that you all have recosted the prescription drug benefit and have gone

from $533 billion to $190 billion, it is really critical that we have the actual details behind how you did it, and I appreciate your saying that we will get those up to the chairman and the ranking minority member.

Again, the reason for asking these questions is this committee, under the leadership of Senator Conrad, and Senator Domenici has been very interested in this area, is trying to figure out a way to get folks to lay down their swords on the prescription issue and the uninsured issue. But if we are having things recosted on prescription drugs without knowing the details about it, that is not going to make it any easier to get a bipartisan agreement. And on the uninsured question, I want to leave it we will support a tax credit portion, but Congress, again, passed a law that made it clear that we envisaged a public program as part of that.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. Let me first say, if I could, before going to Senator Feingold, how much I appreciate the patience of Senator Wyden and Senator Feingold. We have had a very long session here this morning, and I also appreciate very much, Mr. Daniels, your patience.

Senator Feingold.

Senator FEINGOLD. Well, I thank you, too, Mr. Chairman, for your leadership on this issue and for having this hearing.

I thank you, Mr. Daniels, for being here and for your tremendous patience. As you know I disagreed with the size of the President's tax cut, I thought it spent too much of the surplus, that debate is on the record, and I do not seek to have that fight over again today, but I do think it was one of the crucial votes of our time, and I think it was truly regrettable, that is, the outcome of it.

But neither do I believe that we should follow the bad example of passing an irresponsibly large tax cut that we could not afford by now passing spending bills that we cannot afford. Two fiscal wrongs do not make a right, and so I think our course now is plain, and that is what we must do is control spending. It should go without saying that we cannot afford more new tax cuts now, as some in Congress advocate.

Between the Presidential campaign, then-Governor Bush promised to put the annual Social Security surplus in a lockbox to be preserved solely for Social Security. And Tuesday after meeting with President Bush, the majority leader said that he had pressed President Bush to promise not to dip into the Social Security program to make ends meet and that the President had agreed to that.

President Bush has been right in these commitments, and let me take a moment to explain why I think he was. When the 1983 Social Security Commission set the program on the path to run surpluses, it intended that we would use the Social Security surplus to pay down the debt. That idea still makes sense now. By paying down the debt now, we reduce our net-interest obligations and free up the Government's ability to borrow in the future to meet the needs of Social Security and Medicare that we all know are coming.

A lot of analogies are used, but the family one is often a good one. It is like a family with kids who are headed for college. I have got four in college right now as of a couple of days ago. If the fam-

ily pays down the mortgage, then they will be in a better financial position later to pay those college bills or to take out a loan to finance them. More spending or tax cuts now would be the fiscal equivalent of that family going on a wild vacation and putting it on a credit card.

The experience of the 1990's demonstrated that fiscal responsibility leads to lower term interest rates and more freedom for the Fed to lower short-term interest rates. Those changes generate stimulus in the economy must more efficiently than our attempts to micromanage fiscal policy. As CBO Director Crippen pointed out Tuesday, the stimulus effect of Government spending in the amounts we are talking about is negligible at best. So I think we will need to control spending.

We will need to control spending for appropriations and also for mandatory spending items like the farm bill. We will need to control appropriation spending both for domestic spending and also for what I believe is an overinflated military budget. I commend the August 21st statement of the chairman of the Appropriations Committee that the shrinking Federal budget surplus should encourage Congress to scale back the President's proposal to boost military spending.

But I do want to tell you right now, Mr. Daniels, that this is one Democrat who may well join with you and the President to sustain the President's veto of swollen spending if he chooses to take that course.

My questions are brief. Will you commit today that, in the absence of a war or a recession, you will recommend to the President that he veto any spending bills that would cause the Government to spend Social Security surplus funds?

Mr. DANIELS. The answer is yes, and I would just note that this is essentially just like saying that I would recommend vetoes of bills that, in the aggregate, exceed the budget resolution because those numbers are essentially the same. The size of the surplus is essentially the same. So because I think the budget resolution ought to be adhered to, I would have given you that answer anyway, but it happens to apply now because bills that break the budget will, in fact, break that line.

Senator FEINGOLD. How about identifying for us areas where you think some spending coming down the track is too large in your view.

Mr. DANIELS. It is too soon to say. Our focus has been on the total. The President proposed less spending than the budget resolution, as amended by the defense request, would amount to. The Congress has between $5- and $6 billion of room for things the President has not requested. And some of that I think is going to find its way into education and into other of the appropriations bills.

So, as long as the total remains within the limits we just discussed, as long as the major priorities that the President has marked off are not short-changed, I think that we will try to take as cooperative and flexible an attitude as we can, and at this point, there is not a bill in sight that is unacceptably large.

Senator Byrd was quite right to say that, up to this point, no bill is exceeding the allocations which the committee has distributed. So we really hope that will stay the case.

Senator FEINGOLD. I appreciate the focus on the aggregate, and I do appreciate obviously serious deference to congressional input, but I would hope the President would exert leadership with regard to areas where he thinks we have gone too far, even if it does not violate the aggregate.

In that spirit, I was very encouraged to hear about a meeting between President Bush and Senator McCain in April of this year, where the President and Senator McCain agreed to work together to reduce earmarks and pork-barrel spending. Can you give me an update on your efforts on that front and what you further hope to get done in that regard.

Mr. DANIELS. Yes. I was going to make mention of your leadership in this area, Senator, which is very, very I think salutary, and you deserve to be commended for it. The administration did make something of a point that in this area, as in a few others, in recent years there have been some excesses.

There has been a sixfold increase in so-called earmarks or special projects, always a feature of the Federal budget, but suddenly a much bigger feature than anyone had ever imagined. And we do think that this ought to be restrained, and we did designate many of those for nonrenewal or much of that money for nonrenewal.

We have not had a lot of success so far, although I would say, in the foreign operations bill, a large number of earmarks were removed. To my knowledge, that is the best example to date of some moderation in this area. But thank you for your advocacy about this, and as we move to the real business of the appropriations process, we do hope that your call, Senator McCain's and the President's will be heeded, at least in terms of moderating this trend.

Senator FEINGOLD. I look forward to working with you on that.

Finally, do you not agree that even in areas where the President wants more spending, that it ought to be offset with cuts from somewhere else?

Mr. DANIELS. Yes; that is to say, the totals are paramount in our mind. So the President did propose on the order of $50 billion in new spending, much of it for defense, education, medical research and so forth. It was offset in his budget proposals by about $24 billion of reductions, at least from baseline, and many of those have not yet been accepted by the Congress. We will try to see if we cannot talk the Congress into approving more of those than some committees have so far.

Senator FEINGOLD. Thank you, Mr. Daniels, and thank you, Mr. Chairman.

Chairman CONRAD. Thank you. Thank you, Senator Feingold. Thank you, once again, for your patience. Thanks to all members of the committee who were here today, and thank you, Mr. Daniels.

Mr. DANIELS. Mr. Chairman.

Chairman CONRAD. You know, the great thing about our country is this is a democracy, and we get to debate. And we have got differences of opinion——

Senator FEINGOLD. I think we usually give them a show.

Chairman CONRAD. Yes, we have certainly had the opportunity this morning, and we really have genuine differences.

Let me just say I believe that there are serious contradictions in your testimony today. When you say there is no trust fund surplus in Medicare, but the budget resolution written by Republicans said we could not access reserve funds, including the money for defense, if we invaded the Medicare Trust Fund surplus. You know, either there is a Medicare Trust Fund surplus or there is not.

And according to your logic, Republicans in Congress put in a condition that was false and misleading. I do not believe it was false or misleading. I think there clearly is a Medicare Trust Fund surplus, certainly in Part A. It is undeniable there is a trust fund surplus. You said it does not really matter, as I heard you discuss, how Social Security funds are used once they are credited to the trust funds. I just disagree. Of course it matters how the money is used once it is credited to the trust funds, and the President promised that he would not use it for any purpose other than Social Security and paying down the debt. And yet we see by the Congressional Budget Office numbers that you are going to be using Social Security Trust Fund money this year, you are going to be using it in 2003 and 2004, and if the President's defense request goes forward, and the other budget resolution policies, you are going to be deep into both Medicare payroll tax funds, and Social Security payroll tax funds and using them for other purposes in the year 2002.

When you say you can honor all obligations in 2002, that, to me, is fuzzy math. I have got to tell you I do not see how that adds up. I have put up the chart, and I do not see any point in putting it up again, but as we see it, you are going to be taking $65 billion of payroll tax money in 2002 and using it to pay for other Government operations, and that at a time when you are forecasting very strong economic growth.

I believe that is a mistake, and it is a mistake, as I see it, that does nothing but grow under the President's budget plan. In 2003 and 2004, CBO has told us you are going to be taking Social Security Trust Fund dollars, Social Security payroll tax dollars, as you prefer to have it termed, and using it to fund other operations of Government.

Our own conclusion, looking at the next budget cycle, is that under the President's budget plan, by just taking the tax cut, the Republican spending plan and the President's request for additional spending for defense, you will be taking $500 billion of Medicare and Social Security payroll taxes, those receipts, and using it to pay for other operations of the Federal Government. I just think that is a significant mistake, in light of where we are headed, in light of what the President's own Social Security Commission has said and that we are faced with a circumstance when the baby boomers start to retire of deep benefit cuts.

It is like we do not connect the dots around here. Are these things related? Does it matter for those difficult choices if you take the money that is credited to the trust funds, but then use it for some other purpose? I believe it is related.

[The prepared statement of Mr. Daniels follows:]

Statement of
Mitchell E. Daniels, Jr.
Director

Office of Management and Budget

before the
Committee on the Budget
United States Senate

September 6, 2001

SUMMARY

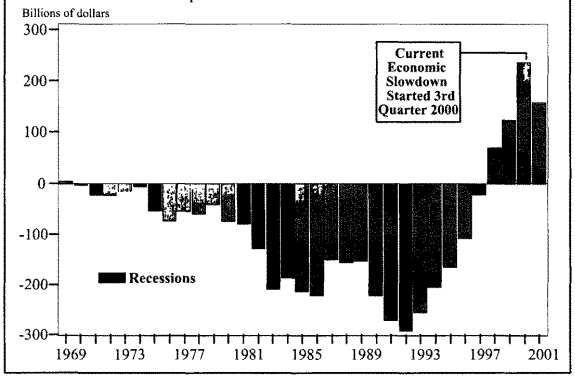
Despite a nearly stagnant economy, the government's finances are remarkably sound. The budget's enormous surpluses have allowed us to deliver significant tax relief to working Americans, providing badly needed fiscal stimulus to counteract the year-long slowdown in the economy. Even while weathering the slowdown and taking action on tax relief, we continue to take in huge surplus revenues, and to use the extra receipts to steadily reduce the nation's outstanding debt.

The current estimate for the 2001 surplus is $158 billion, the second highest in history. This is lower than the $281 billion surplus estimated in the April Budget. The lower surplus is due largely to the year-long economic slowdown and the decision to incorporate immediate fiscal stimulus, in the Economic Growth and Tax Relief Reconciliation Act. The 2002 surplus projection is $173 billion, compared to April's $231 billion estimate. Over the 10 years from 2002 to 2011, the surplus totals $3,113 billion, down from the $3,433 billion estimated in April.

Both this year and next year, the overall budget surpluses are equal to the surpluses generated by Social Security payroll taxes (and interest earnings). The President and Congress are both committed to preserving the Social Security surplus for debt reduction. As a result, the additional surplus available for new spending or further tax relief in the next few years is limited. In order to fully reserve the Social Security surplus for debt reduction, any further initiatives beyond those included in this review will also have to be accompanied by offsets in other areas.

Chart 1. Second Largest Surplus in History

Despite an Economic Slowdown



Tax Relief for Working Americans

From the Administration's first day in office, President Bush worked to deliver on his campaign promise of meaningful tax relief. This package, which was originally crafted to ensure long-term economic growth and to return excess surplus funds to taxpayers, became even more urgent as the extent of the economic slowdown became apparent. Congress moved with exceptional speed in response to the President's plan. On June 7, 2001 the President signed the Economic Growth and Tax Relief Reconciliation Act of 2001.

This historic measure of tax relief reduces the bottom marginal tax rate from 15 percent to 10 percent, delivering savings to every income taxpayer, and reduces the top rate to a maximum of 35 percent. It also doubles the child tax credit from $500 to $1,000, enhances incentives for investment in education, eliminates the marriage penalty, phases out the death tax, and encourages retirement saving.

Of immediate importance, the tax measure includes a rebate provision that puts $38 billion in savings from the new 10 percent bracket quickly and directly back in the taxpayers' hands. The rebate checks, which taxpayers are receiving in the months of July, August, and September, could not have come at a better time to invigorate today's shaky economy. Economic growth has slowed steadily for over a year to a point that it has nearly stopped. The rebate checks will help prevent further deterioration by supporting consumer spending.

Reserving the Social Security Surplus for Debt Reduction

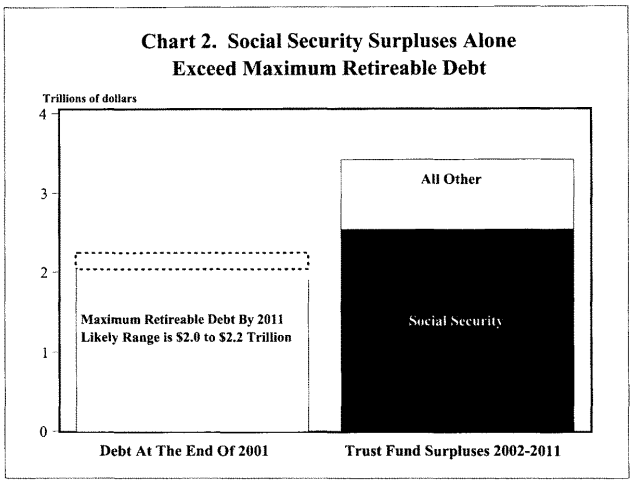
A strong bipartisan consensus has arisen in this country, and in the Congress, to preserve very large surpluses as a threshold condition of public finance. Both parties and both the Legislative and Executive Branches, in this Administration and the previous one, have concurred in maintaining a surplus at least the size of the Social Security surplus.

Some would set the minimum surplus level even higher, using as a target the artificial overage in the Medicare Part A trust fund. This is a relatively modest difference, amounting to a question of whether the minimum surplus should be more like 8.0 percent or 9.5 percent of total receipts. It is also a difference that is completely irrelevant either to the level of future Medicare benefits or to the health of the trust fund financing those benefits, which will be exactly the same size regardless of the level of the overall budget surplus. (For further discussion, see the Medicare section of this document.)

There are several reasons that the Social Security surplus makes a good surplus target. First, unlike Medicare, which costs much more than it takes in, Social Security is in true surplus for the moment. Second, the Administration and a majority of Americans hope for reform that converts a portion of Social Security receipts from mere IOUs to real assets, owned by the worker who paid those taxes. At that point, the notion of a Social Security "lockbox" will take on real, literal meaning.

The final reason for choosing this surplus target is that it permits the Treasury to achieve—with some room to spare—the maximum amount of debt retirement possible. Over the next 10 years, Social Security will take in excess funds of $2.5 trillion, whereas maximum debt retireable without incurring unjustifiable premium expenses is between $2.0 trillion and $2.2 trillion. This year, the Treasury will eliminate well over $100 billion of existing debt, marking the fourth year in a row of such reductions. Further such reductions are scheduled for each succeeding year. This is an important accomplishment for which both political parties, both branches of government, and both the current and prior administrations deserve credit.

The update of the budget outlook in this Mid-Session Review foresees continued large surpluses above the size of the Social Security surplus for all years in the budget horizon. The President is determined to preserve surpluses at this level, and to continue using these funds for the steady reduction of outstanding publicly held debt.



Changes in the Economic and Budget Outlook Since April

Since the President submitted his budget in April, the extent of the economic slowdown has become more evident. In retrospect, its length and depth are clear: the stock market began to fall in March, 2000; manufacturing employment in August, 2000; and GDP growth in the third quarter of 2000. Overall, the economy has grown at only a 1.3 percent rate since the second quarter of last year, including an estimated 0.7 percent annual growth rate in the most recently completed quarter. As discussed in a subsequent section of this review, the Administration—and other forecasters—believe that recent interest rate cuts by the Federal Reserve, coupled with the fiscal stimulus from the Economic Growth and Tax Relief Reconciliation Act, will spur the economy back to solid, sustainable growth by next year.

Table 1. CHANGE IN BUDGET POLICY SURPLUSES

(In billions of dollars)

	2001	2002	2002–2011
April budget estimate of total surplus	281	231	3,433
Social Security surplus	159	175	2,583
Non-Social Security surplus	122	56	850
Change since April:			
Tax rebates and other enacted tax changes	–40	–40	25
Corporate tax timing shift	–28	28	28
Medicare Reform policy	3	11	–37
Tax proposals	.....	3	43
Defense requirements	–4	–11	–198
Farm assistance and other policy	–5	–1	1
Economic and technical adjustments	–46	–44	–46
Related debt service	–1	–6	–136
Total, change	–123	–59	–320
Current policy surplus	158	173	3,113
Social Security surplus[1]	157	171	2,538
Non-Social Security surplus[1]	1	1	575

[1] The 2001 estimate is adjusted to assign $5.6 billion in prior year receipts to their correct year. See text box on page 9 and Appendix A on page 49.

Economic weakness, coupled with the tax rebate action that is designed to counteract that weakness, results in a lower surplus outlook this year and next year. In the current year, economic revisions and technical factors reduce the surplus $46 billion from the April estimate, a difference of about two percent of receipts. Tax rebates and related provisions account for $40 billion, a legislated shift in timing of corporation income tax receipts reduces the surplus another $28 billion, and supplemental spending for meeting national defense and other needs uses $5 billion. This combination of factors and a technical adjustment described below still leaves a very small on-budget surplus for 2001.

In 2002, economic and technical revisions are slightly smaller than in 2001. The effect of the tax relief provisions stays level at about $40 billion, while the shift of corporate receipts is recaptured. The net result is a small on-budget surplus.

One factor artificially reducing the 2001 on-budget surplus from the April estimate is an upward revision to the Social Security trust fund due to reestimates of payroll taxes paid in previous years. As explained in the accompanying box, this practice has the effect of inflating the current Social Security surplus by adding credits during 2001 for taxes actually paid and collected in 2000, 1999, and earlier years. This reduces the apparent 2001 on-budget surplus by $6 billion. Correcting this distortion by assigning the extra revenues to their appropriate year makes clear that there is a small on-budget surplus in 2001. OMB will review with the Department of the Treasury the possibility of prospective changes to record the adjustments in the correct years.

Over the full 10-year budget horizon, the surplus outlook is relatively unchanged from April. The unified surplus total for 2002 through 2011 is now estimated at $3,113 billion, down from the $3,433 billion estimated in the April Budget. The largest factor in the reduction is incorporating the outyear implications of the Administration's $18.4 billion defense amendment for 2002. This is the first installment, totaling $209 billion, of investment in restoring our national defense capabilities after years of neglect. The tax bill, because it was scaled back during Congressional consideration, increases the surplus slightly relative to the April Budget (which assumed the President's proposals), while the 10-year economic and technical adjustments reduce the surplus by $46 billion.

This update to the President's budget increases the resources set aside for Medicare modernization, and an integrated prescription

drug benefit, to $190 billion over the period 2004 to 2011. This new estimate is consistent with the Framework to Strengthen Medicare that the President announced on July 12th and is $37 billion more than was allocated in total to additional Medicare spending in the April Budget submission over 10 years.

The President's April Budget proposed a program to help low income seniors and those with particularly high prescription drug costs get immediate assistance while Congress considered comprehensive reform. However, with the President's support, a consensus is now building in Congress which focuses on comprehensive Medicare modernization. The President's Framework to Strengthen Medicare and his budget reflect this emerging agreement, setting aside substantial resources to meet this objective which could be implemented as soon as 2004. The Administration is committed to continuing to work with the Congress on enacting legislation to strengthen Medicare consistent with the President's framework.

Although the Administration is committed to enacting comprehensive Medicare legislation soon, the President believes we must help seniors get the prescription drugs they need at an affordable price now. That is why the Administration has begun the voluntary Medicare Prescription Drug Discount Card program. This program will allow seniors access to the same kinds of drug discounts that other Americans with good private health insurance currently receive. The President believes that seniors, who face the heaviest burden for prescription drug costs, should not also have to pay the highest retail prices for drugs. The discount card is not a substitute for prescription drug coverage in a reformed Medicare system, but it will bring important relief to seniors who need it beginning next year.

Of the current 10-year total surplus, $2,538 billion is from the Social Security trust fund, down slightly from $2,583 billion in April. As noted above, the Administration is devoting as much of this amount as possible to the reduction of publicly held debt. After reserving the Social Security surplus, the remaining 10-year surplus is $575 billion, down from $850 billion in April, with most of this difference attributed to the $198 billion increase in spending on national defense and the additional commitment to Medicare.

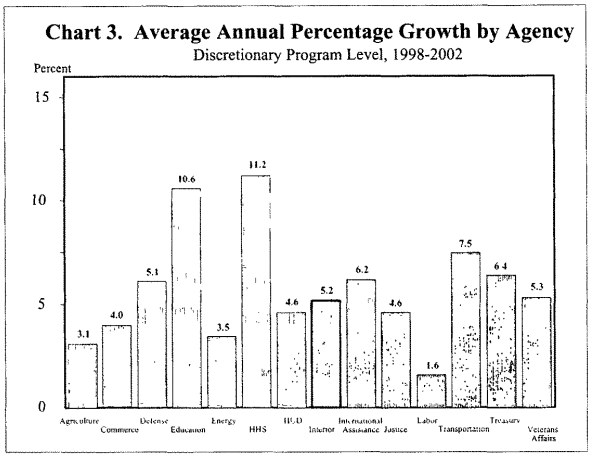
The Best Course Forward

The government's finances are extremely sound. Only persistent, long-term economic weakness can threaten this position. Hence, promoting a return to vigorous growth must be our common objective. The best course forward is clear: first, we must contain spending over the coming year.

Last year's appropriations, agreed to 8 months ago by the last Congress and the last President, contained the largest one-year spending increase in history, about $50 billion over 2000. Obviously, a smaller surge in spending last year would have ensured a larger surplus today. The spending growth rates of 1999 through 2001 cannot be repeated if we are to preserve the on-budget surpluses that we have all worked so hard to create. Congress must limit this year's appropriations to the level of the 2002 Budget Resolution, including the defense amendment recently proposed by the President.

Second, Congress and the President must work together to continue restraining total spending in the next few years. Businesses, states, cities, and families do not hesitate to limit their spending when revenues diminish. The fifty state governments recently reported that collectively they are lowering spending growth from 8 percent last year to a more sustainable 3-1/2 percent in 2002. Spending in the federal domestic agencies exploded during the last three years, including growth of 45 percent at the Department of Health and Human Services and 27 percent at Department of Transportation. These departments can benefit from a period of digestion without great growth beyond these expanded levels.

The Administration is prepared where necessary to extend the principle of restraint to its own high priority initiatives. The Administration continues to propose several tax initiatives from the April Budget, with the effective dates delayed two years until January 1, 2004. In addition, the Administration proposes to fund other initiatives that



can not be delayed within the additional discretionary resources provided in the budget resolution, and will work with Congress to revise these proposals as necessary to ensure their enactment.

There are a number of other items that may place demands on the budget. Consistent with the requirements of the Budget Enforcement Act, action on these or other items with additional costs to the budget must be accompanied by provisions to offset the costs to ensure that no automatic reductions are triggered. Alternatively additional requirements could be funded within the discretionary levels agreed to in the Congressional Budget Resolution including the defense amendment recently proposed by the President. Living within these constraints will ensure that the Social Security surplus is protected and can be fully reserved for debt reduction. Examples of these further requirements include:

- *Farm bill.* The costs of the farm bill now moving through Congress, which restructures farm programs through the next several years, will have to be offset where necessary to maintain on-budget surplus.
- *Tax provisions.* Several long-standing tax credits and other provisions expire at the end of 2001. The Administration supports the extension of these provisions in a fiscally responsible manner and looks forward to working with Congress to achieve that goal. These expiring provisions include Archer Medical Savings Accounts, the work opportunity tax credit, the welfare-to-work tax credit, provisions dealing with the minimum tax for individuals, and the treatment of active financial services income of foreign subsidiaries.
- *Response to natural disasters.* A high level of disaster related needs could require spending beyond the amounts assumed.
- *Railroad Retirement Investment Trust.* The House-passed Railroad Retirement and Survivors' Improvement Act (HR 1140) would authorize a new federal trust fund to purchase stocks and bonds. The purchases could amount to $15 billion. Under

long-standing budget scoring rules, these purchases would be scored as outlays, the same as purchases of stocks, bonds, and any other asset by all agencies within the federal government. However, section 105 of the House-passed bill directs OMB and CBO not to score outlays for these purchases.

Regardless of how the purchases are scored, Treasury would have to pay for them in the same way—by using some of the budget surplus that otherwise would be used to redeem debt held by the public. If all of the purchases were made in 2002, they would exceed the non-Social Security surplus by $14 billion. Treasury would have to use $14 billion of the surplus generated by Social Security to finance the remainder.

This Mid-Session Review presumes a policy of fiscal restraint, but restraint does not mean paralysis. The President's management initiatives and the on-going review of programs at all levels will result in our ability to do more with the same or similar resources. In government, as in any business or family, the burden of proof must be placed on spending proponents to demonstrate the ongoing value received for whatever money is being spent today. Any healthy organization constantly searches for ways to redeploy money from less efficient to more efficient purposes, and it is past time for the federal government to adopt this outlook. We expect that improvements in managing resources that are already underway will pay greater dividends than the exclusive focus on incremental new resources. Excellence is defined by continuing to raise the bar of performance and achievement.

Table 2. CURRENT SURPLUS TOTALS

(In billions of dollars)

	2001	2002
Overall Surplus	158	173
Social Security [1]	157	171
Postal Service	−1	−3
On-Budget [1]	2	4
Non-Social Security	1	1
Examples of potential further requirements		
• Extend expiring tax provisions		
• Farm Bill		
• Funding for natural disasters		
• Railroad Retirement Investment Trust		

[1] The 2001 estimate is adjusted to assign $5.6 billion in prior year receipts to their correct year. See text box on page 9 and Appendix A on page 49.

Table 3. APRIL AND MID-SESSION BUDGET TOTALS

(In billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–2006	2002–2011
April Budget:													
Revenues	2,137	2,192	2,258	2,339	2,438	2,529	2,643	2,771	2,910	3,058	3,233	11,755	26,370
Outlays	1,856	1,961	2,016	2,077	2,169	2,224	2,303	2,398	2,490	2,593	2,706	10,446	22,938
Surplus	281	231	242	262	269	305	340	373	420	465	526	1,309	3,433
Social Security	159	175	193	210	235	251	270	286	301	322	341	1,063	2,583
Non-Social Security	122	56	49	52	34	54	70	87	118	143	186	246	850
Mid-Session Review:													
Revenues	2,013	2,135	2,220	2,328	2,463	2,553	2,668	2,797	2,941	3,095	3,245	11,698	26,444
Outlays	1,855	1,962	2,025	2,111	2,208	2,272	2,354	2,447	2,543	2,648	2,761	10,578	23,331
Surplus	158	173	195	217	254	281	314	350	398	447	484	1,119	3,113
Social Security[1]	157	171	192	211	236	249	266	280	293	311	328	1,059	2,538
Non-Social Security[1]	1	1	2	6	19	32	47	70	105	136	157	60	575
Change:													
Revenues	–124	–57	–38	–11	25	24	24	27	31	36	13	–58	74
Outlays	–1	2	9	34	40	48	51	49	52	54	55	132	393
Surplus	–123	–59	–47	–45	–15	–24	–26	–22	–21	–18	–42	–190	–320
Social Security	–2	–4	–*	1	*	–1	–3	–6	–8	–11	–13	–4	–45
Non-Social Security	–121	–55	–47	–46	–15	–23	–23	–17	–13	–7	–29	–186	–275

* $500 million or less.

[1] The 2001 estimate is adjusted to assign $5.6 billion in prior year receipts to their correct year. See text box on page 9 and Appendix A on page 49.

Accurate Accounting for Social Security

The President is committed to reserving the Social Security surplus for debt reduction and Social Security reform It is evident that there is a widespread, bipartisan consensus that this is the right goal for fiscal policy this year and in the years ahead.

Current estimates indicate the total budget surplus will be $158 billion in 2001, or about $1 billion more than the Social Security surplus.

2001 Surplus Estimates

(In billions of dollars)

Total Budget Surplus	158
Social Security Surplus	157
Non-Social Security Surplus	1
On-budget Surplus	2
Postal Service Loss (off-budget)	−1
Non-Social Security Surplus	1

Given the heightened status, real and symbolic, of the Social Security surplus, it is important to measure it accurately. Current budget practices potentially confuse that measurement in two important ways.

First, the shorthand approach of using the off-budget surplus as a proxy for the Social Security surplus combines Social Security transactions with those of the Postal Service, the only other "off-budget" program. The Postal Service is supposed to break even at a minimum, and in most past years it did. But in 2001 it is estimated to lose approximately $1 billion, so the true Social Security surplus is larger than the off-budget figure by that amount.

Second, a large correction to prior year estimates of Social Security payroll tax collections will be booked in 2001, crediting the trust fund balances with an additional $5.6 billion. This correction reflects the fact that the Social Security surplus was larger than previously thought in 1998, 1999, and in 2000. (There is a lag of a year or more before the necessary information is available to determine exactly what portion of tax proceeds stemmed from Social Security payroll taxes.) Counting this revenue as though it had been paid in 2001 overstates the Social Security surplus for this year.

Precise accuracy in determining the Social Security surplus in any year requires comparing revenue to actual expenditures.* In 2001, the excess of Social Security revenues over expenditures is $157 billion.

(See Appendix A for additional details).

*This correction has been made in this report for the sake of accuracy. Other official publications may use the historical method and therefore report slightly different figures. OMB will review with the Department of the Treasury the possibility of prospective changes to record the adjustments in the correct years.

SUMMARY TABLES

SUMMARY TABLES

Table 8. ESTIMATED SPENDING FROM 2002 BALANCES OF BUDGET AUTHORITY: DISCRETIONARY PROGRAMS [1]

(In billions of dollars)

	Total
Total balances, end of 2002	767.1
Spending from 2002 balances:	
2003	288.7
2004	161.8
2005	100.6
2006	68.9
Expiring balances, 2003 through 2006	.....
Unexpended balances at the end of 2006	147.1

[1] This table is required by section 221(b) of the Legislative Reorganization Act of 1970.

Table 9. OUTLAYS FOR MANDATORY PROGRAMS UNDER CURRENT LAW [1]

(In billions of dollars)

	2000 Actual	Estimate										
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Human resources programs:												
Education, training, employment and social services	10.3	9.0	14.5	15.0	15.5	16.0	17.0	17.8	18.6	19.6	20.7	21.8
Health	124.5	140.3	152.6	170.3	185.4	201.0	217.5	235.7	255.4	276.7	300.7	324.4
Medicare	194.1	214.2	224.3	235.8	248.1	267.4	276.4	297.0	315.9	336.3	357.8	387.0
Income security	206.5	220.0	239.7	248.2	257.1	268.5	278.1	284.5	296.4	306.0	317.8	333.9
Social security	406.0	429.9	452.5	474.4	497.6	522.9	550.3	580.4	613.6	651.5	693.5	738.4
Veterans' benefits and services	26.3	22.8	27.9	29.9	31.5	35.7	34.3	33.3	36.7	38.7	39.8	40.8
Subtotal, human resources programs	967.8	1,036.1	1,111.5	1,173.6	1,235.1	1,311.5	1,373.5	1,448.7	1,536.7	1,628.8	1,730.3	1,846.3
Other mandatory programs:												
International affairs	−4.1	−6.3	−3.3	−3.2	−3.3	−3.2	−3.2	−3.1	−3.0	−2.9	−2.9	−2.9
Energy	−4.0	−3.3	−3.4	−3.2	−3.7	−3.6	−3.6	−3.5	−2.7	−2.4	−2.3	−2.3
Agriculture	32.0	23.5	15.2	11.6	10.9	10.2	9.6	9.3	9.4	9.6	9.5	9.6
Commerce and housing credit	−1.3	−6.8	6.3	5.6	5.4	4.6	3.8	5.4	4.7	5.3	5.0	5.1
Transportation	2.1	2.2	1.8	2.0	2.0	1.9	1.9	1.9	1.9	2.0	2.0	2.0
Undistributed offsetting receipts	−42.6	−47.0	−48.5	−64.0	−64.2	−57.3	−59.2	−61.6	−64.5	−66.7	−69.8	−73.2
Other functions	0.8	1.0	3.2	2.7	4.1	3.5	3.5	3.6	3.7	3.7	3.8	4.0
Subtotal, other mandatory programs	−17.0	−36.8	−28.8	−48.4	−48.8	−43.8	−47.2	−48.0	−50.5	−51.5	−54.8	−57.8
Total, outlays for mandatory programs under current law	950.8	999.3	1,082.7	1,125.2	1,186.4	1,267.7	1,326.3	1,400.7	1,486.2	1,577.3	1,675.5	1,788.6

[1] This table meets the requirements of Section 221(b) of the Legislative Reorganization Act of 1970.

Table 10. MANDATORY PROPOSALS

(In millions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–06	2002–11
Allowance for Medicare Modernization	.....	.....	.....	**14,000**	**20,000**	**21,000**	**22,000**	**25,000**	**27,000**	**29,000**	**32,000**	**55,000**	**190,000**
Health care tax credit	.....	.....	.....	**419**	**4,104**	**5,517**	**5,910**	**6,061**	**6,224**	**6,392**	**6,564**	**10,040**	**41,191**
Other mandatory proposals:													
Agriculture:													
Long-term recreation fee program with four-year reauthorization	.....	.....	–25	–13	–2	–2	28	13	1	.....	.....	–42	.....
Energy:													
ANWR, lease bonuses	.....	.....	.....	–1,200	.....	.....	.....	.....	.....	.....	.....	–1,200	–1,200
HUD													
FHA mark-to-market extension	.....	–218	.....	.....	.....	.....	.....	.....	.....	.....	.....	–218	–218
Interior:													
Use recreation fees to reduce NPS backlog (NPS/FWS/BLM)	.....	.....	–39	–2	49	80	134	92	44	.....	.....	88	358
ANWR, lease bonuses:													
State of Alaska's share:													
Receipts	.....	.....	.....	–1,201	–1	–1	–1	–1	–1	–1	–1	–1,203	–1,208
Expenditure	.....	.....	.....	1,201	1	1	1	1	1	1	1	1,203	1,208
Federal share	.....	.....	.....	–1	–1	–1	–1	–1	–1	–1	–1	–3	–8
Treasury:													
Modify and simplify EITC	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	–335	.....	–335
Veterans Affairs:													
OBRA Extenders:													
IRS income verification on means tested veterans and survivors benefits	.....	.....	.....	–6	–6	–6	–6	–6	–6	–6	–6	–18	–48
Round-down disability benefits to nearest dollar after COLA	.....	.....	–15	–37	–60	–85	–107	–133	–163	–188	–208	–196	–996
Limit VA pensions to Medicaid recipients in nursing homes (includes Medicaid offsets)	.....	.....	.....	.....	.....	.....	.....	.....	–127	–138	–149	.....	–415
Continue current housing loan fees	.....	.....	.....	.....	.....	.....	.....	.....	–275	–280	–286	.....	–841
Loan resale loss	.....	.....	.....	.....	.....	.....	.....	.....	–24	–27	–25	.....	–76
Eliminate Vendee loan program	.....	19	–9	–12	–21	–26	–29	–34	–37	–36	–40	–49	–225
Army Corps of Engineers:													
Recreation user fee increase	.....	–10	–5	–5	–5	.....	.....	.....	.....	.....	.....	–25	–25
FCC:													
Shift spectrum auction deadlines and promote clearing	.....	.....	3,600	–5,100	–2,000	–4,000	.....	.....	.....	.....	.....	–7,500	–7,500
Analog spectrum lease fee	.....	–198	–200	–200	–200	–200	–175	–150	–75	–25	.....	–998	–1,423
FDIC:													
State Bank examination fees:													
Reduction in FDIC outlays	.....	–92	–97	–101	–106	–112	–118	–123	–129	–136	–143	–508	–1,157
FEMA:													
Phase out subsidized premiums for non-primary residences in the flood insurance program	.....	–12	–41	–93	–194	–334	–410	–416	–421	–421	–421	–674	–2,763

Table 10. MANDATORY PROPOSALS—Continued

(In millions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–06	2002–11
Reform flood insurance program for repetitive loss properties that experience chronic flooding	.....	.....	–20	–30	–38	–43	–46	–49	–51	–53	–55	–131	–385
OPM:													
Extend higher agency contributions to the Civil Service Retirement Fund	.....	.....	–469	–482	–449	–415	–380	–343	–306	–268	–222	–1,815	–3,334
Other:													
Indirect impact of other proposals	.....	.....	–2	–4	–7	–7	–6	–3	–4	–4	–7	–20	–44
Total, other mandatory proposals	.....	–511	2,678	–7,286	–3,040	–5,151	–1,116	–1,153	–1,575	–1,584	–1,899	–13,309	–20,635
Total, mandatory proposals	.....	**–511**	**2,678**	**7,133**	**21,064**	**21,366**	**26,794**	**29,908**	**31,650**	**33,809**	**36,666**	**51,730**	**210,557**
Fund with discretionary appropriations:													
Education:													
Expand teacher loan forgiveness	.....	11	5	5	5	6	6	6	6	7	7	32	64
HHS:													
Child welfare preventative services	.....	30	158	192	196	200	200	200	200	200	200	776	1,776
Education and training for older foster children	.....	9	46	58	60	60	60	60	60	60	60	233	533
Charity State tax credit, TANF outlays	.....	.....	400	300	150	.....	.....	–200	–200	–200	–250	850	.....
Interior:													
Correct trust accounting deficiencies (individual Indian money investments)	.....	7	.....	.....	.....	.....	.....	.....	.....	.....	.....	7	7
Justice:													
Radiation exposure compensation	.....	97	155	150	108	68	55	40	20	12	5	578	710
Total, fund with discretionary appropriations	.....	154	764	705	519	334	321	106	86	79	22	2,476	3,090

Table 11. EFFECT OF PROPOSALS ON RECEIPTS

(In millions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–2006	2002–2011
2002 Budget Proposals:													
Incentives for charitable giving:													
Provide charitable contribution deduction for nonitemizers	.....	.....	.....	–527	–1,844	–3,252	–4,879	–6,569	–7,537	–7,568	–7,639	–5,623	–39,815
Permit tax-free withdrawals from IRAs for charitable contributions	.....	.....	.....	–195	–210	–225	–241	–258	–277	–299	–322	–630	–2,027
Raise the cap on corporate charitable contributions	.....	.....	.....	–100	–158	–154	–163	–173	–183	–206	–227	–412	–1,364
Strengthen and reform education:													
Allow teachers to deduct out-of-pocket classroom expenses	.....	.....	.....	–18	–179	–209	–227	–244	–247	–250	–253	–406	–1,627
Assist Americans with disabilities:													
Exclude from income the value of employer-provided computers, software and peripherals	.....	.....	.....	–2	–6	–6	–6	–6	–6	–6	–7	–14	–45
Invest in health care:													
Provide refundable tax credit for the purchase of health insurance [1]	.....	.....	.....	–174	–1,641	–3,445	–3,626	–3,930	–4,029	–4,131	–4,234	–5,260	–25,210
Provide an above-the-line deduction for long-term care insurance premiums	.....	.....	.....	–346	–574	–1,150	–2,007	–2,365	–2,646	–2,945	–3,287	–2,070	–15,320
Allow up to $500 in unused benefits in a health flexible spending arrangement to be carried forward to the next year	.....	.....	.....	–423	–713	–782	–831	–878	–926	–980	–1,036	–1,918	–6,569
Provide additional choice with regard to unused benefits in a health flexible spending account	.....	.....	.....	–22	–39	–45	–52	–60	–69	–81	–94	–106	–462
Permanently extend and reform Archer MSAs	.....	.....	.....	–79	–362	–431	–482	–510	–534	–567	–589	–872	–3,554
Provide an additional personal exemption to home caretakers of family members	.....	.....	.....	–370	–463	–490	–518	–529	–540	–557	–552	–1,323	–4,019
Help farmers and fishermen manage economic downturns:													
Establish FFARRM savings accounts	.....	.....	.....	–88	–230	–161	–116	–85	–65	–50	–41	–479	–836
Increase housing opportunities:													
Provide tax credit for developers of affordable single-family housing	.....	.....	.....	–4	–46	–202	–525	–987	–1,514	–2,020	–2,406	–252	–7,704
Encourage savings:													
Establish Individual Development Accounts	.....	.....	.....	–154	–265	–281	–297	–306	–143	–34	–35	–700	–1,515
Protect the environment:													
Permanently extend expensing of brownfields remediation costs	.....	.....	.....	–236	–373	–364	–355	–344	–333	–321	–310	–973	–2,636
Exclude gains from the sale of property for conservation purposes	.....	–1	–3	–49	–102	–115	–132	–155	–187	–231	–292	–270	–1,267

Table 11. EFFECT OF PROPOSALS ON RECEIPTS—Continued

(In millions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–2006	2002–2011
Energy policy proposals:													
Modify treatment of nuclear decommissioning funds		–91	–160	–172	–181	–192	–202	–212	–223	–235	–247	–796	–1,915
Extend and modify tax credit for producing electricity from certain sources		–116	–203	–222	–125	–58	–59	–57	–55	–56	–58	–724	–1,009
Provide tax credit for residential solar energy systems		–7	–15	–19	–25	–15	–10	–5				–81	–96
Promote trade:													
Extend and expand Andean trade preferences[2]				–154	–214	–55						–423	–423
Additional Energy Proposals:													
Provide tax credit for purchase of certain hybrid and fuel cell vehicles[2]		–22	–81	–180	–358	–615	–1,026	–817	–108	–126	–179	–1,256	–3,512
Provide tax credit for energy produced from landfill gas		–23	–51	–75	–103	–138	–156	–158	–161	–164	–66	–390	–1,095
Provide tax credit for combined heat and power property		–119	–197	–200	–212	–268	–126		6	5	5	–996	–1,106
Provide excise tax exemption (credit) for ethanol													
Expiring Provisions:													
Permanent extension of provisions expiring in 2010:													
Marginal individual income tax rate reductions										–13,910	–67,757		–81,667
Expanded child tax credit											–4,639		–4,639
Marriage penalty relief[1]											–4,532		–4,532
Education incentives		–1	–5	–10	–15	–20	–26	–32	–39	–45	–890	–51	–1,083
Repeal of estate and generation-skipping transfer taxes, and modification of gift taxes		–271	–614	–1,215	–1,792	–2,475	–2,726	–3,226	–4,040	–4,884	–26,651	–6,367	–47,894
Modifications of IRAs and pension plans										–1	–2,371		–2,372
Other incentives for families and children										61	–257		–196
Permanent extension of R&E tax credit				–1,055	–3,431	–5,415	–6,543	–7,388	–8,019	–8,567	–9,168	–9,901	–49,586
Other Provisions that Affect Receipts:													
Recover State bank supervision and regulation expenses (receipt effect)[2]		70	74	76	80	84	88	92	96	101	105	384	866
Total effect of proposals[1 2]		–581	–1,255	–6,013	–13,581	–20,479	–25,243	–29,202	–31,779	–48,067	–138,029	–41,909	–314,229

[1] Affects both receipts and outlays; only the receipt effects are shown here. The outlay effects are shown in Table 10.

[2] Net of income offsets.

Table 12. OUTLAYS BY CATEGORY

(In billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
April estimates											
Discretionary:											
Defense	299.6	319.2	322.1	333.5	347.6	354.6	361.0	374.1	384.9	396.0	411.4
Non-defense	349.8	372.5	389.7	397.8	406.8	415.8	425.5	435.3	445.1	458.4	465.1
Subtotal, discretionary	649.4	691.7	711.8	731.2	754.5	770.4	786.5	809.5	830.0	854.4	876.5
Mandatory:											
Social Security	430.0	451.6	473.5	498.0	524.3	553.0	584.1	618.0	656.2	698.3	743.6
Medicare	216.0	226.4	238.6	252.2	279.1	292.2	314.0	335.6	358.4	384.3	419.2
Medicaid	128.9	142.4	152.7	166.0	180.5	196.4	213.6	232.2	252.6	274.6	297.9
Other	225.6	260.3	264.3	267.8	285.7	284.8	296.2	312.3	323.9	336.2	349.4
Subtotal, mandatory	1,000.5	1,080.7	1,129.2	1,184.0	1,269.6	1,326.3	1,408.0	1,498.2	1,591.2	1,693.5	1,810.1
Net interest	206.4	188.1	175.2	161.5	144.7	127.2	108.9	90.3	69.1	45.7	19.8
Total, outlays	**1,856.2**	**1,960.6**	**2,016.2**	**2,076.7**	**2,168.7**	**2,223.9**	**2,303.4**	**2,397.9**	**2,490.3**	**2,593.5**	**2,706.3**
Mid-session estimates:											
Discretionary:											
Defense	304.0	329.9	335.7	357.0	366.6	376.8	385.3	395.8	406.9	418.5	430.5
Non-defense	347.4	369.5	387.8	395.5	401.9	410.1	419.2	428.5	438.0	450.9	457.4
Subtotal, discretionary	651.4	699.4	723.5	752.5	768.5	786.9	804.5	824.3	844.9	869.4	887.9
Mandatory:											
Social Security	429.9	452.5	474.4	497.6	522.9	550.3	580.4	613.6	651.5	693.5	738.4
Medicare	214.2	224.3	235.8	262.1	287.4	297.4	319.0	340.9	363.3	386.8	419.0
Medicaid	130.3	143.0	155.1	168.9	183.6	199.3	216.5	234.8	255.3	277.1	300.7
Other	224.9	262.4	262.6	264.9	294.8	300.6	311.6	326.7	338.7	351.8	366.9
Subtotal, mandatory	999.3	1,082.2	1,127.8	1,193.5	1,288.8	1,347.6	1,427.4	1,516.0	1,608.8	1,709.2	1,825.1
Net interest	204.2	180.5	174.1	164.8	151.0	137.1	122.3	106.9	88.9	69.0	48.1
Total, outlays	**1,854.9**	**1,962.1**	**2,025.4**	**2,110.7**	**2,208.3**	**2,271.6**	**2,354.2**	**2,447.2**	**2,542.6**	**2,647.6**	**2,761.0**
Difference:											
Discretionary:											
Defense	4.4	10.7	13.6	23.5	18.9	22.2	24.3	21.7	22.1	22.5	19.1
Non-defense	−2.4	−3.0	−1.9	−2.3	−4.9	−5.7	−6.3	−6.9	−7.1	−7.4	−7.7
Subtotal, discretionary	2.1	7.6	11.7	21.2	14.0	16.5	18.0	14.8	14.9	15.1	11.4
Mandatory:											
Social Security	−0.1	0.9	0.8	−0.4	−1.4	−2.7	−3.8	−4.4	−4.7	−4.8	−5.1
Medicare	−1.8	−2.2	−2.8	9.9	8.3	5.2	5.0	5.3	4.9	2.5	−0.2
Medicaid	1.4	0.6	2.4	2.9	3.1	2.9	2.9	2.6	2.7	2.5	2.8
Other	−0.7	2.1	−1.7	−3.0	9.1	15.8	15.4	14.4	14.8	15.6	17.5
Subtotal, mandatory	−1.2	1.5	−1.3	9.5	19.2	21.3	19.4	17.9	17.6	15.8	15.0
Net interest	−2.2	−7.6	−1.1	3.3	6.4	9.9	13.4	16.6	19.8	23.3	28.3
Total, outlays	**−1.3**	**1.5**	**9.2**	**34.0**	**39.6**	**47.7**	**50.8**	**49.3**	**52.3**	**54.2**	**54.7**

Table 13. RECEIPTS BY SOURCE

(In billions of dollars)

	Estimates										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
April estimates											
Individual income taxes	1,072.9	1,078.8	1,092.3	1,117.9	1,157.0	1,196.6	1,255.2	1,330.4	1,410.2	1,499.6	1,598.2
Corporation income taxes	213.1	218.8	227.3	235.5	244.2	252.2	259.9	268.1	275.8	283.5	294.3
Social insurance and retirement receipts	689.7	725.8	766.0	806.0	855.8	896.4	942.0	984.4	1,030.8	1,087.9	1,145.1
Excise taxes	71.1	74.0	76.3	78.3	80.5	82.3	84.8	87.3	90.0	92.8	95.7
Estate and gift taxes	31.1	28.7	26.6	28.3	24.9	22.5	20.4	15.7	13.4	0.7	0.7
Customs duties	21.4	22.5	24.3	25.0	26.0	27.7	29.3	30.7	33.0	34.5	36.2
Miscellaneous receipts	37.6	43.1	45.4	47.8	49.3	51.0	51.6	54.1	56.8	59.5	62.4
Total	**2,136.9**	**2,191.7**	**2,258.2**	**2,338.8**	**2,437.8**	**2,528.7**	**2,643.3**	**2,770.6**	**2,909.9**	**3,058.4**	**3,232.6**
Mid-Session estimates											
Individual income taxes [1]	1,014.3	1,024.2	1,068.0	1,115.9	1,171.1	1,215.2	1,281.0	1,356.0	1,439.3	1,529.6	1,627.1
Corporation income taxes	155.4	229.1	221.3	231.0	258.7	259.3	264.2	270.9	277.9	285.8	295.3
Social insurance and retirement receipts [1]	689.4	721.9	768.7	810.1	860.3	897.7	941.5	982.8	1,027.2	1,082.9	1,139.2
Excise taxes	67.6	70.4	72.8	74.8	76.8	78.3	80.5	83.0	85.7	88.4	91.1
Estate and gift taxes	30.0	28.0	23.6	26.9	24.3	27.2	23.8	24.6	25.9	19.6	0.1
Customs duties	19.8	21.5	23.2	24.2	25.3	26.8	28.0	29.2	31.3	32.5	33.7
Miscellaneous receipts	36.2	39.6	42.6	44.6	46.1	48.1	48.7	50.9	53.5	56.0	58.8
Total	**2,012.7**	**2,134.7**	**2,220.2**	**2,327.5**	**2,462.5**	**2,552.6**	**2,667.8**	**2,797.4**	**2,940.8**	**3,094.8**	**3,245.3**
Difference											
Individual income taxes	–58.6	–54.6	–24.3	–2.0	14.1	18.6	25.8	25.6	29.1	30.0	28.9
Corporation income taxes	–57.7	10.3	–6.0	–4.5	14.5	7.2	4.2	2.9	2.2	2.4	0.9
Social insurance and retirement receipts	–0.2	–3.9	2.7	4.0	4.5	1.3	–0.5	–1.6	–3.6	–4.9	–5.9
Excise taxes	–3.6	–3.6	–3.4	–3.6	–3.8	–4.1	–4.2	–4.3	–4.4	–4.4	–4.6
Estate and gift taxes	–1.1	–0.7	–3.0	–1.4	–0.6	4.7	3.4	8.9	12.6	18.9	–0.5
Customs duties	–1.6	–1.0	–1.0	–0.7	–0.7	–1.0	–1.3	–1.5	–1.7	–2.0	–2.6
Miscellaneous receipts	–1.4	–3.5	–2.8	–3.2	–3.2	–2.9	–2.9	–3.2	–3.3	–3.5	–3.5
Total	**–124.2**	**–57.0**	**–38.0**	**–11.3**	**24.7**	**23.9**	**24.5**	**26.9**	**30.9**	**36.4**	**12.8**

[1] The 2001 estimate is adjusted to correct for $5.6 billion in prior year receipts. See text box on page 9 and Appendix A on page 49.

Table 14. OUTLAYS BY AGENCY

(In billions of dollars)

	2000 Actual	April estimates						Mid-Session estimates					
		2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
Legislative Branch	2.9	3.1	3.3	3.4	3.4	3.4	3.5	3.2	3.3	3.4	3.4	3.4	3.5
Judicial Branch	4.1	4.3	4.9	5.0	5.1	5.2	5.3	4.3	4.9	5.0	5.1	5.2	5.3
Agriculture	75.7	69.6	63.2	61.4	61.9	63.8	65.9	72.1	65.7	63.6	64.5	65.6	66.7
Commerce	7.8	5.5	5.2	5.4	5.3	5.4	5.5	5.4	5.2	5.4	5.3	5.4	5.5
Defense—Military	281.2	283.9	303.4	306.2	317.2	331.0	337.7	288.3	313.9	319.6	340.5	349.8	359.9
Education	33.9	36.7	45.2	49.6	50.6	51.9	53.3	36.9	45.5	50.2	51.4	52.5	54.0
Energy	15.0	16.7	17.2	17.5	17.7	18.1	18.4	17.3	17.3	17.5	17.7	18.2	18.4
Health and Human Services	382.6	430.5	468.8	498.8	532.7	566.7	594.1	428.3	457.1	486.7	532.7	574.4	602.1
Housing and Urban Development	30.8	37.3	34.8	34.9	33.5	33.4	33.6	35.9	34.4	34.8	33.6	33.7	33.7
Interior	8.0	8.7	9.3	9.6	11.1	10.1	10.3	8.2	9.1	9.7	11.4	10.4	10.6
Justice	19.6	20.7	22.5	25.4	23.9	23.3	23.6	20.9	21.7	25.4	24.0	23.3	23.6
Labor	31.4	38.2	42.0	42.3	43.1	44.8	46.7	39.4	43.7	44.3	45.1	46.2	48.3
State	6.8	9.3	9.7	9.7	9.9	10.1	10.4	8.3	10.0	9.7	10.0	10.2	10.4
Transportation	46.0	50.6	54.9	56.9	59.2	61.7	63.4	50.5	54.6	55.2	54.9	56.3	57.5
Treasury	391.2	388.5	381.5	385.1	388.2	388.9	390.3	387.0	380.9	388.0	395.2	399.9	406.7
Veterans Affairs	47.1	45.2	51.5	53.5	55.7	60.3	59.5	45.0	51.0	53.5	55.7	60.3	59.5
Corps of Engineers	4.3	4.6	4.4	4.2	4.3	4.3	4.2	4.4	4.2	4.0	4.1	4.1	4.2
Other Defense Civil Programs	32.9	34.4	35.4	41.2	42.4	43.7	44.9	34.4	35.6	41.5	42.7	43.9	45.1
Environmental Protection Agency	7.2	7.5	7.6	7.6	7.6	7.6	7.6	7.3	7.5	7.6	7.6	7.6	7.6
Executive Office of the President	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Federal Emergency Management Agency	3.1	3.1	3.2	3.0	2.7	2.4	1.9	3.4	3.2	2.9	2.9	2.3	1.9
General Services Administration	*	0.6	–0.2	0.3	0.4	0.4	0.3	0.6	–0.2	0.3	0.4	0.4	0.3
International Assistance Programs	12.1	11.4	12.1	12.4	12.5	12.4	12.7	11.3	12.0	12.3	12.5	12.7	13.0
National Aeronautics and Space Administration	13.4	13.8	14.2	14.7	15.1	15.4	15.8	13.8	14.2	14.7	15.1	15.4	15.8
National Science Foundation	3.5	4.0	4.4	4.5	4.7	4.7	4.8	4.0	4.3	4.5	4.7	4.7	4.8
Office of Personnel Management	48.7	51.0	53.4	56.3	59.5	62.8	66.0	51.0	53.7	56.7	59.8	63.1	66.3
Small Business Administration	–0.4	–1.0	0.7	0.6	0.5	0.5	0.6	–1.0	0.7	0.6	0.5	0.5	0.6
Social Security Administration	441.8	463.0	488.2	511.5	537.4	567.7	595.5	462.6	489.2	512.6	537.2	566.6	593.1
Other Independent Agencies	10.6	4.9	19.0	16.8	17.1	17.8	17.7	1.4	18.7	17.6	18.5	18.2	18.5
Allowances	.....	.....	2.4	3.9	4.7	5.4	5.7	.....	2.4	3.3	4.0	4.9	5.3
Undistributed Offsetting Receipts	–172.8	–190.2	–201.8	–226.0	–251.0	–254.9	–275.8	–189.5	–201.7	–225.4	–250.0	–251.6	–271.0
Total	**1,788.8**	**1,856.2**	**1,960.6**	**2,016.2**	**2,076.7**	**2,168.7**	**2,223.9**	**1,854.9**	**1,962.1**	**2,025.4**	**2,110.7**	**2,208.3**	**2,271.6**

* $50 million or less.

Table 15. OUTLAYS BY FUNCTION

(In billions of dollars)

	2000 Actual	April estimates						Mid-Session estimates					
		2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
National defense	294.5	299.1	319.2	322.1	333.1	347.2	354.0	303.6	329.8	335.5	356.5	366.0	376.2
International affairs	17.2	17.5	21.0	21.3	21.5	21.6	22.2	16.6	21.4	21.4	21.7	22.1	22.6
General science, space, and technology	18.6	19.7	20.8	21.4	22.2	22.6	23.1	19.7	20.7	21.4	22.2	22.6	23.1
Energy	–1.1	–0.7	–0.3	–0.1	–0.6	–0.4	–0.3	–0.3	–0.4	–0.1	–0.6	–0.4	–0.3
Natural resources and environment	25.0	27.4	27.5	27.7	28.0	28.4	28.7	26.6	27.1	27.6	28.1	28.7	29.0
Agriculture	36.6	25.9	18.6	15.0	14.0	14.1	14.5	28.9	20.7	16.8	16.2	15.5	14.9
Commerce and housing credit	3.2	–0.8	6.9	4.7	3.6	3.5	2.3	–5.2	6.4	5.5	4.9	4.0	3.2
Transportation	46.9	51.1	55.0	57.5	59.7	62.1	63.8	51.0	54.8	55.7	55.3	56.8	57.9
Community and regional development	10.6	10.6	11.7	11.3	10.8	10.5	10.1	10.8	11.8	11.3	11.1	10.5	10.2
Education, training, employment, and social services	59.2	65.3	76.6	81.3	82.6	84.7	87.2	64.2	75.5	82.1	84.0	85.4	88.0
Health	154.5	175.3	201.5	224.4	243.3	250.7	264.8	173.8	190.7	212.0	231.7	251.8	271.1
Medicare	197.1	219.3	229.9	242.1	255.9	282.8	296.0	217.4	227.7	239.3	265.8	291.1	301.2
Income security	247.9	262.6	275.7	285.9	295.9	308.8	317.1	265.1	286.5	296.7	306.2	318.4	328.6
Social Security	409.4	433.6	455.1	477.1	501.6	528.1	556.8	433.5	456.1	478.0	501.3	526.7	554.1
Veterans benefits and services	47.1	45.4	51.6	53.6	55.8	60.4	59.6	45.1	51.1	53.6	55.8	60.4	59.6
Administration of justice	27.8	29.4	32.3	35.4	35.5	35.2	35.8	29.7	31.4	35.4	35.5	35.2	35.8
General government	13.5	16.8	16.3	16.7	18.4	17.4	17.6	17.2	16.5	16.9	18.6	17.6	17.8
Net interest	223.2	206.4	188.1	175.2	161.5	144.7	127.2	204.2	180.5	174.1	164.8	151.0	137.1
Allowances	.....	.....	2.4	3.9	4.7	5.4	5.7	.....	2.4	3.3	4.0	4.9	5.3
Undistributed offsetting receipts	–42.6	–47.7	–49.4	–60.4	–70.6	–58.9	–62.4	–47.0	–48.7	–61.0	–72.4	–59.9	–63.8
Total	**1,788.8**	**1,856.2**	**1,960.6**	**2,016.2**	**2,076.7**	**2,168.7**	**2,223.9**	**1,854.9**	**1,962.1**	**2,025.4**	**2,110.7**	**2,208.3**	**2,271.6**

Table 16. DISCRETIONARY BUDGET AUTHORITY BY AGENCY

(In billions of dollars)

	2000 Actual	April estimates						Mid-Session estimates					
		2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
Legislative Branch	2.5	2.7	3.0	3.0	3.1	3.1	3.2	2.8	3.0	3.0	3.1	3.1	3.2
Judicial Branch	3.7	4.0	4.6	4.5	4.6	4.7	4.9	4.0	4.6	4.5	4.6	4.7	4.9
Agriculture	17.1	19.3	17.9	18.8	19.0	19.4	19.8	19.3	17.9	18.8	19.0	19.4	19.8
Commerce	8.7	5.1	4.8	5.3	5.3	5.4	5.5	5.0	4.9	5.3	5.3	5.4	5.5
Defense—Military	287.3	296.3	310.5	319.0	327.9	337.1	346.6	301.9	328.9	337.9	347.4	357.1	367.1
Education	29.4	39.9	44.5	45.5	47.0	48.1	49.1	40.1	44.6	45.5	47.0	48.1	49.1
Energy	17.8	19.7	19.2	19.7	20.3	20.7	21.2	20.0	19.2	19.7	20.3	20.7	21.2
Health and Human Services	45.5	53.9	56.7	61.7	63.3	64.9	66.5	54.1	56.8	61.8	63.4	65.0	66.7
Housing and Urban Development	21.1	28.5	30.4	32.2	33.3	34.6	35.7	28.4	30.4	32.2	33.3	34.6	35.7
Interior	8.5	10.2	9.8	10.0	10.2	10.4	10.6	10.3	9.9	10.1	10.3	10.5	10.7
Justice	18.8	20.9	19.9	21.9	22.0	22.3	22.8	20.9	20.0	22.1	22.2	22.4	22.9
Labor	8.8	11.9	11.3	11.8	12.1	12.4	12.6	11.7	11.4	12.0	12.3	12.6	12.8
State	7.8	7.5	9.1	9.3	9.5	9.7	9.9	7.5	9.1	9.3	9.5	9.7	9.9
Transportation	14.5	18.4	16.3	17.3	17.7	18.1	18.5	18.5	16.3	17.3	17.7	18.1	18.5
Treasury	12.5	14.0	14.7	15.0	15.4	15.7	16.1	14.2	14.7	15.0	15.4	15.7	16.1
Veterans Affairs	20.8	22.4	23.4	23.9	24.4	25.0	25.6	22.3	23.2	23.7	24.3	24.8	25.3
Corps of Engineers	4.1	4.5	3.9	4.0	4.1	4.2	4.3	4.7	3.9	4.0	4.1	4.2	4.3
Other Defense Civil Programs	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.2
Environmental Protection Agency	7.6	7.8	7.3	7.4	7.6	7.2	6.6	7.8	7.3	7.4	7.6	7.2	6.6
Executive Office of the President	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Federal Emergency Management Agency	3.9	2.4	2.2	2.3	2.3	2.4	2.4	2.4	2.2	2.3	2.3	2.4	2.4
General Services Administration	–*	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
International Assistance Programs	13.6	12.9	12.8	13.1	13.4	13.6	13.9	13.0	12.9	13.2	13.5	13.8	14.1
National Aeronautics and Space Administration	13.6	14.3	14.5	15.0	15.4	15.7	16.1	14.3	14.5	15.0	15.4	15.7	16.1
National Science Foundation	3.9	4.4	4.5	4.6	4.7	4.8	4.9	4.4	4.5	4.6	4.7	4.8	4.9
Office of Personnel Management	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Small Business Administration	0.9	0.3	0.5	0.6	0.6	0.6	0.6	0.9	0.5	0.6	0.6	0.6	0.6
Social Security Administration	5.7	6.0	6.4	6.5	6.7	6.8	7.0	6.0	6.4	6.5	6.7	6.8	7.0
Other Independent Agencies	5.8	6.3	6.0	6.0	6.3	6.3	6.4	6.3	6.1	6.0	6.2	6.3	6.4
Allowances	.....	.....	5.3	5.4	5.6	5.7	5.8	.....	5.4	5.0	5.1	5.3	5.5
Total	**584.4**	**634.9**	**660.6**	**685.1**	**702.7**	**720.1**	**737.9**	**642.1**	**679.8**	**704.0**	**722.2**	**740.1**	**758.4**

* $50 million or less.

Table 17. DISCRETIONARY BUDGET AUTHORITY BY FUNCTION

(In billions of dollars)

	2000 Actual	April estimates						Mid-Session estimates					
		2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
National defense	300.8	311.3	325.1	333.9	343.2	352.7	362.5	317.1	343.7	353.0	362.8	372.7	383.1
International affairs	23.5	22.7	23.9	24.4	24.9	25.5	26.0	22.7	24.0	24.5	25.0	25.6	26.1
General science, space, and technology	19.2	20.9	21.2	21.9	22.4	22.9	23.5	20.9	21.2	21.9	22.4	22.9	23.5
Energy	2.7	3.1	2.8	2.9	3.1	3.2	3.3	3.1	2.8	2.9	3.1	3.2	3.3
Natural resources and environment	24.6	28.7	26.4	27.0	27.6	27.6	27.4	28.9	26.4	27.1	27.6	27.7	27.5
Agriculture	4.7	5.1	4.8	5.2	5.2	5.3	5.4	5.1	4.8	5.2	5.2	5.3	5.4
Commerce and housing credit	5.1	0.7	–0.3	–0.1	–0.4	–0.5	–0.5	0.6	–0.1	–0.1	–0.4	–0.5	–0.5
Transportation	15.2	18.9	16.8	17.8	18.2	18.6	19.0	19.0	16.8	17.8	18.2	18.6	19.0
Community and regional development	12.2	11.0	10.4	10.7	10.9	11.1	11.3	11.6	10.4	10.7	10.9	11.1	11.3
Education, training, employment, and social services	44.4	61.1	65.4	67.1	69.0	70.7	72.3	61.1	65.7	67.4	69.4	71.0	72.7
Health	33.8	38.9	41.0	45.7	46.9	48.1	49.4	38.8	40.9	45.6	46.8	48.0	49.3
Medicare	3.0	3.4	3.5	3.5	3.6	3.7	3.8	3.4	3.5	3.5	3.6	3.7	3.8
Income security	31.6	39.5	42.8	45.1	46.7	48.3	49.6	39.7	42.9	45.1	46.8	48.4	49.6
Social Security	3.2	3.4	3.5	3.6	3.7	3.8	3.8	3.4	3.5	3.6	3.7	3.8	3.8
Veterans benefits and services	20.9	22.5	23.5	24.0	24.5	25.1	25.7	22.4	23.3	23.8	24.3	24.9	25.4
Administration of justice	27.1	30.0	29.8	31.9	32.3	32.8	33.5	30.0	29.8	31.9	32.3	32.8	33.5
General government	12.4	14.0	14.8	15.0	15.4	15.7	16.0	14.2	14.8	15.1	15.4	15.7	16.1
Allowances	.....	.....	5.3	5.4	5.6	5.7	5.8	.....	5.4	5.0	5.1	5.3	5.5
Total	**584.4**	**634.9**	**660.6**	**685.1**	**702.7**	**720.1**	**737.9**	**642.1**	**679.8**	**704.0**	**722.2**	**740.1**	**758.4**

Table 18. MID-SESSION BASELINE TOTALS

(In billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002–2011
Discretionary:												
Defense	304.0	317.1	325.5	336.8	351.0	357.5	363.7	376.5	387.3	398.4	413.9	3,627.8
Non-defense	347.4	368.6	387.3	398.0	406.2	416.4	427.8	439.2	450.7	462.6	474.9	4,231.6
Subtotal, discretionary	651.5	685.7	712.7	734.7	757.2	773.9	791.5	815.7	838.0	861.0	888.8	7,859.4
Mandatory:												
Social Security	429.9	452.5	474.4	497.6	522.9	550.3	580.4	613.6	651.5	693.5	738.4	5,775.1
Medicare	214.2	224.3	235.8	248.1	267.4	276.4	297.0	315.9	336.3	357.8	387.0	2,946.0
Medicaid	130.3	143.0	155.1	168.9	183.6	199.3	216.5	234.8	254.9	276.7	300.3	2,133.1
Other	224.9	262.9	259.9	271.8	293.8	300.3	306.9	321.9	334.6	347.5	362.8	3,062.5
Subtotal, mandatory	999.3	1,082.7	1,125.2	1,186.4	1,267.7	1,326.3	1,400.7	1,486.2	1,577.3	1,675.5	1,788.6	13,916.7
Net interest	204.2	180.2	173.1	162.7	147.1	130.6	112.8	93.8	72.1	47.7	19.7	1,139.8
Total, outlays	1,855.0	1,948.7	2,011.0	2,083.8	2,172.0	2,230.9	2,305.0	2,395.8	2,487.4	2,584.3	2,697.2	22,916.0
Receipts	2,012.7	2,135.3	2,221.5	2,333.5	2,476.1	2,573.1	2,693.0	2,826.6	2,972.6	3,142.9	3,383.4	26,758.0
Surplus	157.8	186.6	210.5	249.8	304.1	342.2	388.0	430.9	485.2	558.6	686.2	3,842.0
On-budget surplus [1]	1.9	18.0	18.2	38.9	67.8	92.0	122.2	150.3	191.4	247.3	357.7	1,303.8
Postal service surplus	–1.3	–2.6	0.1	0.2	0.8	1.2	–0.1	0.7	0.9	1.1	1.4	3.7
Social Security surplus [1]	157.1	171.2	192.2	210.6	235.5	248.9	265.9	279.9	293.0	310.2	327.1	2,534.5

[1] The 2001 estimate is adjusted to correct for $5.6 billion in prior year receipts. See text box on page 9 and Appendix A on page 49.

Table 19. FEDERAL GOVERNMENT FINANCING AND DEBT

(In billions of dollars)

	2000 actual	Estimate										
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Financing:												
Unified budget surplus	236	158	173	195	217	254	281	314	350	398	447	484
Financing other than the change in debt held by the public:												
Premiums paid (–) on buybacks of Treasury securities [1]	–6	–11	–10	.....	.....	.....	.....	.....	.....	.....	.....	.....
Changes in: [2]												
Treasury operating cash balance	4	–2	–5	.....	–5	.....	.....	–5	.....	.....	–5	.....
Checks outstanding, deposit funds, etc. [3]	3	–4	1	.....	.....	.....	.....	.....	.....	.....	.....	.....
Seigniorage on coins	2	1	1	2	2	2	2	2	2	2	2	2
Less: Net financing disbursements:												
Direct loan financing accounts	–22	–31	–4	–17	–18	–17	–16	–16	–16	–16	–16	–15
Guaranteed loan financing accounts	4	–1	–1	1	–*	–*	1	1	1	1	1	1
Total, financing other than the change in debt held by the public	–13	–48	–17	–15	–21	–16	–14	–19	–14	–14	–18	–13
Total, amount available to repay debt held by the public	223	110	155	180	196	239	267	295	337	385	429	471
Change in debt held by the public: [4 5]												
Change in debt held by the public	–223	–110	–155	–180	–196	–239	–267	–295	–337	–385	–155	–35
Less change in excess balances	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	–274	–436
Change in net indebtedness	–223	–110	–155	–180	–196	–239	–267	–295	–337	–385	–429	–471
Debt Subject to Statutory Limitation, End of Year:												
Debt issued by Treasury	5,601	5,727	5,829	5,935	6,040	6,125	6,201	6,266	6,303	6,310	6,568	6,963
Adjustment for Treasury debt not subject to limitation and agency debt subject to limitation [6]	–15	–15	–15	–15	–15	–15	–15	–15	–15	–15	–15	–15
Adjustment for discount and premium [7]	6	6	6	6	6	6	6	6	6	6	6	6
Total, debt subject to statutory limitation [8]	5,592	5,717	5,819	5,926	6,031	6,115	6,192	6,256	6,294	6,300	6,558	6,954
Debt Outstanding, End of Year:												
Gross Federal debt: [9]												
Debt issued by Treasury	5,601	5,727	5,829	5,935	6,040	6,125	6,201	6,266	6,303	6,310	6,568	6,963
Debt issued by other agencies	28	27	27	26	25	23	22	20	20	20	20	20
Total, gross Federal debt	5,629	5,753	5,855	5,961	6,065	6,148	6,223	6,286	6,323	6,330	6,588	6,983
Held by:												
Debt securities held as assets by Government accounts	2,219	2,453	2,711	2,996	3,296	3,618	3,959	4,317	4,691	5,082	5,495	5,926
Debt securities held as assets by the public: [5]												
Debt held by the public	3,410	3,300	3,145	2,965	2,769	2,531	2,264	1,969	1,632	1,248	1,093	1,057
Less excess balances	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	–274	–710
Net indebtedness [10]	3,410	3,300	3,145	2,965	2,769	2,531	2,264	1,969	1,632	1,248	819	348

* $500 million or less.

[1] This table includes estimates for Treasury buybacks of outstanding securities only through 2002. These estimates assume that Treasury will buy back $35 billion (face value) of securities in 2001 (in terms of settlements) and $40 billion in 2002. The premiums paid on buybacks are based on experience to date and the interest rates in the economic assumptions.

[2] A decrease in the Treasury operating cash balance (which is an asset) would be a means of financing a deficit and therefore has a positive sign. An increase in checks outstanding or deposit fund balances (which are liabilities) would also be a means of financing a deficit and therefore would also have a positive sign.

[3] Besides checks outstanding and deposit funds, includes accrued interest payable on Treasury debt, miscellaneous liability accounts, allocations of special drawing rights, and, as an offset, cash and monetary assets other than the Treasury operating cash balance, miscellaneous asset accounts, and profit on sale of gold.

[4] Indian tribal funds that are owned by the Indian tribes and held and managed in a fiduciary capacity by the Government on the tribes' behalf were reclassified from trust funds to deposit funds as of October 1, 1999. Their holdings of Treasury securities were accordingly reclassified from debt held by Government accounts to debt held by the public, which affected the change in debt held by the public without affecting borrowing or the repayment of debt.

[5] The amount of the unified budget surplus that is available to repay debt held by the public is estimated to be more than the amount of debt that is available to be redeemed in 2010 and subsequent years. The difference is assumed to be held as "excess balances." ("Excess" means in excess of the amounts held for operational and programmatic purposes.) The debt held by the public is the amount of Federal debt securities held by the public. The net indebtedness is the debt held by the public less the excess balances.

[6] Consists primarily of Federal Financing Bank debt.

[7] Consists of unamortized discount (less premium) on public issues of Treasury notes and bonds (other than zero-coupon bonds) and unrealized discount on Government account series securities.

[8] The statutory debt limit is $5,950 billion.

[9] Treasury securities held by the public and zero-coupon bonds held by Government accounts are almost entirely measured at sales price plus amortized discount or less amortized premium. Agency debt is almost entirely measured at face value. Treasury securities in the Government account series are measured at face value less unrealized discount (if any).

[10] At the end of 2000, the Federal Reserve Banks held $511 billion of Federal securities and the rest of the public held $2,899 billion. Debt held by the Federal Reserve Banks is not estimated for future years.

Chairman CONRAD. And with that, again, we thank you very much for your appearance today.

Mr. DANIELS. Thank you.

[Whereupon, at 12:38 p.m., the committee was adjourned.]

THE ECONOMIC OUTLOOK

TUESDAY, OCTOBER 2, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:15 a.m., in room SD–562, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Clinton, Corzine, Domenici, and Grassley.

Staff present: Mary Ann Naylor, Majority Staff Director; and G. William Hoagland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. Why don't we come to order? First of all, I want to apologize to the witnesses. As is frequently the case here, we had a vote right at 10 a.m., so a number of our members are still at that vote and will be on their way here momentarily, but we are going to proceed, because I understand Mr. Hubbard has some time constraints. So we want to proceed as expeditiously as possible. I first want to thank all of the witnesses for coming. We certainly appreciate your being with us today, and this is a difficult time.

The horrific events of September 11th affected our Nation in many ways; obviously, one way is the economy, and this morning we are going to be having a hearing to discuss the effects on the economy, and also talk about what we do from here. Is additional stimulus required? If so, how much and of what type? We know the economy was already weak at the time of the attack. Growth in GDP had been slowing and was only .3 percent in the second quarter. The unemployment rate, which had been close to 4 percent for all of 2000, had increased to 4.5 percent in the spring and then to 4.9 percent in August.

I think we have charts that show these points. This shows what has happened to the growth in real GDP; obviously, very substantial declines. The unemployment rate had come down from 7.8 percent back in the early 1990's. We had seen a sharp decline, and now, in recent months, an uptick there. Standard government statistics on the state of the economy come with a lag, but there was plenty of other evidence that economic activity nearly ground to a halt after the attack. I was in New York yesterday and over the weekend, talking to business leaders there. I think all of us in our conversations with private sector leaders have heard the same thing; that there was a very steep reduction in business activity

after the attack, and while we see some coming back—very good news, we see more people on airplanes, we see people coming back into the malls and shops and back into the show rooms—nonetheless, we are not back to where we were before September 11th.[20]

I think we will also hear testimony that the key to achieving a rapid recovery is to bolster business and consumer confidence, but that confidence appears quite fragile now. A University of Michigan index of consumer sentiment for September was down sharply. You can see from this chart very steep declines. The level for the entire month did not drop as much as experts were expecting, but the reading for the last week of the survey was down very sharply, and that is shown by the dot on this chart, because that represents, not a monthly reading, but 1 week, and we saw a very steep decline in that week.

If consumers are worried about their jobs and their incomes, they will be reluctant to spend. If consumers cut back on their spending, businesses will face falling sales and will be reluctant to invest. We could face a downward spiral of economic activity. The traditional response in those circumstances is economic stimulus. The Federal Reserve has been providing monetary stimulus through the year with a succession of interest rate cuts. We are now seriously debating whether we should provide additional fiscal stimulus, as well.

My own judgment is that we will probably need additional fiscal stimulus. After the consultations I have made last week and over the weekend, and discussions among my colleagues, I think there is a growing consensus that we will need additional fiscal stimulus. We will know better as we receive additional input on what is happening with consumers. Chairman Greenspan and Secretary Rubin have alerted us that we should wait before we make any final decision, until we see this additional data. But I do not think we can wait too long, because if we are going to have an effect, we need to decide on the size of the stimulus package and the elements of the stimulus package.

Chairman Greenspan mentioned a figure of 1 percent of GDP, or $100 billion dollars. It was not entirely clear to me whether he included steps that have already been taken in that $100 billion; but in surveying economists, we have received estimates of anywhere from a $50 billion additional package to $150 billion, as necessary to really give a lift to the economy at this time. That is a broad range. I would be interested in the distinguished witnesses here this morning, what they sense, not only in terms of the current state of the economy, which is what we asked them to talk about here today, but also if additional stimulus is required, how much stimulus and in what form?

In thinking about the actions we are going to take, we need to keep our eye on two key priorities. First, we have to attend to the immediate needs of defending this Nation and promoting economic recovery. We are in a position to provide whatever resources are necessary to defend this Nation. No adversary should have any doubt that the leadership of this country is joined at the shoulder in a common commitment to do whatever is necessary to defend our country. I have never seen such strong bipartisanship in the

[20] CHART NOT AVAILABLE AT PRESS TIME.

entire 15 years I have been in the U.S. Senate. In public meetings and in private, the leadership has been absolutely joined in a commitment to work together and to take this to the next level, and to do it in a fully bipartisan way.

Let me just indicate that I believe, not only is it critically important that we add fiscal stimulus in the short-term, but that we also couple that with fiscal discipline for the long-term; that it is critically important that while we are adding fiscal stimulus, we also need to be very cognizant of the effect of that package over time. We should do nothing that reduces our revenue base in the future, because that will have a feedback effect on interest rates today. Secretary Rubin made very clear that if you are going to do fiscal stimulus, additional fiscal stimulus, it should be temporary in nature. It should not have permanent effects in terms of lowering the revenue base when we already face difficult challenges as a result of the weakening economy and the attack on September 11th.

His message is a message that I believe in and share; and that is we have got to be very careful that we do not take steps that have an adverse effect on interest rates now, and if we would take permanent steps, permanent spending as part of a stimulus package, or permanent tax cuts as part of a stimulus package, that could adversely affect interest rates now, put upward pressure on interest rates, and offset what we are doing in terms of fiscal stimulus by having a reverse effect on the monetary side of the equation.

So I was very pleased to see the President indicated this morning that same thing; the President, as I understand it, indicated he is nearing consensus with Congress on a stimulus plan that could boost the economy without doing long-term damage, and the long-term damage he was referencing was putting upward pressure on interest rates, really this same message that a number of us have been trying to deliver as we talk about the need for additional fiscal stimulus.

We are very fortunate to have with us this morning three distinguished witnesses to help us examine how to meet these obligations, to provide short-term stimulus while protecting long-term budget discipline. Dr. Glenn Hubbard, the Chairman of the Council of Economic Advisers; Dr. Martin Baily, who is Dr. Hubbard's immediate predecessor at the Council of Economic Advisers in the Clinton administration; and Dr. Alan Krueger who has served as Chief Economist at the Labor Department in the Clinton administration. In addition to their government service, I might note that each has a very impressive research record in the academic community.

I think it is interesting there seems to be very little disagreement among them about the current state of the economy and of the importance of restoring business and consumer confidence. But I expect we will have a lively debate about which policies are best for achieving that goal. Before we go to the witnesses, Senator Corzine, if you would have any opening statement you would care to make, please feel free to do so, and then we will go to the witnesses.

Senator CORZINE. I will be brief. I appreciate very much your holding this hearing, Mr. Chairman. I think it is at the heart of

certainly the second-most-important issue that we have on the country's agenda, and there is a real need, in my view, for us to act, I believe, on fiscal stimulus now and fiscal discipline later, and I am sure we will get into it, but am anxious to hear the thoughts of the distinguished panelists, and I appreciate them being here and look forward to the discussion and debate.

Chairman CONRAD. Well, thank you, and it is good to have you here. Let me just say I have been handed another news report. President Bush said Tuesday the United States needs an economic stimulus package large enough to get economic activity going after the attacks of September 11th, but not large enough to push up long-term interest rates. Again, I think we are seeing a consensus develop, that we need additional short-term stimulus, but we need to devise a package that does not adversely affect long-term interest rates, because that could completely offset on the monetary side what we are trying to do on the fiscal side. So the more reports we see, I think, it is very encouraging that we are very much on the same page in terms of how we need to proceed.

With that, Dr. Hubbard, thank you so much for being here, and please proceed with your testimony.

STATEMENT OF R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. HUBBARD. Thank you, Mr. Chairman, Senator Corzine. I am happy to be here today to talk with you today about the outlook for the economy and about some of the very important policy issues that you raised. It is certainly true, as Senator Corzine was alluding, as well, that the terrible tragedy that is associated with the terrorist attacks has exacted an economic toll, as well as the human toll. If I may just briefly comment on the outlook prior to September 11th, I think it was clear, as you indicated in your remarks, Mr. Chairman, that the U.S. was experiencing a growth slowdown.

I think the probability of an outright recession was low before September 11th, but the fact that the economy was growing much slower than its potential rate of growth dictated that the unemployment rate was likely to rise in the near-term, some of which we have already seen. Even prior to September 11th, growth rates this much below their potential levels could not and were not acceptable, so monetary and fiscal policy had already begun moving decisively to reverse the pre-September 11th recessionary pressures.

The economic consequences of the events of September 11th I think can be broken down into two parts; the first would be to consider the physical collapse of the World Trade Center and the surrounding buildings, and the attendant damage in human cost as an adverse supply shock to the economy; that is, a shock that reduces the economy's ability to provide goods and services. These supply shock consequences of the attacks no doubt will reduce the rate of growth of GDP during the third and fourth quarters of 2001, and I think it is fair to say increase significantly the likelihood that the economy is in a recession.

This first step, though, treats the attacks as if they were a contained physical event. As you indicated, Mr. Chairman, that while

it is horrible in human terms, is perhaps not the greatest economic consequence. The second and potentially more important economic event is because the acts arose as a result of terrorism, and the economic aftermath includes shocks to household and business confidence, as well as an increase in the uncertainty that surrounds the atmosphere in which all of us as individuals or as businesses must make decisions.

The effects on confidence and uncertainty give rise to a whole host of transactions cost increase in business that reduce output growth. On the demand side of the economy, the attacks and their repercussions lowered confidence about the future, and along with it the willingness of households and businesses to spend and invest. To be more precise about the outlook for consumer confidence, I would refer you to the consensus economic forecast of the private sector, as reflected in the September 20th special survey of the blue-chip economic indicators.

If one looks at the consensus first in those data, there is an indication of a modest recession fueled by a decline in confidence in equity values. The consensus is for a decline in real GDP of about .5 percent in the third quarter and .7 percent in the fourth quarter. That same consensus estimate predicts a growth rebound in 2002, with growth of 1.4 percent in the first quarter, 2.8 percent in the second quarter, and 3.7 percent for the remainder of the year. I should caution you that even with this recovery, the unemployment rate would likely rise throughout 2002.

What I would really like to focus attention on is not that consensus which has been portrayed repeatedly in the media, but the range of estimates that underlies the blue-chip forecast, and that range of estimates really is a range of views in the private sector about the effects of the terrorist attacks on confidence. I think that range suggests the need to think seriously about downside risks to the economy's outlook over the near-term, and, as you noted, Mr. Chairman, policies that would address the source of the economy's vulnerability.

It is nonetheless the case that there are public policies out there that will be buffering against the downward pressure on demand. On the monetary side, the Federal Reserve reduced the Fed's fund rate target on September 17th by 50 basis points. Interest rates were reduced in a coordinated step in Europe and Canada. From a fiscal perspective, as you know, the $40 billion general emergency appropriation and the aviation disaster relief bill will provide additional stimulus, not only later this year, but throughout 2002. Those steps already will be helping the economy's recovery.

With that as a quick precursor of where we are, what are the implications for public policy? I think the simple analysis of the short-term consequences that I just gave you suggests some lessons; one is that improvements in confidence themselves, should they be able to be obtained, are a potent stimulus. A rapid rebound of household and business sentiment will hasten the arrival and pace of the recovery, and a longer decline in confidence could lead to a significant period of retraction. So what should be the framework for policy evaluation if confidences is the emphasis?

First of all, it is important that policies be forward-looking. As terrible as the events were, we should not be trying to replicate the

world as it was of September 10th. Policies should provide consumers and businesses with the confidence that the policy infrastructure is in place to ensure the safe conduct of economic activity. As a very good example, I would point you to the response of both the administration and the Congress to the immediate problems in commercial aviation. I think it is clear that prudent investment in aviation security can and is helping to restore confidence in air travel, and a more secure infrastructure in aviation will support the numerous industries related to the travel and tourism sector.

On a broader scale, a policy focus on uncertainty, the so-called hardening of the American economy against terrorist intrusions, will be an important linchpin in the institutional setting for restore confidence. This kind of security is not merely physical, it is also economic. For example, we need to pay close attention to the need for financial insurance against increased risks and how to help private insurance markets work better; another aspect of policies to provide support for a transition to new features of the economic environment. Toward that end, it is no accident that the administration early on, along with the Fed and financial regulatory authorities, focused attention on the smooth functioning of securities markets and financial institutions.

As a caution, I will remind you of something you know well, which is it is important to distinguish between forward-looking policies that smooth the transition to where we must go, and investments that are backward-looking attempts to compensate industries and activities that may now grow more slowly and contract. A source of great benefits in our economy is market-driven restructuring and the reallocation of capital and workers and ideas. Bailouts that attempt to preserve a lost status quo are always tempting, but will interference with this valuable market function.

There are also important and controversial, to be frank with you, transition issues on the demand side. While I am not here today to advocate a specific economic recovery package on behalf of the administration, I think some general comments are possible following the President's remarks this morning. Businesses certainly face uncertainty along many dimensions, and among that uncertainty is the overall state of demand, suggesting helpful policy responses.

As I noted earlier, the key aspect of policies here is not really just dollars or the level of spending or a tax cut. For example, to some it might be appealing to follow a Japanese-style public works program of construction outlays. I think that is a mistake. It does not address the key issues of confidence and is likely to harm fiscal discipline. On the other hand, I think, as the President noted, prudent supplements to unemployment insurance and health insurance are stabilizing, and the administration looks forward to working with the Congress on activity for displaced workers.

Augmenting aggregate consumption demand through onetime transfers to households I would judge as being less likely to be successful. To draw the distinction more sharply, consider the recently enacted tax cut. Despite all the talk about the "rebates," the underpinnings are quite different from a one-time fiscal stimulus you might contemplate today. In the previous tax cut, Americans received checks that were a down payment on a large, permanent

tax cut. That tax cut is a model for further policies to address transitional shortfalls in consumption demand. For example, accelerating some or all of the tax law changes for individuals would be stimulative, as well as good tax policy and long-term budget responsible.

I think it is fair to say that similar considerations apply on the business side, as you indicated, Mr. Chairman. One policy in the corporate sector which would be a promising change in business taxation would be to lower the cost of capital for investment by shifting toward more expensing of fixed capital investment. Partial expensing, in which a proportion of investment would be expensed and the balanced depreciated, would stimulate fixed-capital investment and would be consistent with many economists' visions of fundamental tax reform.

Additionally, one could imagine cuts in the corporate income tax rate. Cuts in the corporate tax rate would raise corporate tax flow for investment, employment and restructuring. If enacted for a significant period of time, any such reduction would reduce the present double-taxation of equity, raise equity values, reducing the cost of capital for investment and raising household net worth.

To be effective, should you go this route, tax changes on the business side, where they are—on the expensing side or corporate rate cuts, should be accompanied by a reduction in and hopefully elimination of the alternative minimum tax on the corporate side. In the non-corporate sector, one could obtain similar benefits from accelerating reductions in the marginal tax rates already enacted.

Finally, I think it is important to come back to the discussion of the budget that you led off with, Mr. Chairman. Any discussion of confidence-building proposals is likely to and should stimulate a debate over fiscal responsibility. Proposals for action should be fiscally responsible, in that they should not lead to a deterioration in the Federal Government's long-term budget condition. Here, though, I want to sound two notes of caution; one, I think the distinction is not so much between whether a policy is temporary or permanent, but whether it has short-term or long-term effects on the budget. For example, proposals toward partial expensing or accelerating rate cuts have within them permanent flavors, but short-term budget impacts. That is a very important point.

Second, I think it is important to remind ourselves something we know, of course, that budget surpluses are the product of a strong underlying economy, not the other way around. Our ability to carry out all of the priorities of the Nation depends on economic growth. To summarize, on going forward, the events of September 11th certainly represent a human disaster. They also represent an economic loss to our Nation and to the world. Going forward, it is obvious that the potential for terrorism raises concerns about the economy's ability to produce goods and services and demand for those goods and services.

I would like to end, though, on an optimistic note, even with these terrible circumstances. The private economy of the United States is very resilient. With prudent investments in security, public policies to promote confidence, I have little reason and almost no reason, to be frank with you, to suspect that the economy's long-

term fundamentals have been shaken by the tragedy of September 11th.

Thank you again, Mr. Chairman, Senator Domenici, Senator Corzine, for the opportunity to appear before you today. I would be delighted to answer your questions.

[The prepared statement of Mr. Hubbard follows:]

Testimony
of
R. Glenn Hubbard
Chairman
Council of Economic Advisers
Before the
Committee on the Budget
United States Senate

October 2, 2001
10:00 A.M.

Mr. Chairman, Senator Domenici, and members of the Committee, it is a pleasure to appear before you today to discuss the outlook for the U.S. economy. The terrible tragedy associated with the terrorist attacks on New York and Washington exacted an economic toll on the United States as well as a human toll.

Growth in the U. S. Economy and the Outlook Prior to September 11

Prior to the tragedy on September 11, the United States was experiencing a growth slowdown: Real GDP growth slowed to only an average 1.2 percent annual pace during the past four quarters, with a low of 0.3 percent in the second quarter of 2001. While the probability of an outright recession was low, the fact that the economy was growing slower than its potential rate of growth dictated that the unemployment rate was likely to rise in the near term. Economic disruptions emanating from the bombings in New York and Washington certainly worsened the short-run growth prospects.

Even prior to September 11, growth rates this much below their potential levels were not acceptable. Accordingly, monetary and fiscal policy moved decisively to reverse pre-September 11 recessionary pressures. The Federal Reserve cut the target federal funds rate by 300 basis

points from the beginning of the year through September 11, and $41 billion was returned to taxpayers during the third quarter as a downpayment on a large permanent tax cut.

Looking outside the nation, the United States continues to have an interest in the resumption of economic growth in Japan and accelerated growth in Europe. During the first half of 2001, GDP declined in Japan, and the rate of decline accelerated. In Europe, the rate of GDP growth remains positive, but has decelerated. Moreover, European Commission surveys of the outlook for new manufacturing orders, industrial production, and consumer confidence indicate recent declines. From a direct U.S. perspective, more rapid growth in the major economies will raise our growth prospects as well. More broadly, it will enhance the likelihood of stability and progress in the rest of the world, such as developing Asia and Latin America. In the absence of resumption of global growth, trends in output and asset prices may force painful adjustments in these economies.

Economic Consequences of the Events of September 11

To analyze the effects of the terrorist attacks on the World Trade Center and the Pentagon, it is instructive to consider two steps. First, the collapse of the World Trade Center and surrounding buildings acted as an adverse supply shock to the economy—that is, an adverse effect on the economy's productive capacity. The physical damages from the attacks likely were not sufficiently consequential to affect the underlying potential growth rate of the economy. However, the loss of life, the damage to the financial sector, and the interruption of commercial aviation temporarily restricted the economy's ability to supply goods and services in the short run. These "supply shock" consequences of the attacks substantially reduce the growth rate of GDP during the third and fourth quarters of 2001, and increase significantly the likelihood that

the economy is in a recession. These consequences also imply a greater gap between the economy's actual and potential growth rate, with adverse consequences for employment.

This first step treats – for strictly analytic purposes – the attacks as a contained physical event. Of course, there is a second, and more important, effect. Because the destruction on September 11 arose as a result of terrorism, the economic aftermath includes shocks to household and business confidence, and increased uncertainty regarding the overall environment. The effects on confidence and uncertainty give rise to a number of additional supply-side costs of transacting business—ranging from enhanced security to more costly insurance—which reduce output growth.

On the demand side, the attacks and their potential repercussions lowered household and business confidence about the future, and along with it their willingness to spend and invest. Prior to the attacks, a focus of policy was to ensure a continued flow of resources – incomes, cash flow, and so forth – to households and businesses to provide a base for sustained growth in aggregate demand. If confidence effects are substantial, the attacks must necessarily shift our focus somewhat – away from simply providing dollars to households, for example, and toward buttressing the confidence of households to make purchases out of those dollars.

What is the outlook for consumer confidence? To gain a sense of the magnitudes involved, one can derive estimates of the expected decline in confidence by utilizing the changes to the Blue Chip consensus forecast due to the terrorist attacks. The implied drop in confidence appears substantial and likely incorporates effects of recent equity price declines. Using the most recent Blue Chip consensus forecast as a guide, the implied decline in confidence is expected to be temporary—following roughly the path of the confidence decline and recovery during the Gulf War—and is essentially eliminated by the second half of 2002. The Blue Chip

Consensus forecast is, of course, only an estimate. More shallow declines in confidence would permit a more rapid recovery. Larger and more sustained declines in confidence would suggest a longer downturn and slower recovery, particularly if accompanied by prolonged weakness in equity prices.

To be concrete, the consensus economic forecasts of private sector economists (as reflected in the September 20, 2001 special survey of the Blue Chip Economic Indicators) indicates a modest recession, again fueled by a decline in confidence and equity values. (While a recession is declared officially by the National Bureau of Economic Research, I use the term in its common association with two quarters of negative GDP growth.) The consensus estimate is for a decline in real GDP of 0.5 percent and 0.7 percent in the third and fourth quarters, respectively, of this year. Consensus estimates of GDP growth rebound in 2002, with growth of 1.4 percent and 2.8 percent, respectively, in the first two quarters of 2002, and 3.7 percent in the second half of 2002. Even with this recovery, the unemployment rate is likely to rise through 2002.

A range of estimates underlies the Blue Chip forecasts, and that range reflects a divergence of views about the depth of the initial decline in confidence and the persistence of that decline. For example, the range between the average of the top ten and bottom ten estimates is 0.4 percent to –1.5 percent for the third quarter of 2001, 1.5 percent to –2.4 percent for the fourth quarter of 2001, 3.3 percent to –0.8 percent for the first quarter of 2002, 4.0 percent to 1.0 percent in the second quarter of 2002, and 3.8 percent to 1.8 percent for growth during 2002 as a whole. This range suggests the need to think seriously about downside risks and policies that address the source of the economy's vulnerability in the quarters ahead.

Existing public policies also continue to buffer against the downward pressure on aggregate demand. On the monetary side, the Federal Reserve reduced its federal funds rate target on September 17 by 50 basis points, and interest rates were reduced in Europe and Canada. From a fiscal perspective, the $40 billion general emergency appropriation and the Aviation Disaster Relief bill will provide additional stimulus later this year and throughout 2002. These policy moves will mitigate somewhat the effects of the terrorist attack on output growth and unemployment, and should aid a recovery in 2002, though again downside risks remain.

Implications for Public Policy

This simple analysis of the short-term economic consequences of the events of September 11 suggests important lessons for public policy. Consumer and business confidence is a key factor in calibrating the depth of any downturn occurring as a result of the terrorist attacks and the pace of the subsequent recovery. Indeed, improvements in confidence are themselves a potent stimulus; a rapid rebound of household and business sentiment will hasten the arrival and pace of recovery in 2002. A longer decline in confidence could lead to a significant period of mediocre output growth and rising unemployment, as I noted earlier.

Hence one way to evaluate policy responses is by their effect on household or business confidence. What is the framework for policies?

First, the tragedy of September 11 is a seminal event and policies should be forward-looking, not attempting to simply replicate the world of September 10. Policies should provide consumers and businesses with confidence that the policy infrastructure is in place to ensure the conduct of economic activity in this new environment. As an example, consider the response of the Administration and the Congress to the immediate problems in commercial aviation.

The problem is not simply one of keeping commercial aircraft flying. Instead, a key feature of the policy response is the provision of funding for enhanced security, thereby addressing the root cause of the airline industry downturn – diminished confidence by travelers. This funding should address aircraft security, security personnel and screening of passengers and baggage. Prudent investment in aviation security can restore confidence in air travel, and a more secure infrastructure in aviation will also support the numerous industries related to the travel and tourism sectors of the economy.

On a broader scale, a policy focus on security – the hardening of American economic activity against terrorist intrusions – will be a linchpin in institutional setting for restored confidence. This kind of security is not merely physical, it has economic dimensions as well. For example, we must pay attention to the need for financial insurance against increased risks and ensure that private insurance markets are able to function as well in the future as they have served us in the past. These considerations require great deliberation—as I argue below, there are pitfalls in pursuing these policies, as an inappropriately heavy-handed approach may impede the private sector's inherent speed and flexibility in responding to new challenges.

Second, policies should minimize to the greatest extent possible the increased transactions costs induced by the terrorist attacks. Again, consider the recent disruption in commercial aviation, which contains elements of higher transactions costs for the airlines– greater security costs. However, it also contains higher transactions costs – greater cargo transport costs, loss of speed and flexibility in transport and business meetings, and so forth – for the business sector as a whole. A policy response that addresses the underlying need for security infrastructure in a cost-effective way will reduce overall transactions costs in supply, and minimize the loss in economic efficiency in adapting to this new environment.

Cost-effective responses are an important aspect of this adaptation. As an example, consider the need for increased security of economic activity, both physical security and the security of transactions – backup computer systems and the like. To the extent that our economic response results in duplicative security efforts by multiple parties, or excessive mandate of security policies, we will wastefully siphon funds that could be devoted to productivity enhancements and other investments into this effort.

The key to our recent economic success – and the foundation of economic performance in the future – is productivity growth. The historical lesson is that private markets are resilient, efficient, and flexible in meeting new challenges. We should seek as our objective new standards for the security of the economy, but should be wary of dictating *how* to achieve our objectives. One of the success stories of the past thirty years has been the productivity benefits of deregulation. We should be wary of losing these benefits via excessive new regulation.

The third aspect of policy is to provide support for the transition to new features of economic environment. Toward this end, it is no accident that the Administration, the Federal Reserve, and financial regulatory authorities focused attention in the aftermath of the tragedy on the smooth functioning of securities markets and financial institutions. More generally, my remarks above on transactions costs are part of a focus on reducing disruptions on the supply side. The President has displayed leadership in enhancing security and building the infrastructure for the supply of goods and services.

It is important to distinguish between forward-looking policies and investments that smooth the transition to a new environment and backward-looking attempts to compensate industries and activities that may grow more slowly or contract. A source of tremendous economic benefits is market-driven restructuring, and its associated reallocation of capital,

workers, and ideas to new uses. Bailouts that attempt the preserve a lost status quo can be tempting, but will interfere with this valuable market function.

However, there are transition issues on the demand side as well. While I am not advocating an Administration position on what should be in a specific economic stimulus package, some general comments on economic recovery are possible. Businesses face uncertainty along many dimensions, among them the overall state of aggregate demand, and policies may be helpful in this dimension as well. As I noted earlier, the key aspect of policies is not merely dollars. To some, it might be appealing to follow a Japanese-style public works program of construction outlays. However, this does not address the issue of confidence – it instead covers it in an unproductive and economically wasteful fashion. Prudent supplements to unemployment insurance and health insurance are stabilizing. However, augmenting aggregate consumption demand through one-time transfers to households is less likely to be successful. The evidence from a similar effort in the 1970s is that households largely save – not spend – such one-time transfers. In the current environment, the decline in confidence has the potential to produce even stronger precautionary instincts.

To draw the distinction more sharply, consider the recently enacted tax cut. Despite all the talk about "rebates," the underpinnings are quite different from one-time fiscal stimulus. Americans received checks that are a downpayment on a large, permanent tax cut. Put differently, these dollars are part of a larger policy that enhances the security of their long-term disposable incomes. By addressing both the flow of resources and their "security" this policy can support the growth of consumption demand. The tax cut is a model for any further policies to address transitional shortfalls in consumption demand. In this light, accelerating provisions of

the tax law changes for individuals enacted in June will be stimulative, as well as good tax policy.

Similar considerations apply on policies to bolster business investments in physical and human capital. To the greatest extent possible, such policies should be consistent with the support of long-term fundamentals. Also, in the corporate sector, a reduction in corporate income tax rates raises corporate cash flow for investments, employment, and restructuring; if enacted for a significant period of time, such tax reductions will also reduce the present double taxation of equity-financed investment and raise equity values, reducing the cost of capital for investment and raising household net worth. Corporate income tax rate reductions also raise after-tax profitability for a broad cross-section of companies, including both physical-capital-intensive and human-capital-intensive firms. To be effective, such a tax change should be accompanied by a reduction in the corporate Alternative Minimum Tax rate. In the noncorporate sector, similar benefits could be obtained by accelerating the reductions in marginal personal income tax rates recently enacted.

Also in the corporate, sector a promising change in business taxation would be to lower the cost of capital for investment by shifting toward expensing of fixed investment. Partial expensing—in which a proportion of investment is expensed and the balance depreciated—would stimulate fixed capital investment and would be consistent with many economists' vision of fundamental tax reform. Sound tax policy requires that such expensing be permanent; a permanent change would not generate large long-run budget costs, as expensing is a form of accelerated depreciation.

Finally, any discussion of confidence-building proposals is likely to stimulate debates over fiscal responsibility. Proposals for action should be fiscally responsible, in that they should

not lead to a deterioration in the federal government's long-term budget position. It is important, however, to remind ourselves that budget surpluses are the product of a strong underlying economy—not the other way around. Particularly in the current context, policies to bolster confidence and asset values may mitigate declines in economic activity, and corresponding declines in revenue, in the future.

Going Forward

The events of September 11 represent a human disaster and an economic loss to our nation and the world. Going forward, the potential for terrorism raises concerns about the ability of the economy to produce goods and services and household and business demand for goods and services. It is appropriate to view the terrorist attacks as an important historical demarcation, and I have stressed the role that appropriate policies can contribute to addressing the need for security and confidence, the reality of new transactions costs, and the strains of transitions.

However, it would be an oversight to fail to point out that another part of confidence in the transition is not losing sight of those things that remain unchanged. Even in this new environment, an open global trading regime and a more efficient tax system remain a route to increases in our standard of living. The United States would gain substantially from further reductions in world barriers to trade in agricultural and industrial products and services. To take another example, significant economic gains for the United States remain possible from fundamental tax reform—in particular, from reducing the multiple layers of taxation on productive capital and the complexity associated with those layers of taxation.

To conclude, the U. S. economy is very resilient, and, with prudent investments in security and public policies to promote confidence, I have little reason to suspect that the economy's long-term fundamentals have been shaken by the tragedy of September 11.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.

Chairman CONRAD. The ranking member has joined us.

Dr. Hubbard, how long do you have?

Mr. HUBBARD. I need to be out in about 20 minutes, if it is——

Chairman CONRAD. Well, why don't we do this, then, and I would apologize to the other witnesses, because normally we would go ahead with the full panel, but Senator Domenici has opening remarks that he might like to make. We do that at this point, and then go back to you for questions, and then proceed with the rest of the panel.

Senator DOMENICI. Thank you, Mr. Chairman, and thank you, Senator Corzine, for not objecting to that arrangement.

First, thank you, all three of you, and good morning. We really appreciate your effort to come out here and help us today. I would like to welcome our witnesses, especially you, Dr. Hubbard, for agreeing to testify. You bring with you a knowledge about what is going on in the White House. Whether you are going to be talking about that or not, I am certainly not going to ask you.

First, I would like to make a few points about the economy. Given the current economic situation, from my perspective, our decision to cut taxes, at least in the first 2 years, 2001 and 2002, that decision looks more prudent every day. Some ask today, "It didn't look like the stimulus fixed the economy." But it looks to me that the answer to that observation would be it would probably be worse if we had not put that amount of money into the hands of the taxpayers, most of which is spent as consumers.

Cutting taxes was the right thing to do and at the right time. There is room for taking up the out-year taxes at a later date. Some do not think they fit in with the problems we have. But, for now, I am very pleased that we are proceeding to talk about stimulus, both on the spending and tax side. The July to September quarter looked to be in a recession mode before the terrorist attacks. I will ask you that question, what you think about that, Mr. Hubbard, a mild recession, but a recession nonetheless.

Nobody doubts that the events of September 11th are going to deepen and lengthen the recession, which 82 percent of the blue-chip economists think we are in today. We lost a great deal of human talent, fiscal capital, on that ominous day. The attacks also caused widespread disruptions in the production processes, trade at the borders of America almost halted for a solid week, unheard of, unexpected. For the time being, the attacks have rattled the consumer.

Consumer confidence was already coming down, starting back 15 months ago, as this recession crept slowly upon us. And now, with the September 11th event, it looks like we have to look at every action we take, as does our President, to build back confidence among the consumers, and certainly on a micro basis, confidence in the commercial airlines of this country.

Mr. Chairman, I flew over the weekend twice. I assume you did, on commercial airlines. Did you fly a commercial airline?

Chairman CONRAD. [Nodding head up and down.]

Senator DOMENICI. I noticed that by Saturday and Sunday, there were pretty good crowds on the airplanes. I was on two that were full, which was not going to be my—was not my expectation when I arrived. So, for the time being, we clearly have to work on the

confidence of the American people with legislation that would convince them and convince us that the airlines are safer than they were before, and we are doing everything we can, even if there is some cause for people to be inconvenienced.

So clearly to me, the two top priorities must be to protect the American people from further attacks and to get the economy going. It is not as easy to get the economy going when the people of the country are suffering from the trauma of a terrorist attack like this, a war. That makes the job of suggesting them—to the American people—that we can do better and they can do better, that they ought to be good consumers—it makes it more difficult. Nonetheless, I think we are on that path.

I think this committee wants to be helpful, and I am sure the President does. The downturn is deeper and probably longer than we knew back then. We need to move forward to continue to address the economic slowdown with temporary tax cuts and spending increases. Automatic stabilizers like unemployment insurance, at least for those who were involved in this disaster, should kick in at some level that we can afford, but it ought to be done.

The war against terrorism is going to take a lot of Federal resources. So that is another one we are going to have to scrutinize what the administration asks for, but be ready and willing to use money in that regard.

Mr. Chairman, I want to just lay before the Senate where we think the current surplus is. I think it is going to be agreed upon by the people that are going to work on policy, both at OMB and here. This is a small chart, but the most important number is 52, this little green box, 52. Whatever the surplus was prior to September 11th, and we think it was in excess of $176 billion, we now have only $52 billion of that left. That is taking into account the spending bills and how much we will spend in the spending bills, the tax cuts, and, obviously, the huge amount of money that we are losing, to the Treasury, because of the reduction in growth, which is the biggest item here.

Economic and technical changes, about which we had no control, but had to do with recession, is an $80 billion reduction in the available resources. So what do we look at? This was not worked out by me or by us. It was worked out together with the Chairman's staff and I believe the staff of OMB. Is that correct, Mr. Chairman?

Chairman CONRAD. And the staff of the House.

Senator DOMENICI. And the staff of the House, Democrats and Republicans. This is what they all say the $52 billion is what is left, and I will want to find out from each one of you is the recession serious enough and can we do enough about it by cutting taxes and targeted spending, that we should go into deficit spending, or should we limit ourselves to the $52 billion that is available?

Thank you, Mr. Chairman. I appreciate your kindness, letting me talk later in the hearing.

Chairman CONRAD. It is always good to have you here, and we are pleased to have a chance to hear your opening remarks before we go back to the witnesses. I would just confirm what the Senator has said. We established a working group of the Chairman and ranking members of the Senate and House Budget Committees,

working with the Office of Management and Budget, and together we concluded that in 2002, that there would be $52 billion on a unified basis left. That is down sharply from what the estimates were in August, down much more sharply from where they were in January. Then it was over $533 billion. Now it is down to $50 billion, and that is before any additional stimulus package; that is before any additional defense request from the President, which we have heard may be forthcoming, as well.

So that does represent a sharp reduction. It indicates we will be using all of the Medicare Trust Fund surplus for other government programs. It indicates we will be using a significant majority of the Social Security payroll taxes to fund other government operations, something many of us feel strongly we should not do; but we recognize our country has been subjected to a sneak attack. On top of that, we have had a substantial economic blow, and in that context I think we are united that the top priority has to be to defend this Nation and to rebuild, and to strengthen the economy. Those are the things we must do, and we must do them together.

I have been very pleased at the way the working group has proceeded, with Senator Domenici and his able staff, and the staffs of the House leadership, both the chairman of the House Budget Committee and the ranking member there and their staffs, as well as the Office of Management and Budget, and we will continue to do that.

I would ask you, Dr. Hubbard, do you believe additional fiscal stimulus is necessary? And, if so, what would be a range of the amount of fiscal stimulus that might be needed?

Mr. HUBBARD. Well, I think, Mr. Chairman, to answer your question, we first have to step back and ask fiscal stimulus for what? I think, as you and Senator Domenici both indicated, the decline in confidence is what we need to be guarding against. The very slow rate of growth we will be experiencing in the third and fourth quarters is not something one can do much about with current policy. The question is stopping the decline in confidence going forward. With that in mind, I think certainly the consideration of a stimulus package is a good idea. The administration wants to work with the Congress, as the President already did this morning with the leaders in that discussion.

I think it is not size, per se, that matters, but what is in it. The size, of course, will be important, but I think that you should start your discussions by thinking of what you want to accomplish and which policies, and then tailor the size to fit the desired amount for overall long-term budget purposes.

Chairman CONRAD. Let me just followup and say this to you; that as you went through things that you thought might be useful, there are things there I strongly agree, some I strongly disagree with. Let me just go to the two on the business side. I personally strongly believe expensing ought to be a part of this, and it is maybe one place where we can have a pretty good bipartisan agreement as you say. I do not agree with permanent corporate income tax rate cuts. No. 1, in the meetings that we have had with Secretary Rubin and Chairman Greenspan on the Finance Committee, they both dismissed that approach as not having much fiscal stimulus in the short-term, and that it would hurt us on the long-term

side of the equation by reducing the revenue base, when we already have a problem, and, as Secretary Rubin so clearly said, putting upward pressure on interest rates.

A number of us have said we could be in a situation where we have one foot on the fiscal accelerator, and on the other hand, one foot on the monetary brake. It is critically important that we coordinate the policy here, so that we are giving not only fiscal lift to the economy, but monetary lift, as well, so that we are putting more money into people's and companies' pockets that will be spent, and, on the other hand, making certain that we do not put additional pressure on interest rates.

Secretary Rubin had an op-ed, I noticed, in The New York Times over the weekend making this case. So I was encouraged by what the President said this morning; the President saying fiscal stimulus enough to give lift to the economy now, but not do it in a way that has an adverse effect on interest rates. So I did want to express that, and you are welcome to respond in any way you would like. As I indicate, expensing, to me, and by the way, both Chairman Greenspan and Secretary Rubin, in the closed meeting with members of the Finance Committee, both of them listed expensing as one of their top choices. Any comment that you would want to make on that?

Mr. HUBBARD. Well, on those two business provisions, Mr. Chairman, I agree with you, of course, the partial expensing—move toward expensing is good tax policy. I would caution you, in your deliberations, to remember that it is good tax policy if it is permanent. I think it is not a good precedent to suggest that we can fine-tune the economy through temporary investment incentives that create uncertainty in the business community.

Having said that, expensing has an advantage to which you referred quite well, which is it is almost self-undoing. It is moving forward depreciation allowances and its long-term budget costs are much smaller than its short-term cost. On the corporate rate cuts, we probably will have to agree to disagree. I think on pure policy grounds, a corporate rate cut is reflationary. It would reflate asset values and provide the greatest incentive across all businesses. It is important to remember many businesses are not as fixed-capital intensive as they once were.

As to the out-year costs of a corporate rate cut, it would depend on the kind of corporate rate cut that one is looking at, but it is certainly possible to structure corporate rate cuts that have very modest outyear costs. The evidence with which I am familiar with, at least, from the Federal Reserve on effects on long-term interest rates of fiscal policy, would suggest only a handful of basis points' interest rate response to any of the kinds of policies that have been talked about in the past few weeks. But I certainly agree with you on your concern for and admiration of an expensing proposal.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Why don't yield to Senator Corzine?

Chairman CONRAD. Senator Corzine.

Senator CORZINE. I was taken with the comment you had on page 3 of your comments, where you talked about reduced output growth that follows from the events of September 11th, which I think is pretty true, but you related it to enhanced security and

more costly insurance. I am concerned that these things may undermine long-run productivity growth. These do not really address some of these costs that will be the ripple effects—do not really deal with output. They deal with productivity, because they are expenses that do not lead to greater growth.

Are you concerned that some of our long-run projections with regard to productivity growth in the economy are permanently changed with respect to the events of September 11th?

Mr. HUBBARD. Well, with respect, Senator, to the examples you gave, on the issuance front, I think there are ways to work with the insurance industry, as we are already doing in the administration, to work on transactions cost and making sure that insurance and reinsurance markets function well. As to your very important question about the effects of security expenses on productivity, if one were to have to spend $100 billion a year on security forever, one might expect a productivity growth decline on the order of a tenth of perhaps .15 percent. That is substantial. I do not think that is what we are looking at in terms of enhanced security expenditures over the long-term.

Internally, in the administration, our long-term productivity growth rate assumptions have always been modest by the standards of many in the private sector and the Fed. So it would not affect our assumptions underlying the budget.

Senator CORZINE. I raise this question, because I think this has a lot to do with those long-term interest rate intuitions or expectations that are built into the shape of a yield curve, which actually has not—at least long-term rates have not basically changed since an early move at the first of this year. They have stayed fairly stable, at least as reflected in U.S. Treasury rates, and lead me to wonder whether the marketplace, at least as reflected in long-term rates, which people are tending to be concerned about, are not reflecting overall fiscal structures that we put in place, and particularly as we look to the outyears, the second decade after the implementation of our tax cut.

Do you have any reason to think that there is a possibility that we ought to be reviewing some elements of the previous tax package?

Mr. HUBBARD. Generally speaking, no. The one suggestion I would suggest, by way of stimulus, would be accelerating rate cuts in the tax package. But if your question is as to the outyear costs, no, Senator, I do not. Nothing in the events would suggest to me that there is a serious decline in the economy's potential growth rate, which is really the heart of your question.

Senator CORZINE. Do you believe that an inheritance tax cut, as we have built into this program, is stimulative to the economy?

Mr. HUBBARD. Well, are you referring to the timing of the estate tax or just the enactment as currently in law?

Senator CORZINE. We currently have it, and we could obviously review the timing.

Mr. HUBBARD. Well, the estate tax is a capital tax. Let's be honest. It is a pernicious form of capital tax on top of other layers of capital taxation, and there would be very few economists who would come before you and suggest that it is great capital tax policy, even if you wanted to have a capital tax. As to whether you

want to accelerate the estate tax into the current environment, I do not think that is as apt as accelerating the rate cuts or the business provisions that the Chairman alluded to.

Senator CORZINE. OK. I think that is good, Mr. Chairman.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Dr. Hubbard, I have been thinking about Japan. They have been in a—while they are a big, powerful economy, second-largest in the world, they have been 10 years, more or less, in a recession. They have tried to get out of it. While I do not know the details, I know something about it. They have spent a lot of money. They started their biggest public works projects. They have spent so much money that they have a huge deficit now that they never assumed would occur, and the economy has never come out of the ditch.

What did they do wrong, and what did we learn from that, that should indicate where we should go? I will just add to that, in your discussion, is it better to have a larger stimulus, rather than a small one? If we do not know which one is going to work, isn't it better to go ahead and have a large economy if it does not harm the economy in the outyears?

Mr. HUBBARD. Well, to take your two questions in order, taking the Japan question first, there have been many policy problems in Japan. But I think the one you are referring to is the over-reliance on public works spending. Just as when each of us as a household makes investment decisions or a business makes an investment decision, it matters what you are going to do with the money, and in the case of Japan there was considerable wasteful public works spending, instead of reducing regulation and reducing taxes. I think that is a lesson that is widely appreciated now by the new Japanese government, and I think one lesson for us is not to undertake massive spending programs for their own sake. We should make sure we are very careful of what we do with the money.

As to the question of a larger or smaller stimulus package, I think, again, what is centrally important is long-term budget discipline be maintained. I think a stimulus package should be reasonable in the short-term, subject to agreement with the Congress and the President. But I think first and foremost the elements of that package need to be discussed before any specific numbers.

Senator DOMENICI. Take it as true that we now figure we have $52 billion left of the surplus, instead of the $176 billion just before the terrorist attack. Not all of that change is due to the attack. It is just that the chickens came home, and we started having to put the reality into budgets, of what was occurring in the economy. So you know what the economy looks like, you know what the surplus looks like. Should the surplus be a limitation on what we do to stimulate if, in fact, it is found that we need to stimulate and we need to do more, rather than less?

I will say, so you will not think I am trying to pull you in, I, frankly, am willing and have said and have told our chairman that I do not think the 52 should be the end-all package, because there is a bigger issue than going and spending this and going in the red, and that issue is we need to get the economy going again or we lose more money each year, and we would not even have 52 to spend.

Mr. HUBBARD. Let me start with where you just ended. Again, the surplus position we have on any year's basis or going forward is a reflection of the health of the economy, and I think it is fair to say that we should be concerned about the long-term economy and about the long-term fiscal position, just as in a household we are more concerned with our long-term positions than with our year-to-year positions, so I think we should guide ourselves here.

As to specific numbers, I think it really depends on a package that Congress and the President work toward. I think a specific number is at the moment a secondary step to figuring out what is best.

Senator DOMENICI. Likewise, we have the issue of defense spending. I think it probably fits in the same category. If we think it is a higher priority than paying down the debt or accumulating surplus for a given period of time, then we do that on the basis of that being a higher priority for America now and in the future. Is that correct?

Mr. HUBBARD. That is certainly true.

Senator DOMENICI. My last question has to do with the state of the economy now. Where do you think we are in terms of growth now? We are all waiting around for another quarter to turn out, but are we in recession, if recession is defined as two quarters of negative growth?

Mr. HUBBARD. Well, I think it is too soon to tell. I think the probability of two quarters of negative growth is high, and I think the third quarter is likely to be particularly adversely affected, and likely the fourth. I think the bigger question to which all of you alluded in your remarks or questions is what about next year or the path out? In terms of thinking about public policy, the third quarter or the fourth quarter is less influenceable by decisions we make than next year. So I think the short-term outlook is not good.

But I think I would share the view of most in the private sector, that with prudent decisions in the Congress and the administration, there is every reason to believe that a recovery would commence during 2002.

Senator DOMENICI. You have given kind of how you would encapsulate and define what would be a good stimulus. I am just going to quickly tick these off, and you say good or bad: Income tax rebates?

Mr. HUBBARD. Well, it would depend on the structure, but in general onetime tax changes are particularly effective. That is as short an answer as an economist can give you.

Senator DOMENICI. All right. Payroll tax rebate?

Mr. HUBBARD. Again, it is the rebate issue, something that is onetime is less likely to be effective.

Senator DOMENICI. Well, I am just going to give you the 10 that have been bantered around. We will put them in the record.

Senator DOMENICI. I think they are the same ones that our Chairman and his staff would put down. They are just the result of what people have talked about, and I would ask you at your convenience to answer—your convenience should, in this case, be very quick. [Laughter.]

Mr. HUBBARD. OK.

Senator DOMENICI. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, and let me just—I know that you have to go.

Mr. HUBBARD. I apologize, Mr. Chairman.

Chairman CONRAD. I understand, and we are sort of at the outer limits of your time constraint. Let me just leave you with one thought, because I think it is very important as we communicate—and I have said this to the Director of OMB and I have said it to the Treasury representative that was at the meeting of the budgeteers, and the meeting of the chairmen of the Fiance and Ways and Means Committee, and ranking numbers; as we look at the possible long-term budget outlook, looking not only at 2002 and beyond, what we see now is a sea of red ink at the bottom; that is, what we see is hundreds of billions of dollars of payroll taxes being used to pay for other government operations—I mean, hundreds of billions of dollars.

So I just say to you, I am going to resist permanent tax reductions as part of a stimulus package. I am also going to resist permanent spending increases for the very same reason, that I think we have already got very serious long-term fiscal problems. I think we had them before. I think they have become more severe as a result of the attack and the economic weakening. So as we calculate what can be done to give fiscal stimulus in the short-term, I think it is critically important we keep in mind this long-term circumstance, and that is why Secretary Rubin and others have warned us about not doing things that have permanent effect, in terms of reducing the revenue base, or permanent spending, because those things will dig the hole deeper and put upward pressure on interest rates.

Mr. HUBBARD. If I could just——

Chairman CONRAD. Yes, absolutely.

Mr. HUBBARD. First, to 42-year-old eyes, all I could make out was the red and the black, so I will not stipulate——

Chairman CONRAD. You can see there is a lot of red there.

Mr. HUBBARD. But to your question about temporary and permanent, again, I think the focus that you ought to have is permanent and temporary effects on the budget, as opposed to whether a policy is temporary or permanent, and I think that is what you meant, and I would certainly agree.

Chairman CONRAD. Very well. We are going to excuse Dr. Hubbard. Thank you for being here. We appreciate your testimony. We are going to go to our other two witnesses now and ask them to proceed, and we will handle both their testimony and then go to questions, if we could. Welcome. It is very good to have you here, Dr. Baily. We appreciate so much your willingness to come and testify once again before the committee.

STATEMENT OF MARTIN NEIL BAILY, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BAILY. Thank you, Mr. Chairman, Senator Domenici, Senator Corzine. It is a pleasure to be here. I do have a written statement that I would ask be entered into the record. I am, unfortunately, sort of trying to stave off a cold here. So if I lose my voice once or twice—I feel fine, but I apologize if I am a little hard to

follow. A lot of the things, I think, in my testimony, a lot of the things that I was planning to say have already been said here. You said many of them, and also Glenn Hubbard and the other Senators made some of the same comments. So I am not going to necessarily go over that same ground again. Let me try to be brief.

I think we all agree that the economy was weak to start with, and this looks as if it has pushed us on the edge of a recession. I think two quarters of negative GDP are quite likely. We may escape in the third quarter. I say in my testimony the consensus, and I was looking at the survey that was done in the Wall Street Journal, but it was almost the same as the blue-chip one that Glenn Hubbard was talking about, was for negative .6 in the third quarter and the fourth quarter. We may escape that negative number in the third quarter. The consumption number that just came in was positive for August, but it is going to be very small, even if it is not negative, and I think the chances are very high that we will get a negative number in the fourth quarter.

The reasons have been given. I think businesses are being very cautious in their spending. I think consumers are very naturally sort of saying maybe it is time to take a moment before we make a major expense. I would urge you not to put too much weight on the Consumer Confidence Index. I say that not because I think it is not important, but some of the empirical evidence suggests that it is not quite as important perhaps as the weight that has been given to it right now. But that said, I still agree with the general thrust of what has been said here, that we have a weak economy, we have a lot of layoffs that have been announced.

The second comment, and again this is sort of agreeing with things that have been said, is we have already done quite a bit to try to reverse that; the spending package which has been passed; the actions of the Federal Reserve. I want to applaud the fact that this has been sort of a worldwide response. We often talk here in the United States about U.S. policy as if it affected the rest of the world, but that somehow we are immune from impacts from the rest of the world, and that is not true. The weakness in Japan, the weakness in Europe, does affect us. So I thought it was an excellent move that the European Central Bank cut its own interest rates a little bit.

I think the U.S. has been the locomotive of growth for the world for a long time, and it is up to Europe to sort of step up to the plate and try to do a bit more. I might hope that Europeans might do more than they are doing to help the world economy get going, but I mention that in part because we do not always get sort of coordinated downturns around the world. Sometimes one country goes up, one other country goes down.

At the moment, we seem to be in a situation with somewhat of a coordinated downturn, and I think that should lead us to be more forceful in making sure that we have policies in place to push the U.S. economy forward. Now, what are some of the forces that will give rise to growth? I think there is a natural pattern to business cycles. They do not just depend on what policy we do. As the economy goes down, we get an overhang of too much investment, too many inventories, and some of that adjustment has already taken place.

There are some forces in place that will help us to come out of the recession, even just with the policies that have already been passed, the $40 billion of additional Federal spending, of which about half should come in this current fiscal year; the money that has been given to the airlines and what the Federal Reserve has done. Now, is there a downside risk? In other words, might it be the case that even if we get a nasty fourth quarter, which we might, with a substantial decline in GDP, is there some risk we will not bounce back next year?

Yes, I think there is some substantial risk of that, and in my written testimony I talk about the stock market as a potential source of that weakness, as it does have an impact on both consumer confidence and on spending. And you can kind of—trying to call which way the market is going to go is not something I want to do, but certainly there is a possibility that the market will be weak going forward, and that will help sort of drag us down into a weakened economy.

There are other possible ways in which the economy could be weak. If we did get an increase in oil prices, which we have not had so far, that is another thing to be concerned about, that might give us a weaker economy. So, given these downside risks, what should we do? Well, clearly monetary policy is on the job, and the Fed is going to announce today what it is going to do. Most people expect it to have some additional cut in interest rates, but certainly the Federal Reserve has acted very aggressively to lower rates and also to provide liquidity to the banking system, and I think that has been a major positive, in terms of getting us out of this economic slowdown.

I have somewhat mixed feelings about both how much of a fiscal stimulus should be given or even if we should sort of give one right now. I think, on the one hand, we sort of maybe need an insurance policy. We do not want to go downhill. On the other hand, I am concerned, as Senator Conrad has described, at some of the red ink we look like we may get going out into the future, and I do not want to exacerbate that problem. I am a believer in fiscal discipline. I think it stood us in very good stead in the 1990's and contributed to the very strong economic performance, the low interest rates, the high investment that we had, and I would hate to see us undermine that long-run fiscal discipline in anything we do now.

So that also colors my thoughts about what we should sort of have either ready to go or at least in our back pockets as a fiscal stimulus. First, on the size, well, when Alan Greenspan and Bob Rubin say a total package of around $100 billion, I listen to what they say. I think that would translate into an additional about $50 billion. Perhaps we should have ready a little bit more than that, somewhere in the $50 billion to $100 billion. If we want to do something now, then maybe $50 billion now and have something ready to go if things really turn out to be as nasty as we fear, but hope is not going to happen.

So what should be in that package? I do favor temporary tax cuts. Now, I understand some of the difficulties of temporary tax cuts. If you do something temporary on the household side, the concern would be is if it is not permanent, then people are going to save a bigger fraction of it, and that is a perfectly valid argument

and I understand why people say, "OK, we need something permanent." But it is not, in the end, a decisive argument because people do not save all of a temporary tax rebate. A lot of people in our society live pretty much from week to week and month to month, and if you put a little cash in their pockets they are going to spend it, and I think they have spent. I think you saw in the consumption numbers for August—you actually saw the effect of the tax rebates in boosting consumption a little bit.

So I think if we did another personal tax rebate, that I would run off a payroll tax to make sure that people who are not paying Federal income tax would get something, so geared to people who pay payroll taxes. I would favor a tax cut given out to households, a temporary tax cut given out to households. Now, there is a proposal that has been put forward by Alan Blinder, which was to give a temporary sales tax rebate, and that is an example, and I will mention another one in a minute, where a temporary tax cut could actually be even more effective than a permanent one, because you say, "OK, if you buy now, we are going to give you a break on the sales tax; but if you buy later, then you do not get that break." So it is an incentive that potentially could be greater in the short run than in the long run.

Now, I am a little bit concerned about logistics in Alan Blinder's proposal. There are a few States that do not have sales taxes, and you would have to do something for them, but I think it is something worth thinking about, whether a temporary sales tax would be feasible or just too difficult to administer. I am afraid I do not know whether it is really feasible or not. I certainly think it is something worth looking at.

So, in summary, though, a temporary tax cut that helps households, either a sales tax cut or putting cash in people's hands, I think should be part of the fiscal stimulus package. The second thing that I think should be part of the fiscal stimulus package is something on the business side to stimulate investment, and I think you could either have a temporary investment tax credit or a provision to expense equipment, and that was mentioned and discussed earlier. Again, I do not feel strongly which one you might choose. I think either could be structured to give an encouragement to business investment.

But, again, this is a situation which is perhaps counter to conventional wisdom on the tax side. But if you have a temporary tax break, you actually encourage people to make the spending now. You say, "If, over the next year or over the next year-and-a-half, or however long you want to make it, you make some business investment, we are going to give you a tax break on the business investment you make now." Glenn Hubbard said, "Well, we do not want to do that, because that is fine-tuning the economy." Well, I do not know about fine-tuning the economy. I think we do want to tune the economy. We are potentially going into recession, and that is exactly what we want to do. We want to find a tax break that is going to work right now and help encourage spending right now.

So there are situations where fine-tuning can be a dangerous thing to do, but I do not think this is one of them. I think if we want to do something to help the economy, now is the time to do it. The chances are the U.S. economy is going to be much stronger

a year or so from now than it is right now. So I am not worried about the fine-tuning argument. So, again, my first two choices are a tax break for households and then some kind of tax break for business investment. I think there are other things that I would like to see as policies, that if you could get agreement to them and work out a bipartisan arrangement, I think would be good to see.

One is to try to do something to shore up the safety net, the social safety net that we have, which I think has got some holes in it at the moment. And Alan Krueger is an expert on a lot of those things, and I am going to let him take the lead on some of those, which I know he is going to talk about. But let me just say I would endorse efforts to sort of shore up the unemployment insurance system. There are a lot of people who do not get benefits, and I think, like Alan, I would like to see increased eligibility before I would like to see extended benefits, because I think the problem at the moment is not enough people are getting the benefits, and we want to get more benefits out to people who are not getting them.

The other area of the social safety net which is clearly a problem is health insurance, and if workers are going to lose their jobs, I think we should take a look at whether the existing COBRA provisions or Medicaid provisions are adequate, and I do not think they are. We have 40 million people without health insurance, which surely, if we are worried about consumer confidence, losing health insurance is certainly not something that is going to add to your confidence.

So, again, these may be things that are difficult to do in a bipartisan and short-term package, but if we could, I would love to see us do something on the safety net side. And then the next thing on the safety net side, and this is a proposal that has been out there for awhile. I am not going to talk about it at length, but again I would urge people to take a look at it, and that is a wage insurance policy, and that has been proposed recently by Lori Kletzer and Bob Litan; Lori Kletzer, who is at the institute where I work, and Bob Litan, who is at Brookings, and it is a thing that says that workers who lose their jobs and then take another job may find that they have lost some wages. And a wage insurance plan says the Federal Government steps in and pays a proportion of the difference, and the advantage of that program is that it actually encourages workers who get laid off to take new jobs.

So it is a proposal unlike sort of the social safety net, which can—I would not say it always does—but can have the problem of encouraging people to remain unemployed. But if you have a proposal with wage insurance, it actually goes in the opposite direction. It says if you get another job, we are going to actually help you with that one. I am not going to have time to spell out any details, and it is available in a detailed proposal that they have made, but I think again it is worth looking at.

Let me quickly say, if I have got any time left, things that I do not think would be my choices to stimulate the economy. First, I do not think a capital gains tax cut would stimulate the economy. It is a proposal actually that could backfire on you, because it could encourage people who have capital gains to sell their assets, and that is not something we particularly want to do right now when the market is already weak. I do not think there is much evidence

in the econometric literature, and I cite in my testimony some people who looked at this. I do not think it would do a lot to stimulate investment, certainly in the short-run.

The second proposal that I do not think would be terribly helpful would be a cut in the corporate income tax rate. Again, while I do not say do nothing, but it is very expensive in terms of bang for the buck, that you would lose a lot of revenue and you might lose it for a long time if you cut your corporate tax in terms of what you get in extra stimulus. And then that take me to the final point, and I testified here before your committee not long ago, Senator, and I was struck by the fact that my testimony was slightly redundant, since you said a lot of the things already that I was going to say. But let me just reinforce what you said earlier and what was said by other members earlier about the need to maintain fiscal discipline.

There is a sign, and I have it in the testimony, that 30-year rates went up a bit after the attack, and I think that was an indication that markets were concerned about whether fiscal discipline was going to be seen. Now rates have subsequently come back down and the 10-year does not look as much, but let me stress here that when you see interest rates, you are kind of seeing a horse race between a slowing economy, which is bringing rates down on the one hand, and then concern about the deficit, which is pushing rates up.

And so we cannot always tell necessarily by looking at what has happened to rates exactly what the effects will be. I think there is no question that if we undermine fiscal discipline, if we get the sea of red ink that you described there, that you held up, and my 56-year-old eyes were certainly able to see the red ink there, that you had up there, that that is going to have an effect on long-term interest rates and is going to undermine a little bit what the Fed is doing in terms of stimulating the economy.

So let's not lose sight—as you have said—let's not lose sight of the long-term fiscal discipline and the need to make sure that anything we do now, and we certainly should contemplate a fiscal stimulus package, but let's make sure that we do not undermine long-term fiscal discipline. And I would revisit the long-term tax cuts that we passed. I am not sure we can afford the same level of tax cuts as we passed earlier, because things have changed.

The economic outlook, which we know was uncertain, has turned out to be not as favorable. Hopefully, the long-run will come back strong, in which case we can go back and pass some of those tax cuts again, but we do not know that is going to happen, and I am concerned that we are overestimating what growth is going to be, and we may be underestimating what the spending needs are going to be. You said you want to hold the line on spending, and I support that, but I think we probably are going to have to spend more money on national security, defending ourselves against terrorist attacks, for a long time. That is going to be expensive. We are going to have to pay for that, and we want to pay for that not by raising interest rates or undermining long run growth.

Thank you.

[The prepared statement of Mr. Baily follows:]

Testimony Prepared for the

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By

Martin Neil Baily

The author is a Senior Fellow at the Institute for International Economics in Washington DC. He was previously the Chairman of the Council of Economic Advisers and a member of President Clinton's cabinet (August 1999 to January 2001). He has also served as a Member of the Council. The views expressed here are those of the author and should not be ascribed to the trustees, or other staff members of the Institute for International Economics.

America has shown its best side in recent weeks in the efforts to help the victims of the September 11 attacks. And it is showing its strength as it moves to strike back and tighten security at home. Dealing with the economic impact of these horrendous crimes has, appropriately, not been the first priority.

But, of course, the economic impact is important. And finding the right economic response to the crisis is a vital part of showing the terrorists they have not undermined the strength of America and its allies. Americans had believed they were safe from aggression in their own country, but today many feel understandably nervous about the future. Consumer confidence has fallen--according to a CNN/Time poll, 40 percent of consumers plan to cut back on spending and 42 percent plan to cut back travel. Many businesses were directly affected by the crisis, and many others are cautious about new investments.

In this testimony I will look at the state of the economy in the aftermath of the attacks, and at the economic policies that should be used in response to the crisis. Policies must be chosen that meet the needs of the economy for short run stimulus, while at the same time preserve the strong economic fundamentals that have supported the extraordinary economic performance of recent years. In short, how do we get America working again, while maintaining fiscal discipline?

The US Economy was Already on the Edge of Recession. Prior to the attack the economic data were mixed. On the positive side, consumer spending was higher in August and seemed to be proceeding normally in early September. Motor vehicle sales were running at about the same level as in August, and chain store sales were down only slightly. Excess inventories had been sharply reduced. There were some signs the economy was turning the corner. On the other hand, investment remained in a slump, having fallen 15 percent in the second quarter. The August employment report was weak and construction spending fell. Consumer confidence in early September was declining. My own view is that the balance of evidence was negative. Instead of seeing the hoped-for rebound in economic activity, we were already seeing signs of a very weak or even a negative number for US GDP growth in the third quarter. Meantime, US manufacturing has been in recession for some time.

Since the terrorist attacks, a recession in the United States and a broad global slowdown appear to be much more likely. The consensus estimate is for a decline of 0.6 percent in U.S. GDP in both the third and fourth quarters of this year. The amount of the decline in the fourth quarter is very hard to predict, however. The fundamentals of the US economy are sound. There is very little risk that we will fall into the kind of sustained economic weakness that has troubled Japan for a decade. But there is a risk there will be some very nasty economic data for a while. There is a chance of a decline of as much as 10 percent at an annual rate in the fourth quarter of this year. I do not think such a huge decline is likely, but the economy did decline by this amount in the second quarter of 1980 as a result of restraints on credit. If there is a large drop in GDP in the fourth quarter, it would be important to reassure Americans that the decline is a short term reaction and the economy will rebound quickly, just as it did in 1980.

The forecasting group, Macroeconomic Advisers (MA), estimates that the attack destroyed $13 billion of private and government capital. Some industries have been directly affect, notably airlines, hotels and insurance companies. US airlines have announced layoffs of around 89,000 (with 8,000 more at UK airlines). There are also immediate spillover effects from the affected industries. Boeing has announced layoffs of around 30, 000 over the next 12 to 15 months, anticipating that aircraft orders will fall. Many meetings and conventions have been cancelled and tourism is down sharply. Layoff announcements can often be misleading, as they sometimes exaggerate the extent of the net employment reduction that actually takes place. But there is little doubt many companies are in difficulty right now. MA estimates the impact of the attack was to lower economic activity in the third quarter by $24 billion at an annual rate—quite a hit given that the quarter only had three weeks left to run.

The short run impact of the attack is broader than just the industries directly affected. There has been an increase in uncertainty, fostering a desire to wait and see before undertaking major economic commitments. The Michigan consumer confidence survey showed a sharp decline after September 11. It is natural for each individual consumer to react to the uncertainty by holding back on spending decisions, but the impact of such caution by all consumers becomes self-fulfilling, as a drop in total consumption brings on layoffs and rising unemployment. Businesses also react to uncertainty by holding back, and that could slow or abort the needed recovery in capital spending.

So far there has not been much of a spike in oil prices. In fact, prices now have fallen in anticipation of weaker demand, and the pledge by oil-producing countries to maintain stability in the oil market. But the possibility of a disruption of oil supply hangs over the global economy. An extensive conflict could result in a sharp run-up in oil prices. If that happens, the recession will be deeper or longer.

What has been done to counteract the short-term economic weakness? The immediate imperative is to restore confidence and bolster demand and good policies have already been followed to do this. Central banks around the world, notably the Federal Reserve in Washington and the European Central Bank (ECB), have added liquidity to the global financial system. In a crisis, banks can find themselves short of cash or other liquid assets. The Fed and other central banks have allowed private sector banks to borrow cash and reserves more easily to tide them over until they can adjust. The integrity of the banking and financial system has to be maintained and the easing of borrowing requirements will ensure that. The global financial system is wide and deep and can absorb even a body-blow like this one.

Even before the crisis, there was a clear case for interest rate reductions. The Fed had been expected to make further rates cuts, but the ECB, over its short history, has been much less willing than the Fed to act to forestall or offset economic weakness, in fact it only has a mandate to maintain price stability. Following the crisis, however, the ECB came through and joined the Fed in a half percentage point cut in rates. Other central

banks also responded. The fact that there was a coordinated response of central banks around the world is helpful to the US recovery.

Fiscal policy will help mitigate or shorten the recession. The US had already enacted a tax cut and mailed out tax rebate checks to millions and a further tax stimulus package is under discussion. The Congress has also passed a $40 billion emergency package of increased spending, available for rebuilding, for the military and for enhanced security needs. And a package of around $15 billion has been passed to help the airlines.

Even though spending weakness will continue in the US through at least the end of this year and probably into the first part of next year, the chances are good that economy will recover next year, even if no further policy stimulus were given. There is a natural pattern to business cycles. In the boom there is over-optimism that results in over-investment and over production. As demand weakens, excess inventories pile up and there is little need for further investment. The traditional ingredients of a recession are slumping investment and falling inventories and both were already evident before September 11 in the current slowdown. But once the inventory overhang has been worked off (I noted earlier the progress in this area) and short-lived equipment wears out or becomes obsolete, production starts to turn back up and investment bottoms out. The US economy is very resilient and bounces back from recessions. Looking at all US recessions since 1945, the average length of downturns has been eleven months, suggesting that recoveries come pretty quickly, unless there is some unusual drag on the economy. Beyond the natural resilience of the economy, the policy steps I have just described will start to take effect. Monetary policy always works with a lag, but the evidence is that it works. Around $20 billion of the $40 billion of additional Federal spending is expected to occur over the next twelve months.

The Importance of Global Growth The US is not the only country experiencing economic problems. Japan is in deep trouble, with not only a declining economy, but also a financial system on the edge of collapse. Europe was holding up better, but forecasts were dropping there too, notably in Germany, which is heavily affected by the world-wide demand for capital goods. A recent report showed Euro area industrial production declined 1.4 percent in July. The newly industrialized Asian economies that rely on exports were facing the collapse of high-tech demand. Latin America was struggling, especially Argentina, and Turkey has had a particularly difficult time.

It is heartening that there was a coordinated response to the economic threat by central banks. But the US must encourage its allies going forward to monitor their economies and take further steps towards stimulus as needed. It is vital at this time that Europe does its best to sustain growth in the face of the new threat to stability. The US has been the locomotive of the global economy for some time and needs help from Europe now. If the downturn worsens, further interest rate cuts may be needed from the ECB. Japan must also take forceful steps to try and recover from its recession. The latest figures on

Japanese industrial production were extremely weak. Japan must address its financial crisis and not become a stone dragging the global economy under water.[1]

Downside Risk The US and other stock markets had weakened substantially before the terrorist attacks, the Dow dropping by about 15 percent from a high in May through September 10. This was depressing consumer spending and weakening consumer confidence. European and other international markets had also been weak and they fell further in response to the attacks. US markets were closed, but once they re-opened, there was heavy selling as the Dow dropped another 14 percent. As this is written some of that sell-off had been reversed, but continued market volatility is likely.

One can make a good case that markets will be very weak going forward, but one can also make a good case that they will recover. The case for recovery is based on the fact that the attacks did very little real damage to the US capital stock or its ability to generate income and wealth. The 90s saw an explosion of new technologies that have greatly increased real economic wealth, both tangible and intangible and these assets have not disappeared. In addition, past experience shows that stock market weakness following crises generally has been rather quickly reversed. This was the case following the Kennedy assassination, the Iranian hostage crisis, the Gulf War, and others. Only the energy crisis of the early 70s was followed by sustained market weakness and that was a different kind of crisis.

Those who believe the market will continue to trend downward, on the other hand, can argue that stocks were probably over-valued before the slowdown and the terrorist attacks. Price earnings ratios were way above their normal historical range, built on the belief that profits would grow at extraordinary rates in the future. In this view, the economic slowdown combined with the terrorist attack has provided a reality check that will reduce market values for some time to come.

In short, no one knows how the market will play out, but it is at least possible there will be sustained market weakness or volatility. Markets have a tendency to 'overshoot,' moving too high in good times and too low in bad times. They may overshoot on the negative side in the current crisis and consumer and business confidence and spending would be hurt further in that event, and contribute to deeper or longer slowdown.[2]

Because of stock market weakness or for other reasons (such as oil price increases), the recession may turn out to be more severe than expected. And the question then becomes, what should be done about this risk. Should further expansionary monetary and fiscal policies be used now, or should we hold off?

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[1] Adam Posen has described the decisive actions Japan should take to deal with its financial crisis, see "Japan 2001—Decisive Action or Financial Panic," *International Economics Policy Brief, Number 01-4*, Institute for International Economics, Washington DC, March 2001.

[2] The stock market and the economy are inter-related. If the stock market improves, this will help the economy recover. If the economy recovers, this will help the stock market improve. Causality does not just run from the market to the economy.

Monetary policy could do more if needed, by making further interest rate cuts. The danger of inflation seems very low, especially as slow growth around the world is depressing prices. Monetary policy has been an outstanding contributor to the growth and stability of the US economy and will surely continue that role if the going gets tougher. We can have confidence that the Fed will take whatever additional policy actions are needed.

An Additional Fiscal Stimulus Package I have mixed feelings about whether an additional fiscal stimulus should be given to the economy right now. On the one hand, such a package would provide an insurance policy against a deeper or longer recession than expected. On the other hand, there is a serious danger of undermining fiscal discipline over the long term and undercutting the policy stance that has worked so well over the past decade. I would prefer to wait a few weeks or so to see how the economy moves before actually passing the package, but it makes sense to put a stimulus package together now and have it ready to go.

A stimulus package should be designed to achieve the following goals. First, the tax cuts or spending increases should go into effect quickly. Second, they should either have sunset provisions or be consistent with long run fiscal goals. Third, the package should put money in the hands of those who will be most likely to spend it. The size of the package should be adjusted depending on the severity of the situation as it emerges over the next few weeks or beyond. Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Rubin have suggested that a total fiscal stimulus of $100 billion in FY 2002 may be needed. Given that roughly half that amount is already in the pipeline, the additional package should be designed initially to be around $50 billion. Perhaps another $30 billion of provisions should be debated, if it turned out that they were needed.

On the household side, I favor tax rebates targeted at moderate-income taxpayers, including those who pay payroll taxes but did not receive a rebate, or received only a partial rebate, in the first round. This would be seen as equitable and it would not create problems for fiscal discipline down the road. It would give money to families with low and moderate incomes that would likely spend most of it. I could also support the temporary sales tax rebate proposed recently by Alan Blinder. The advantage of this proposal is that it encourages people to spend now while the tax cut is in effect. Giving additional tax rebates is not a sure-fire solution to economic weakness, but it would help.

In a time of crisis it is important to achieve agreement and be ready for action. This is why I am suggesting tax rebates as the first priority. But if the political environment is receptive, it would also be appropriate to take a look at the social safety, which will become more important with a heightened risk of recession. One way to sustain consumer confidence is to make sure families are protected if job loss does occur. The unemployment insurance program is currently serving only a fraction of the unemployed and needs to be shored up. Workers are scared that their families will lose health insurance coverage if they lose their jobs, so COBRA and Medicaid programs should be re-examined to make it easier to retain adequate coverage. Even in the economic boom

around 40 million Americans lacked health insurance coverage and a serious recession could easily make that problem worse.

A good policy that has been under discussion and that would support the safety net is wage insurance. Many workers who are laid off are able to take new jobs at wages that are comparable to or even higher than the wages they lost. But a significant fraction of laid off workers suffer substantial wage loss in new jobs, and many are discouraged from taking new jobs because they would have to accept lower wages. Under a wage insurance program, the Federal government pays workers a fraction of the difference between the wages they earn on a new job and the wages they were paid on their old job for a period of time. Such a program would cushion the blow of layoffs that are now taking place and would encourage laid off workers to take new jobs.[3] Wage insurance is a controversial policy and it may be hard to introduce quickly in a short run package, but it is a policy that has much to commend it in good times, and would be very helpful now that layoffs are a greater threat.

On the business side, there is a case for a temporary investment stimulus. This could be either an investment tax credit or a provision to allow the expensing of certain categories of equipment that, under current law, must be depreciated over time. I do not feel strongly about which of these two approaches is better. Either approach would get an influx of cash into the hands of companies that are investing. Paradoxically, a temporary investment stimulus would be more effective than a permanent one. We would be saying to companies: Invest over the next year and get a tax break. If you put off the investment until later, the tax break will be gone. A tax provision like this would not persuade companies to invest if they already had excess capacity or were near bankruptcy. But there are always bright spots even in a weak economy, and so some companies would decide to upgrade their computers or buy a new fleet of autos this year rather than waiting until next year.

Policies that would not be effective in stimulating the economy include a capital gains tax cut or a cut in the corporate tax rate. Neither policy has been shown in econometric studies to provide much stimulus to investment. For example, a recent study from the Congressional Budget Office estimated that reducing the top tax rate on capital gains from 20 to 15 percent would have almost no impact on private saving and economic growth.[4] A cut in the capital gains tax could even have the perverse effect of encouraging people to sell stocks and lead to further stock market declines.

A permanent reduction in the corporate income tax would be very expensive, in terms of the long run loss in revenue, relative to any stimulus effect it might have on the

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[3] This proposal is described by Lori G. Kletzer and Robert E. Litan in "A Prescription to Reliever Worker Anxiety," *International Economics Policy Brief, Number 01-2,* Institute for International Economics, Washington DC, February 2001.

[4] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," CBO Memorandum, August 1998.

economy.[5] In particular, it would take a large, expensive rate cut to give a significant boost to the stock market, and hence consumption.[6]

I am not in favor of accelerating the provisions of the tax cut package passed earlier this year. However, if accelerating some of the tax cuts is to be part of a compromise needed to achieve passage of a stimulus package, I would emphasize provisions that provide the most assistance to moderate income families, rather than the upper bracket rate cuts and estate tax provisions which affect only a small group of taxpayers.

Preserving Fiscal Discipline We should not abandon budget targets over the longer term. The US faces pressing budget problems in the future as the baby boom generation moves into retirement. It is vital to keep paying down the national debt while the opportunity is there, before facing the massive increases in pension and health care costs that are looming on the horizon. Saving the Social Security surpluses and even the Medicare surpluses was a good idea. In addition, it is important for the US to increase national saving in the long run and reduce its foreign borrowing. Running budget surpluses will help do this. Good policy, in short, means easing the constraints on budget policy this year and next, but simultaneously re-examining the long run budget prospects and looking for ways to preserve long term fiscal discipline.

Even before the September 11 attack the Congressional Budget Office had issued a new set of budget projections with sharply lower estimates of the surpluses. Since that time and since the attack, the prospects for a weak economy are far greater in the short run and the uncertainty about the long run growth prospects has increased. In addition, sharply higher spending on defense and security are in prospect for years to come. The short run stimulus package, while it may be necessary, will have some adverse effect on the budget outlook even over the long term, because it raises the national debt and the interest burden.

The danger of undermining fiscal discipline has already been seen in financial markets. Long term interest rates had declined in recent weeks with the slowing economy. Following the terrorist attacks, there was a sharp increase in the yield on 30-year Treasury bonds (see attached figure). This does not appear to have been the result of an increase in expected inflation (judging from the behavior of indexed bonds). Rather it expressed concern that long term budget discipline may have been undermined. The yield has fallen back subsequently, but remains higher than before the attacks. This is striking given that short term interest rates have fallen further and most forecasters have reduced their estimates of economic growth.

The Federal reserve has cut short term interest rates to stimulate the economy. In order for these cuts to have their full benefit, long rates must come down also. To achieve this, policymakers should re-affirm their commitment to fiscal discipline. This would help

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[5] See Joel Friedman and Iris Lav, "A Permanent Corporate Tax Rate Cut: The Wrong Medicine for Short-term Economic Ills," Center for Budget and Policy Priorities, September 26, 2001.
[6] See William Gale, Peter Orszag and Gene Sperling, "Notes on Tax Policy in the Aftermath of the Terrorist Attack, *Mimeo,* September 28, 2001.

stimulate the economy today. Any fiscal stimulus package should be viewed in the context of long run budget goals. Wars are expensive and this war on terrorism will be expensive for years to come. We should expect that if we spend more now and in the future and if we also give more tax cuts now, then there will be less money available later. I would favor preserving the Social Security surpluses in future years even if we have to put on hold some of the permanent tax cuts. If the economy comes back very strong and there is more money available, then there is nothing to stop us from restoring the tax cuts.

Productivity and the Peace Dividend There is discussion today of the possible adverse effects on productivity of the increases in government spending. The peace dividend, it is argued, was a reason for the rapid growth of productivity in the 1990s. Yes and no. The surge in growth was heavily driven by technological advance. The decline in military spending did help make room for the increase in capital spending that, in turn did indeed contribute to productivity growth. However, *provided we preserve fiscal discipline* there is no need to sacrifice long run growth for greater security. We just need to make sure we pay for the increased spending. If we continue to run budget surpluses and pay down the debt in the years ahead, this will keep interest rates low and encourage investment once the economy recovers. If we allow the surpluses to erode, interest rates will be higher and investment will be lower.

Conclusion The destruction and loss of life at the World Trade Center and the Pentagon have been a terrible blow to the US and to the world. We should do our best to minimize the collateral damage to the US and the global economy.

- In the short term, some economic weakness is very likely. Predictions for US GDP in the fourth quarter are all over the place. We should be braced for bad news, just in case.
- The Federal Reserve and other central banks have acted quickly to preserve the financial system and lower interest rates to spur spending and investment. Monetary policy does work, given time.
- Other countries, and Europe specifically, should step up to the plate and help sustain global growth through the use of further expansionary policies as needed.
- The tax cuts already in place, and the increased spending coming on stream, will provide a substantial fiscal stimulus to the US economy.
- Based on the experience of prior cycles and given the expansionary monetary and fiscal policies already in place, we can expect a recovery by next year.
- It is worth having in hand a further fiscal stimulus package, either for use now as an insurance policy, or for use later if conditions deteriorate further than expected. The package should include further immediate tax rebates, including rebates for those who missed out on the last round. It should include an investment stimulus, either a temporary investment tax credit or a temporary provision to allow the expensing of equipment. Temporary tax cuts can be effective--spend now or lose the tax cut.

- The social safety net has become more important and needs to be shored up. Wage insurance would be a good policy. A capital gains tax cut or a cut in corporate incomes taxes would not be cost-effective in stimulating the economy.
- There is pressure to accelerate the tax cuts already passed. If this is done, move first on the cuts that help moderate-income families. Most importantly, however, let's not lose sight of fiscal discipline. It worked in the 90s and should be preserved once we get through the immediate crisis. Any stimulus package should be evaluated in the context of long run fiscal discipline.

Chairman CONRAD. Thank you very much.
Dr. Krueger.

STATEMENT OF ALAN B. KRUEGER, PRINCETON UNIVERSITY

Mr. KRUEGER. Thank you. Good morning, Mr. Chairman and Senator Grassley, Senator Corzine and Senator Clinton. I appreciate the opportunity to share my views about where the economy is at the moment, where it might be headed, and public policies that might be appropriate in light of the current situation. Martin and Glenn have left me little to add on the current economic situation. I think we see things largely in the same way, and I might add, Mr. Chairman, your analysis in your opening statement, I think, is very much in line with the way I view economic developments.

One thing I would mention is that even prior to September 11th, economists were surprised that consumption spending had held up as well as it had been holding up. Stock market values have declined considerably. One estimate I saw was in the neighborhood of $5 trillion in the year preceding September 11th. Ordinarily, one expects declines in stock market wealth to lead to declines in consumer spending, and we had not seen the decline that one would expect from past relationships.

So I think there was already a concern that the American consumer was overspent and the consumer might not continue propping up economic growth. The terrorist attacks, I think, are the type of destruction that the economy could ordinarily get by, as horrific as the attacks were. And if one looks at one-of type events of similar magnitude in terms of destruction of human life and property and so on, like earthquakes, it is the type of thing that an economy usually bounces back from; and, in fact, looking at past hurricanes and earthquakes, they often set of an investment boom as buildings are rebuilt and so on.

Chairman CONRAD. Could you pull the microphone a little closer to you? You have got to be close.

Mr. KRUEGER. So I think the reaction of a number of economists initially was that the attacks of September 11th would have relatively little effect on the economy. My own sense is that is probably not the right interpretation. I think that the economy was in a precarious state before September 11th, as already has been mentioned. Economic growth was essentially stagnant. There was concerns that consumer spending would fall sharply, anyway, and I think there was also some doubt, at least in some people's minds, about whether the remedies that had been used prior to September 11th were having their intended effect.

I know some economists have raised questions about whether the interest rate cuts were being as effective as one might have hoped, and whether they would have been sufficient to prevent the economy from declining further. So, in light of that situation, I think the terrorist attacks have caused a sharp decline in consumer confidence, as you showed, Mr. Chairman, a national reaction of fear; and I think consumer jitters are the main risk right now to the short-term economic outlook. And the fear, as has been mentioned, is that consumers will suddenly cut back on spending; that will

cause businesses to reduce investment, to close, lay off workers, and that we could have a downward spiral.

So, to my mind, the main approach that public policy could use right now to be helpful is to try to restore consumer confidence. And, as I think about what belongs in a stimulus package, I think reducing consumer jitters should be the main objective for the short-term, and I also share Martin's view and the view of others that one has to be concerned about the long-term budget position. But I also agree with what Martin said very well, that now is the time to fine-tune the economy. This is the time that one can have an impact when it would really help.

Now, there are some automatic stabilizers that are already in effect. Unemployment insurance is an important one, and that is one I will comment on in more detail, but our tax structure also has a stimulatory effect. Progressive income taxes lead to lower revenue when the economy slows down, and that will also stimulate spending. The same thing that is causing the red on the chart is going to have a stimulatory effect without any change in policy.

There has not been very much data since the September 11th attack, and what data are available does suggest a considerable slowdown, especially in consumer spending. I would also mention that unemployment insurance claims went up for the week ending September 19th, to the highest level since December 1991. We will get additional information on Friday on the unemployment rate from the Bureau of Labor Statistics, except there will be less information in those data than one might expect.

The survey week for the current population survey is the week containing the 12th. The attacks occurred on the 11th, so that week would also contain Monday the 10th. The way the Bureau of Labor Statistics calculates employment and unemployment, if someone worked on Monday and was unemployed the rest of the week, that person would show up as employed, not unemployed. So the numbers that are going to come out on Friday will largely reflect trends that were going on prior to September 11th, so I would caution the members of the committee not to make too much out of those data.

One thing that I think is worth looking at in those numbers is the hours data, because the hours data are collected in a different way and they will reflect cutbacks in that week. But that is quite preliminary. It is just the first week after these horrific attacks took place. Traditionally, the first line of defense in a slowdown has been unemployment insurance, and as Martin said, I think it is important to shore up the unemployment insurance system, and I would mention four areas where unemployment insurance could be reformed.

First, fewer than one-third of the unemployed receive benefits. The take-up rate for unemployment insurance has been declining over time. And one of the real fears I have is welfare reform can change the equation quite dramatically. A number of people entered the work force in the late 1990's because of welfare reform. Many of them are concerned about their eligibility for TANF or have used up their eligibility for TANF. Many of them, and I have to say I and many others were quite surprised by how well they were doing in the labor market, but many of them will fail to qual-

ify for unemployment insurance benefits, either because they have a short record of work experience or because they have low earnings, or probably most importantly because they are seeking part-time work, and in a majority of States, those who are seeking part-time work are not eligible for benefits.

So one suggestion I would make is that the States be required to extend coverage to those who are seeking part-time work. In addition, period that is used to determine eligibility, the period of earnings, can be shortened. We could rely on more recent data, instead of using the first four of the last five calendar quarters of earnings. A second area I would recommend is the level of benefits. In a number of States, benefits are quite low. California just decided or just—the Governor just signed a bill yesterday to increase benefits.

I think a great concern in a number of States is that the level of benefits is probably too low. It is probably too low in ordinary circumstances and too low in light of the economic risks we currently face. A third area I would recommend reforms is the area of funding. I had written an article in January of 2001, advising that the States increase their level of reserves. In a number of States, most important, I think, New York, the reserves for the unemployment insurance funds are dangerously low. If the funds become insolvent, then they will borrow from the Federal unemployment insurance fund at market rate.

The Federal unemployment insurance fund, fortunately, is well-funded at the moment, but one suggestion I would make is to reduce the rate that they borrow at, perhaps cutting the interest rate to zero. Now, one might also ask how did we get into this predicament? Why weren't the State funds at a higher level of reserves? I think part of the reason is that a number of States lowered tax rates during the 1990's and have not maintained very good experience rating. Experience rating is really a quite-unique American system that raises the tax rate for companies that have a bad record of past layoffs; and our current system subsidizes companies if they are in a situation where they have had many layoffs.

So one thing I would recommend doing is coupling changes in the current funding with longer-term changes, to require States to maintain a variety of different tax rates, so that companies can be taxed a rate which reflects the costs that they impose on society. Then the fourth area I would mention is one that has probably received the most attention, is extended benefits. The traditional response in a downturn, by the Federal Government, is to increase extended benefits, and the U.S. system of unemployment insurance typically pays benefits for 26 weeks. That is short, compared to other countries. On the other hand, it seems to work well for us. It seems to give people enough time to search for a new job or to make different arrangements, to perhaps arrange for job training and so on, and it does not leave them in a situation where they are complacent about their job search activity.

Studies have found that when the duration of benefits increases, the duration of unemployment increases, as well. Now, I think in a prolonged recession, one wants to extend benefits. I think that makes a great deal of sense. We do not know yet whether this will be a prolonged recession. This could quite possibly be a V-shaped

recession, where we bounce back very quickly because of the actions that the Fed has taken, and the actions that the Congress is considering.

So one suggestion I would have would be to re-examine the trigger for extended unemployment insurance benefits, which was set at a time when the natural rate of unemployment was much higher than it is currently. I think that rate needs to decline, but at the same time I would recommend combining when the trigger for extended benefits takes place with a few months out, or maybe 6 months from now. So, in other words, I think if our downturn continues into the second quarter of 2002, then the need for extended benefits is much greater than it would be if we just had a one-or two-quarter downturn, and then we turn around.

So one suggestion I have is to think about lowering the trigger for extended benefits, but at the same time setting that at a point a few quarters in the future. So on the margin I would recommend using funds to try to expand eligibility for unemployment insurance benefits, increase the level of benefits in States where benefits are quite low, and only after those main concerns are taken care of, addressing the extended benefits.

I would also mentioned that if this does turn into a prolonged recession, we need to take another look at dislocated worker training programs.

[The prepared statement of Mr. Krueger follows:]

PREPARED STATEMENT BY

ALAN B. KRUEGER
PRINCETON UNIVERSITY

"THE ECONOMIC OUTLOOK AND POLICIES IN LIGHT OF RECENT EVENTS"

BEFORE THE

BUDGET COMMITTEE
UNITED STATES SENATE

Washington, D.C.

October 2, 2001

Good morning, Mr. Chairman and distinguished members of the Senate Budget Committee. My name is Alan Krueger and I hold the Bendheim professorship in economics and public affairs at Princeton University. I appreciate the opportunity to share my views on recent economic developments in light of the horrific terrorist attacks of September 11th, the economic outlook going forward, and public policies that might be appropriate in the current situation.

I. THE ECONOMIC SITUATION

After growing at a rapid rate in the second half of the 1990s, GDP growth fell precipitously to less than 2 percent per year in the third quarter of 2000, and fell to only 0.3 percent in the second quarter of 2001, the most recently available data. Although it is unclear whether the economy entered a recession, it is clear that growth was essentially stagnant even before September 11th. A slowdown in business investment was a major reason for slower GDP growth. The modest GDP growth that existed was mainly a result of robust consumption growth. Because consumption spending makes up more than two-thirds of GDP, changes in consumption have a large impact on economic growth.

Another major relevant economic development is that the value of the U.S. stock markets fell by close to $5 trillion in the year preceding September 11th. It was puzzling to many economists that consumption remained so strong in spite of this large drop in wealth. A rough rule of thumb is that a $1 decline in stock market wealth leads to about a 3 to 4

cent decline in annual consumption.[1] This relationship would imply a $150 to $200 billion drop in consumption, which has not materialized.

The events of September 11th are likely to change the short-run economic outlook in many ways. Ordinarily, the loss of life and destruction wrought by the terrorist attacks – horrific as the were – is something that the economy could readily bounce back from. In the past hurricanes and earthquakes have had relatively small short-run effects on national income, and have set off an investment boom that increased measured GDP. But the reaction to the recent terrorist attacks are likely to be different, in part because of the precarious position the economy was in prior to the attacks, and in part because it is unclear what the military reaction to the attacks will be, how long it will last, and how effective it will be. In addition, the attacks came at a time when some observers were beginning to question whether the traditional economic remedy for a slowdown (i.e., interest rate cuts) was working this time.

The main short-run economic concern, in my opinion, is that the terrorist attacks will cause a quick and sharp contraction in consumer spending. First, consumers are scared, shocked and in mourning, and face increased uncertainty for the future. This understandable psychological reaction is likely to cause a cut back in consumer spending, which is beginning to show up in data on consumer confidence, visits to shopping malls and year-over-year retail store sales.[2] Second, since the markets reopened on September 17th, the value of equities fell by about an additional $1 trillion. This would be expected to reduce consumer spending by another $30 to $40 billion per year. Many economists were already waiting for the consumption shoe to fall, and the terrorist attacks and the stock market decline could set such an effect in motion.

If consumption contracts sharply, economic growth will decline. Moreover, inventories will pile up, investment will decline and unemployment will rise.

A second major risk to the economy is that business failures in some key industries may rise as a direct effect of the attacks. For example, the airline and hospitality industry are obviously directly affected. The attacks also struck at the heart of the financial industry. It is quite impressive, however, that the financial markets quickly returned to close-to-normal functioning. The smooth functioning of the capital markets may be one of the unsung feats of this disaster.

The unemployment rate has been rising for nearly a year, and equaled 4.9 percent in August 2001, after reaching a 30-year low of 3.9 percent in September and October of 2000. Last month's unemployment figures showed a 0.4 point jump, and also indicated that the downturn in the labor market was beginning to take on features of a typical downturn: the unemployment rate jumped more for minorities than whites, and more for less-educated and less-experienced workers than for well educated, more experienced

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[1] For an accessible survey of the literature, see James Poterba, "Stock Market Wealth and Consumption," *Journal of Economic Perspectives*, Spring 2000, pp. 99-118.
[2] "From the Markets to the Bedside Table," *The New York Times*, September 30, 2001, Week in Review Section, p. 4.

workers. The unemployment rate for September will be announced by BLS on October 5, and the survey reference week will contain the week of the terrorist attacks. However, given the definition of employment used in the BLS household and establishment surveys (employed during the reference week), it is unlikely that the unemployment or employment data will reflect much of the impact of the events of September 11th on the economy; instead, they will largely reflect preexisting trends. It is possible that the early effects of the reaction to the terrorists attacks will be reflected in reported work hours, however.

Figure 1 displays weekly claims for Unemployment Insurance (UI). The latest, preliminary numbers pertain to the week ending September 19, 2001, so they reflect the first wave of layoffs in the aftermath of the terrorist attacks. New claims for UI increased from 392,000 to 450,000, the highest level since December 1991.

The terrorist attacks could serve as a focal point, leading companies to make deep cutbacks at a time when many were considering cutbacks anyway. If this is the case, the downturn could be relatively sharp, widespread and perhaps short lived (say 2 or 3 quarters). There is a historical tendency for sharp downturns to have V-shaped patterns, in which growth bounces back quickly after the economy bottoms out. This type of a recovery is certainly not a guaranty, but the odds are probably slightly stronger for a V-shaped than U-shaped business cycle at the moment.

II. ECONOMIC RISKS AND THE APPROPRIATE POLICY RESPONSE

As mentioned, I think the greatest short-run risk to the economy is consumer jitters, causing a collapse in aggregate demand. A sudden, sharp drop in consumption can have a cascading effect, leading to plant closings and layoffs because of a shortage of aggregate demand, and in turn leading workers to cut back consumption further because they have lost their job or perceive an increased risk of unemployment. If consumption remains strong, economic recovery will be swifter, regardless of the short-run performance of the stock market.

The main longer run concern for the economy is that productivity growth falls from the increased level reached in the late 1990s. The current economic situation is unlikely to have much effect on long-term productivity growth. Another longer run concern, however, is that long-term interest rates increase and thereby discourage investment.

In my view, government policy could do a lot to restore confidence and reduce consumer jitters. A number of principles have been proposed for elements of a short run stimulus package. These include: the additional spending or tax cut be temporary, not permanent; the additional spending or tax cut help the short-term economic outlook; the spending or tax cut should stimulate new investment, not reward old investment; the spending or tax cut stimulate demand; and the package should maintain long-term budget discipline. I agree with all of these principles. But to this list I would add another principle: first shore up the traditional safety net. In times of economic difficulty, people turn first to

Unemployment Insurance (UI) and other components of the safety net. A strong safety net helps to automatically stabilize the economy. People are more willing to take risks and maintain more normal consumption patterns in uncertain times if there is a strong safety net beneath them.

III. UNEMPLOYMENT INSURANCE AND JOB TRAINING

Unemployment insurance is an important component of the economy's automatic stabilizers. UI expenditures rise in recessions and fall in booms. For example, outlays for unemployment compensation increased from $14 billion in 1989 to $37 billion in 1992, when the unemployment rate peaked, and fell to $21 billion in 1995 when the labor market improved.[3] Unemployment benefits are a strong counter cyclical force because they adjust quickly and automatically to changing economic conditions.

Unemployment benefits are well targeted to families in need, and as a result they help to maintain consumption in a downturn. In addition, an administrative system is already in place to deliver UI benefits quickly and efficiently. And shoring up the UI system as I propose below will not hurt the long-term budget picture.

Most importantly, UI provides an essential source of support for families that have a laid off worker. The amount a family spends on food – a bare necessity – falls by 7 percent, on average, when the head of a household becomes unemployed, according to a study by Jonathan Gruber of MIT.[4] Absent unemployment benefits, he estimates that a spell of unemployment would cause food consumption to fall 22 percent – about three times as much. And UI benefits probably have an even larger impact helping families maintain consumption of discretionary items, like new clothing for school and books.

Offsetting the salutary "consumption smoothing" effect of unemployment benefits, many economists have also documented a distortionary effect: as benefit generosity increases, workers tend to remain unemployed longer.[5] Higher benefits apparently reduce the amount of effort people devote to searching for a job. In addition, research indicates that some employees and employers game the system, placing workers on rotating temporary layoff so they can receive benefits while on vacation.

Ideally, the optimal unemployment benefit would balance the desired consumption-smoothing effect against the undesired distortionary effects. Professor Gruber, building on earlier theoretical work by Martin N. Baily, calculates that the average unemployment benefit in the United States, which on average replaces around 40 percent of previous earnings, after taxes, is close to the optimal level given workers' aversion to the risk of

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[3] Source: *Green Book*, House Committee on Ways and Means, Washington, DC: Government Printing Office, 2000, Table I-5.
[4] Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87, March 1997, pp. 192-205.
[5] See Anthony B. Atkinson, John Micklewright, "Unemployment Compensation and Labor Market Transitions: A Critical Review," *Journal of Economic Literature*, Vol. 29, December 1991, pp. 1679-1727.

job loss.[6] The generosity of UI benefits, however, varies considerably across the states: the maximum weekly benefit last year ranged from a low of $190 in Mississippi to over $600 in Massachusetts. Although the cost of living also varies across states, variability in benefits outstrips variability in living costs. So raising the benefit-earnings replacement rate in the least generous states would make economic sense. Because the distortionary effect of benefits is probably less severe in a downturn, one could also argue for a temporary benefit increase.

I believe that additional reforms in two aspects of UI can have a particularly valuable impact in the current economic environment. These reforms concern eligibility requirements and financing, and are discussed below.

A. ELIGIBILITY

States set different standards for eligibility for UI. The typical state requires workers to have earnings exceeding a specified level in four of the previous five calendar quarters to qualify for benefits. In addition, workers are ineligible for benefits if they voluntarily quit their job. In a majority of states, otherwise eligible workers are disqualified for benefits if they are not available for, and seeking, full-time work.

Fewer than one-third of unemployed workers receive UI benefits. This ratio is considerably lower than it was in the 1970s. The UI recipiency rate is below 100 percent because the take-up rate (i.e., fraction of eligible unemployed workers who apply for benefits) has declined over time and because many unemployed workers are ineligible for benefits because their work record does not qualify them for benefits or because they are unable to actively search for full-time (as opposed to part-time) work.[7]

The current downturn could be particularly severe for laid off workers who recently left welfare to join the workforce in response to welfare reform. This group consists primarily of low-income, single mothers. Many of these workers will not qualify for UI because they have worked an insufficient number of quarters of work to meet the eligibility standards, because their earnings were too low, or because they are searching for part-time work due to family obligations and a majority of states exclude part-time job-seekers from benefits. Many of these workers have exhausted their TANF eligibility, or are concerned about exhausting their TANF eligibility. An obvious change to help these workers would be to direct the states to temporarily waive or relax their UI eligibility requirements for applicants who were on TANF or AFDC in the last 5 years.

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[6] Of course, there is a limit to how far one wants to take estimates from this simple model of behavior.

[7] Evidence suggests that a decline in the take-up rate is mainly responsible for the decline in the recipiency rate in the 1980s. The take-up rate declined because of changes in the regional distribution of unemployment and because of declining real after-tax benefits; see Rebecca Blank and David Card. "Recent Trends in Insured and Uninsured Unemployment: Is There an Explanation?" *Quarterly Journal of Economics*, 106, November 1991.

Probably a better solution, however, would be to temporarily require the states to pay benefits to otherwise eligible workers who are searching for any job, part-time or full-time. This broader change would avoid the necessity to inquire whether individuals have received TANF in the last 5 years, and would also treat workers in similar current circumstances similarly. In addition, this change would recognize that the work and family situation of the workforce has changed since UI was enacted in 1935. Workers who would be made eligible for UI benefits as a result of this change would be primarily single-parent, female, and low-income workers.

In addition, to expand UI eligibility for those who elected to work instead of go on welfare in recent years, an "alternative base period" could be used to determine eligibility for a temporary period.[8] That is, instead of determining eligibility based on earnings in four of the previous five calendar quarters, states could use workers' more recent earnings histories. For example, if earnings exceed a certain threshold in two of the previous three quarters, workers could be deemed eligible for benefits. This change would expand eligibility to those who have joined the workforce more recently (many of these may have been on AFDC if the program had continued) and to workers with more inconsistent work experiences. Based on the experience of 12 states that have already moved to an alternative base period, the National Employment Law Project estimates that UI eligibility increased by approximately 4 to 6 percent as a result.[9]

B. FUNDING

To pay for benefits, the UI system builds up reserves during prosperous times and draws them down during slack times. A common measure of the health of trust funds is the reserve ratio: the ratio of accumulated trust fund balances to annual payroll. A higher reserve ratio provides more protection in an economic downturn. Unfortunately, the UI reserve fund in several states – most importantly, New York and Texas – were quite low even before September 11th.[10] Phillip B. Levine, an economist at Wellesley College, calculates that to remain solvent through a severe recession, like the one experienced in the early 1980's, unemployment insurance funds would require a reserve ratio of at least 1.25 percent.[11] Using this standard, 15 states were at risk of insolvency in a severe recession based on their reserve funds as of the first quarter of 2001. In New York the reserve ratio was 0.28 percent and in Texas it was 0.22 percent. Figure 2 shows nationwide data on the state trust fund balances as a percent of payroll as from 1970 through 2001Q3. Although the trust funds are in better shape than they were at the end of

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[8] This change has previously been recommended by the Wendell Primus and Isaac Shapiro of the Center on Budget and Policy Priorities and by the National Employment Law Project.

[9] "Unemployment Insurance: Key Elements for an Economic Stimulus Package," National Employment Law Project, New York, September 2001.

[10] See Alan B. Krueger, Economic Scene; "Now is the time to reform unemployment insurance -- before it's really needed," *The New York Times*, January 4, 2001, p. B2.

[11] Phillip B. Levine, "Cyclical Welfare Costs in the Post-Reform Era: Will There be Enough Money?" Mimeo., Wellesley College, December 28, 2000.

the 1970s and early 1980s, it is clear that reserves are below where they were prior to the last recession.

This predicament has arisen because many states did not build up their funds during the 1990s, and because experience rating – that is, the extent to which a business's payments increase with its past record of laying off workers – is poorly implemented. If the funds become insolvent, they will borrow from the federal government at close to market rates, and probably tighten eligibility standards to stem the shortfall. If state funds are on the verge of becoming insolvent, there is a real risk that UI administrators will become more stringent in admitting applicants to the program. States will also be more likely to restrict eligibility standards and less likely to increase benefits. An obvious way to shore up the system is for the federal government to *temporarily* lend to state funds from the federal fund at a below-market or zero interest rates.

As part of this package, I would also recommend that states be required to implement real experience rating and maintain ample fund balances within three years (i.e., after the economy improves). This would shore up the long-run financing of the state programs. In addition, a study by Phillip B. Levine and David Card of U.C. Berkeley estimates that the unemployment rate would decline by six-tenths of a percentage point if industries were fully experience rated – that is, if employers in an industry were required to pay the full additional costs of unemployment benefits for layoffs in that industry.[12]

The federal government sets minimum standards for state unemployment insurance programs and has a history of encouraging experience rating. This is a unique aspect of the American system of UI. Better experience rating could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers, and by requiring the states to have at least 10 different rates (currently, some states have only 2 rates: 0 or 5.4 percent). In addition, I would recommend that the per employee taxable earnings cap – which range from $7,000 to $10,000 in most states – should be raised, which would allow better experience rating at lower tax rates and make the financing less regressive. Improved experience rating would discourage employers from laying off workers, and help to internalize the externalities layoffs impose on society.

It is important to note that while the reserve funds in many states are potentially inadequate, the three federal UI funds have been maintained at responsible levels, and currently have around $38 billion in total, with about $13 billion in the federal loan account (FUA).

C. EXTENDED BENEFITS

A traditional government response in a recession is to extent the duration of UI benefits from 26 weeks to 39 or 52 weeks. In a severe, long-lasting recession, extended benefits make a great deal of sense. But research has found that the average duration of

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[12] David Card and Phillip B. Levine, "Unemployment Insurance Taxes and the Cyclical and Seasonal Properties of Unemployment," *Journal of Public Economics*, vol. 53, February 1994.

unemployment spells rises if benefit duration is expanded, and effort devoted to searching for a new job declines as a result.[13] Relatively short benefit durations is one reason why the unemployment rate is lower in the U.S. than in Europe.

If the current downturn is short lived, then extending the duration of UI benefits at this time could inadvertently raise the amount of unemployment above where it otherwise would be. It is impossible to know precisely how long the current downturn will last. As a consequence, on the margin, I would recommend expanding eligibility for benefits over extending benefit duration in the present situation. However, it might make a great deal of sense to legislate extended benefits *conditional* on the unemployment rate surpassing a specified level (e.g., 6 percent) *after* a specified date in the future (e.g., March 2002). Such a policy will not extend benefit duration unless the downturn lingers, and therefore reduce the risk that extended benefits inadvertently prolong the length of the downturn.

D. TRAINING FOR DISLOCATED WORKERS

Money was recently rescinded from the Labor Department's Dislocated Worker Training budget. Now is the time to increase training funds for dislocated workers, not reduce them. Many workers who lose their job in the current downturn will need training to obtain work in other sectors. Research suggests that federal training programs that target experienced workers, and provide training for marketable skills, are effective.[14] From a permanently laid off worker's perspective, dislocated worker training seems to be most helpful when it comes with income support, such as that provided by the NAFTA displaced worker program.

IV. A TEMPORARY PAYROLL TAX CUT PROPOSAL

If tax relief is sought, I would recommend considering exempting the first $5,000 of earnings from the OASDHI payroll taxes. This temporary tax cut could take effect immediately on January 1st, and the Social Security Trust Fund could be made whole by a transfer from general revenues. All workers would benefit from this tax cut, and low-wage and part-time workers will benefit disproportionately more. Because low-income workers have a high propensity to consume from additional income, this type of tax relief would be particularly helpful at stimulating spending. This type of tax relief will also reach many workers that did not benefit from the income-tax rebate Congress recently enacted. In addition, employer administrative hassles paying the tax would be reduced.

The principle economic drawback of this proposal vis-à-vis many other tax cut proposals is that, except for part-time or part-year workers, the marginal tax rate does not change. But most economists have concluded that the labor supply response to tax cuts is quite

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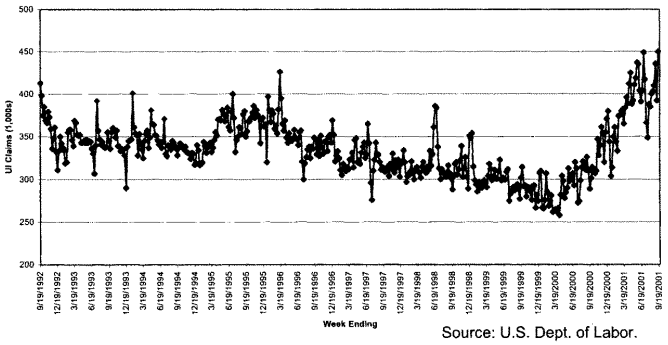
[13] See Lawrence Katz and Bruce Meyer, "The Impact of Potential Duration of unemployment Benefits on the Duration of Unemployment," *Journal of Public Economics*, XLI, 1990, pp. 45-72.

[14] See U.S. Dept. of Labor, Office of the Chief Economist, *What's Working (and what's not): A Summary of Research on the Economic Impacts of Employment and Training Program*, 1995..

modest.[15] More importantly, in my view, the main goal of a tax cut that is part of a stimulus package should be to stimulate short-term consumer spending, and this tax cut proposal will like have a substantial, immediate effect on consumer spending because it is broad based.

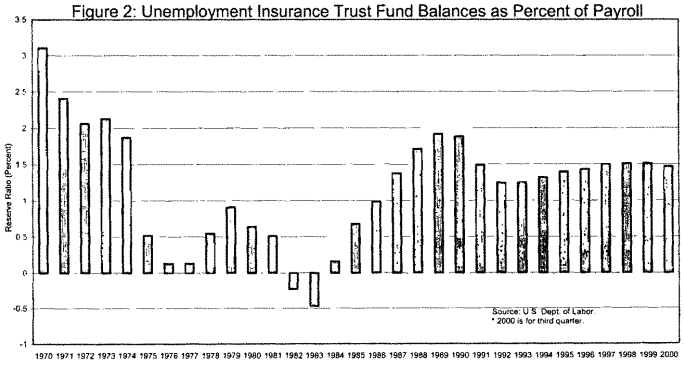
[15] See, for example, the survey of labor and public finance economists in, "Why Do Economists Disagree About Policy?" (with Victor Fuchs and James Poterba). *Journal of Economic Literature*, vol. 36, no 3, September 1998, pp. 1387-1425.

Figure 1: Number of New UI Claims by Week (Seasonally Adjusted)



Source: U.S. Dept. of Labor.

Figure 2: Unemployment Insurance Trust Fund Balances as Percent of Payroll



Chairman CONRAD. All right. Let me stop you there and go to questions, because we are rapidly running out of time. I asked Dr. Hubbard the question of do we need stimulus; if so, how much and of what type.

Dr. Baily, you addressed that to some degree, but let me ask you very directly, both of you, do you think we need additional stimulus? If you were having to make a decision this week, what would be your decision?

Mr. BAILY. I wish I would have a few more weeks to see what the data looks like before making that decision. If it was this week or nothing, I would probably go ahead and do a fiscal stimulus. But if I had a chance to wait a week or two, get the package ready, negotiate and get the package ready, I would probably prefer to wait a week or two.

Chairman CONRAD. The problem here is very simple. We are running out of legislative time. No. 2, you have got to have a decision to go ahead before you get the negotiation on a package, and negotiation of something of this magnitude and this importance is going to take some time. A package of whatever amount—we are talking about tens of billions of dollars, potentially, maybe as much as $100 billion—that is not going to happen just overnight. It is going to take some time to work through the process.

So, in my judgment, a decision is going to have to be made quite soon, not necessarily this week, but pretty soon.

Mr. BAILY. Well, I think in that case, the risks are on the downside, and so I would go ahead. So I would support the stimulus package.

Chairman CONRAD. What level of additional stimulus do you believe would be required in a $10-trillion economy to have some impact?

Mr. BAILY. Well, remember that I said I think we have already done quite a bit, but I would think a $50 billion package would help.

Chairman CONRAD. All right. And if you were designing that $50 billion, how much would be spending? How much would be tax reduction?

Mr. BAILY. I think that we have already had a fairly substantial spending increase that has already been passed, so I would tend to put most of it on tax reduction of one kind or another.

Chairman CONRAD. All right.

Dr. Krueger, the same questions, I would put to you. Do we need stimulus, in your judgment? We are having to make a decision in the next week or so, next week or 10 days. What would be your decision? If you think stimulus is necessary, what level of stimulus would be important, in terms of making a difference in a $10 trillion economy, and what should the emphasis be on?

Mr. KRUEGER. Well, I concur that we do need stimulus and am quite sympathetic to the issue of timing. I think the sooner, the better. I think it makes a great deal of sense to agree upon a total amount, and as Glenn and Martin said, of course that total amount depends on the form. Not everyone has the same views of the form that spending should take. So you might think about a little bit larger than what is optimal under each person's plan, given that

there will be compromise and a number of elements which might not all go in the same direction.

So, given that, I would think something which is on the order of 1 percent of GDP or a little bit larger makes some sense.

Chairman CONRAD. So you would be in the $100 billion range?

Mr. KRUEGER. I would be in the $100 billion range, that is right, and I think it is important that it not affect the long-term budget position, as you emphasize. In terms of what form it takes, the spending or tax cuts, Martin hesitated, because I think that is not an easy answer for an economist to give. Of course, it depends on the details of the program, and to some extent it really does not matter. I mean, you could structure them in a way in which it has the same impact on the economy, so to us it is almost an arbitrary distinction.

Chairman CONRAD. Let me stop you there, because I tell you, I have got more doubt about the tax side now than I did before, and the reason is my observations of what people are doing, even with the rebate that I strongly favored that we put out there earlier, an awful lot of that did not get spent. I mean, if we have got a demand problem, how do you address that in the short-term? My initial inclination was putting money in people's pockets and companies quickly that would be spent. I tell you, after talking to people, I have less confidence that it is going to be spent.

I think people are sufficiently uncertain, because of layoffs, and companies are uncertain because of demand, that there is a hesitancy on the part of both to spend whatever we put out there in a tax cut, and it tells me that maybe we should be putting more emphasis on the spending side, to actually have that money be buying things to give stimulus at this time. I would just be interested in your reaction.

Mr. KRUEGER. Well, that is, in part, why I would turn to unemployment insurance first. The people who are receiving unemployment insurance need the income to survive.

Chairman CONRAD. And the money would be spent.

Mr. KRUEGER. I think it is clear that it would be spent, and studies have found that it is spent; even consumption of food, bare essentials, rises in family budgets, if they are eligible for unemployment insurance benefits, compared to other families that do not qualify. Now, one of the issues, which I am sure you understand, is that the previous tax cut was spread out probably to the middle income and above. A payroll tax cut would be focused more on lower-income families, which would probably have a higher marginal propensity to spend the money.

But I think, as Martin pointed out, also, the idea of a retail sales tax cut, a temporary sales tax cut, would probably give you the biggest bang for the buck in terms of consumer spending. There is some question in my mind—and I am a great fan of Alan Blinder's work—about whether that is the best—distributionally—best way of having a tax cut, as opposed to a payroll tax cut. In my prepared testimony, I gave one possible idea, which would be to exempt the first $5,000 of the Social Security payroll tax. That would be more broad-based, more like a rebate.

Chairman CONRAD. OK.

Senator Domenici.

Senator DOMENICI. Could I yield mine to Senator Grassley? He has been here a long time.

Chairman CONRAD.: Certainly.

Senator GRASSLEY. Well, our distinguished chairman asked two questions that I was interested in, and I appreciate very much the answers you gave, and I will not followup on those; but could I go to a point that Mr. Krueger made about—well, not a point you made, several points you made. But they all seemed to, if I listened and heard correctly, fall into fine-tuning or redefining existing programs. You are not suggesting any new spending programs or entitlement programs?

Mr. KRUEGER. Well, I think the unemployment insurance approach—that is obviously an existing program, and I think making that the first priority has a lot to be said for it. It could happen quickly. The spending naturally returns to a lower level after the economy returns, so in that sense it is temporary. It reaches people who are in great need. The payroll tax cut idea is—in some sense, that is a new program. It is a new way of structuring a current program, and I would also recommend doing it temporarily, not to affect the longer-term budget picture, but that is correct.

Senator GRASSLEY. OK. If you had—I got in late on your testimony, Dr. Baily, but if you were suggesting spending programs and you said you thought more ought to be on the tax side, but if you suggested any, you would be using existing machinery, not suggesting new programs; right?

Mr. BAILY. I think, in general, the one area that I did mention where I think there would be some benefit to spending, and I think you have to be careful if you are going to increase spending, you are not just doing it to create jobs; you are doing it in a way that is going to be constructive, and one area that I mentioned is in the health-care area. There are, after all, around 40 million people without health insurance. So if we were to expand the funds available to provide health insurance for families or children, that would, I think, help on the consumer confidence side, and I think that money would be spent and would be well-spent.

Senator GRASSLEY. Well, would you take into consideration that, for instance, under the existing CHIP program, families up to $35,000 can get help under that program for their children? Do you mean beyond that, or you would make efforts to make sure that all the children that are covered by that would actually be getting the program, which is not the case today?

Mr. BAILY.: Well, it is not the case today. I think the CHIP program is a good program, but it only goes partway to serving the uninsured. So expanding coverage through the CHIP program, and maybe allowing the parents to get coverage, and things of that sort——

Senator GRASSLEY. OK. And then could I go back to you, Dr. Krueger, about your point about the first step is to make sure that we do everything we can do to enhance confidence? What we have done thus far—my question is does this fall into the category of enhancing confidence and having good economic benefits from it—you know, like what we did for airlines, what we have done for the emergency expenditures because of the disaster in several different ways, in fact, in ways yet-undetermined, in the sense that there is

$40 billion out there and that only about six or 7 have been allotted, and also maybe airport security, the things we do along that line?

Mr. KRUEGER. Absolutely. The airline industry, I think, is quite unique, in that it was so directly affected by these horrible acts, and I think acting quickly on the airline industry made a great deal of sense. I think from here forward, looking at specific industries, kind of looking at the ripple of these events, is near-impossible to do in a very sensible way. It is very hard to distinguish the direct effects from kind of these ripple effects, and effects that were already in motion before September 11th. But I would certainly think that the actions that the Congress took already are helping to restore confidence.

Senator GRASSLEY. What you just said, on the difficulty of knowing how far to go, you really do not know where the last domino falls then.

Mr. KRUEGER. I think that is absolutely right. My own personal view is at the industry level, I would just stop where you have, and then turn more broadly.

Senator GRASSLEY. And then your point about maybe doing something with worker training programs, we already have 12 worker retraining programs. Would you suggest going beyond that, or maybe those that we have do not quite fit the needs?

Mr. KRUEGER. I do not think it is the number programs. I think it is the amount of money to train people in those programs.

Senator GRASSLEY. So using the existing programs and maybe making more resources available.

Mr. KRUEGER. Exactly. One of the things we have found—I have done quite a bit of research on job training. One of the things we found is that it is the group of workers that seems to benefit, that seems to be the real issue for whether job training works, rather than the specific nature of the training program. We have gone from CETA to JTPA, and now the Workforce Investment Act, and what really, I think, seems to hold up is that youth job training is very difficult to do unless it is something which is very expensive, like Job Corps. Job Corps does seem to work, but it is a very expensive program, and kind of more shallow programs for youth are not very effective.

On the other hand, when we look to adult workers, community colleges training, the training that was available in JTPA, seemed to have a reasonable return, and I think those are the kinds of workers who are going to be affected by the current downturn.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Corzine.

Senator CORZINE. Yes.

Professor Krueger, did you say $100 billion incremental, or were you saying including the packages we have already put together?

Mr. KRUEGER. I was intentionally vague when I answered that, so I did not say. I think $100 billion inclusive of what has already been spent is probably the minimum, and then I would say up to $150 billion. I do not know how much of the $40 billion that has already been allocated is going to have a stimulatory effect.

Senator CORZINE. There is a question, I guess, in economic theory about sort of rebuilding and paying for structure, about what kind of multiplier that kind of so-called investment would have in overall economic growth. I was curious; we have all talked about long-term rates seem to be high on people's minds. What kind of rise in long-term rates do we think we have to experience before it has meaningful impact on the economy? We are talking about a 25-basis point—or an order of 1 percent move so far in the timeframe that we have been talking about in September. Is that the kind of meaningful movement that you are talking about, or do we have to have one-or 2-percentage point moves to really undermine the kind of spending and tax proposals that are on table?

Mr. BAILY. Well, any increase in rates is going to have a small negative effect. I may try and give you, if I may, a written response to that. Since I am no longer the Chairman of the Council of Economic Advisers, I do not have a staff to get those answers prepared for me; but clearly 25 basis points is not going to do serious damage. But if we are talking about when we get to 50 basis points, then that does have an effect. If you think about how much even 25 basis points can do on mortgages, certainly 50 basis points on mortgages can make a difference. It makes a difference to the monthly payments, and therefore qualifying for a mortgage.

So I think an increase in interest rates does have an effect, a negative effect, on the economy.

Senator CORZINE. And so if we spent $100 billion, you are of the view—incremental dollars—you are of the view that we could erase that with less than a 1-percentage-point increase in interest rates? Is that the kind of tradeoff that we need to be making?

Mr. BAILY. The way I would think about it is at the moment we are in a situation where demand is weak, the interest rates are low, because people are looking at an economy where investment demand is low and where spending on consumer durables is low; and so the priority is to get money out there for people to spend, either with a tax cut or with the spending that we are doing, and that is the first priority. And I do not think we have to worry about interest rates over the next 6 months, because I think they are going to be low.

What we do have to be concerned about is that the things that we do now do not undermine where the budget is going to be 5 years from now or 10 years from now, because the markets—and you are expert on the markets much more so than I—they are going to look at that long-run projection for the budget and say, "OK, the 10-year rates, mortgage rates, 30-year rates, those are going to reflect, not what we do right now or at least only very slightly will they affect what we do right now; they will respond to what we do over the next five or 10 years."

Senator CORZINE. Let me ask—this is always an uncomfortable question—but if you were designing a stimulus program today, would you design it with the elimination of estate taxes and marginal movements of those in a period ahead? Would you move high marginal rates as a means to create stimulus? And I ask this in the context that 65 percent of the tax cut that we already implemented hits in 5 years and out, and one might argue that is relatively weak in its stimulative impact today. You could argue that

you need to accelerate it. That would be one step which I think Chairman Hubbard talked about, or you could talk about using that to protect our long-term fiscal stability by considering reexamining some elements of that and then investing that money in the short run. I just wonder if you all would have any commentary on that, with respect to our current sort of tradeoff of long-term fiscal stability, versus the need for, I think, a recognized stimulus program, generally accepted in people's minds today.

Mr. BAILY. I do not think that the estate tax—eliminating the estate tax or reducing estate taxes would do much for you in terms of short-term stimulus at all. The cuts in top time marginal income tax brackets would have some effect, but as I think I agree with where you are sort of heading on this, which is that the effect of those tax cuts is to undermine or to take a lot of revenue away from the outyears, and not have a huge effect in terms of short-term stimulus. So they are certainly not the things that I would choose as a way of stimulating the economy in the short-run. In fact, I would like us to revisit those tax cuts that were passed and say can we still afford them, given the long-run situation.

Mr. KRUEGER. I would add I agree with that completely. What everyone thought about the tax bill that passed previously, the new situation, I think, has to change one's view of it, and I think we are not in a current situation where changes in marginal rates are what is most important. I think what is most important is to maintain consumer confidence and to give people a reason to spend so that the economy does not go into a sharp contraction. My own personal view is that effects of marginal rates are a bit overrated by many economists. So I agree completely with Martin, that I think it is a good time to revisit the outyears in the tax cut; that, I think, would help the long-term bond rate. And I would focus more on ways to try to stimulate spending in the short-term.

Senator CORZINE. Thank you.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Thank you very much. Senator Clinton, do you have a schedule problem?

Senator CLINTON. No.

Senator DOMENICI. I will not take very long, anyway. Let me just talk about a couple of things with you and then ask you about two programs. First of all, it is a lot easier to discuss the kind of tax package one would put together when you are sitting at those tables and we are at this table in the middle of a recession, as compared with an economy that was booming, that looked as if, for some people, it had achieved a spiritual value such that it would never die. In the meantime, it did die, and now we are looking at how do we give the economy some stimulus to get back where it was and proceed at high productivity, low inflation, significant growth annually in the gross income of the country?

So, first, might I ask, are either of you concerned that when we get the economy going again, and surely, based on history, it will get going again, are you concerned that the economy will not be vested with this so-called new economy that everybody talked about, which, in fact, produced the qualities that I just enumerated?

Mr. BAILY. I have been a believer in the new economy. I think we had a new economy the 1990's, and new technologies contributed to faster productivity growth. I think those new technologies still have a lot to offer the economy, and so I think we can expect to see productivity growth going forward that was stronger than we had for 20 years, in the 1970's and 1980's. At the same time, I think there were some temporary factors in the 1990's, that we had really an investment boom of unusual magnitude, that probably is not going to last in quite the same way, and that contributed something to that productivity, both because of the making of the equipment and then the installing of the equipment.

So I have previously testified that I think we can expect a return to trend productivity growth of about 2 percent a year, and I think that it is a good number. It is a little bit slower than the late 1990's, but it is still a good number.

Senator DOMENICI. How do you feel, Dr. Krueger?

Mr. KRUEGER. I agree with that. I do not think that the current situation affects the long-run productivity growth prospects. I think the only sense in which it might is if long-term interest rates increase considerably. That reduces investment. Much of the technological change was conveyed through new equipment and so on, but, by and large, I do not think that this should be viewed as affecting the economy's long-term potential.

Senator DOMENICI. I want to talk about just two programs. I have heard the words "tax abatement" here today. I think you are the first to mention it, Dr. Baily. Is that thought of by you and by others who have put it in the marketplace these days, that you would do that for a short time and give the American consumer a real reason to spend, because they are going to get a good break?

Mr. BAILY. That was the idea, yes.

Senator DOMENICI.: Would you be thinking about that during a Christmas season, as you see it, or would you let the Christmas season do its own stimulating and do it at another time; just your thoughts?

Mr. BAILY. I think doing it for the Christmas season, or the holiday season more broadly, that there would be something to be said for that, yes.

Senator DOMENICI. What if we do that? How do we tell our people that it is fair, even though States have varying sales taxes, and I mean varying in a big way? Some still have four and some have 10.

Chairman CONRAD. Some have none.

Senator DOMENICI. So would you just address that for the record, please?

Mr. BAILY. I am not going to give you a very good answer on that, I am afraid. This is a proposal that I think needs to be looked at, but as I mentioned in my testimony, I think there are some logistical problems with doing it, given the range of State taxes. Remember my first choice was to give an income tax rebate like the one we had before, except to people who pay payroll taxes, as well as people who pay income taxes, so we do not miss people on that score.

Senator DOMENICI. Dr. Krueger?

Mr. KRUEGER. Well, I think one issue depends upon how big the tax cut is, and I do not think there are too many States that have zero sales tax rates, but what one could consider doing is some type of transfer to those States. One thing I would add about the retail tax cut, which is quite appealing, is State and local governments are also going to go through a budget crisis, and they can undo much of what goes on at the Federal level if they contract. The retail tax cut certainly helps, with the money being provided to the State governments—would help the financial position of the States.

Senator DOMENICI. Last, I want to just talk about the concept of loan guarantees in a recession, as compared with grants. It appears to me that there is a growing momentum to broaden the scope of what we ought to do for people that have been damaged because of the terrorists, and some people are saying what about all these businesses that went under? And I am sure somebody is introducing a bill, saying let's take care of them.

I have come up with the notion that if we are going to do any expanding of that type, that for purposes of good fiscal policy, we ought to get the biggest bang for the buck, and the littlest cost to the Treasury. And it seems to me loan guarantees at a good rate of interest, but rather long, would be a better way to do it than have a program that just bails people out or gives them money to make up their losses. Do either of you have a thought?

Dr. Krueger.

Mr. KRUEGER. Well, my initial reaction is that sounds like something well worth considering. I think one question is where would you draw the line?

Senator DOMENICI.: Yes, I understand.

Mr. KRUEGER.: And I think that is a difficult issue, but otherwise it seems to me——

Senator DOMENICI. But we are going to have the same issue if we agree to have grants. It is still going to be where do you draw the line.

Mr. KRUEGER.: That is correct.

Senator DOMENICI.: I am just assuming, before they get out with all those, that maybe somebody ought to expand the loan guarantee and let that take place under good management so it can go out and find out what the scope is and make some decisions on how they are going to cover people. I am going to make this suggestion, and I thank you both for your comments. I also thank you for taking of your time today. We are in an unordinary situation, in that we do not know yet who is going to put this package of stimulus together. Is it going to be the committees that have general jurisdiction in the area, or will it be put together by the White House and others?

In any event, I think we have more than a little reason to participate. If nothing else, we ought to bring to the table the criteria for which—about which we would agree here, bipartisan, that they ought to be looking at this injection of funds. The criteria should be certainly that you do not want to invest in a program just to take a simple, but profoundly wrong one, that said you are a claimant and we are going to help you, and do not worry, we are going to help you in the 10th year, so we have a program to help you in

the 10th year. I do that just to show how ludicrous we might be, because that is not imperative.

What is imperative is that you tell somebody that you are going to do something that is needed now and early next year, I would assume, and you all seem to be nodding on that, and I have not seen anything different from my chairman. I just hope we can have an impact on that.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Clinton.

Senator CLINTON. Thank you, Mr. Chairman. One of the challenges that I think we face is the new required assessment that we are undergoing that is, I guess, loosely referred to as homeland defense or homeland security. I do not believe we yet know what the costs will be. We have never faced anything quite like this.

There is a very long list of concerns that need to be addressed, whether it is protecting our water and food supplies, protecting our pipelines, protecting our energy infrastructure, protecting our transportation infrastructure. There is a very long list that I think rightly will demand our attention, and, in some respects, it will be long-term commitment. But I believe infrastructure spending will have to go up. I do not see any way around it, if we are going to be able to protect the American public to the extent we all want.

And this is probably an unfair question to ask you, because I am reminded by Senator Domenici's comments you are on that side of the table and we are on this side of the table. But what is the impact of infrastructure spending in terms of its stimulative effects and the speed at which it can be delivered, compared to simply tax-cutting stimulus? Is there any research or opinion that you could share with us on that?

Mr. BAILY. Well, I think you can get a tax cut out there more quickly. I guess the simple wisdom is that spending has a slightly bigger effect, because each dollar gets out there right away; it adds to GDP right away and then has some multiplier effect after that. Whereas, a tax cut, not all of it gets spent. So I think that was behind Chairman Conrad's view that maybe some of the stimulus should be geared toward the spending side. But, as I say, the offsetting thing there is to make sure that the money is well-spent and you can spend it quickly, and I think that is a little bit harder.

Now, in this particular case, there may be a lot of things that we know that we have to do, that we have to go out and do to improve our security, and so that may again affect the decision we make.

Mr. KRUEGER. I would also say I would draw a distinction between security and infrastructure spending, designed to try to improve economic growth in the future. For example, I do think that we have a big need in this country to spend more on schools. As much as I feel that need, I do not think that that is the answer to the current crisis, and especially when one thinks about construction. I think there is going to be a lot of construction, especially in the Northeast, and I think one concern I would have about certain types of infrastructure projects would be that they might lead to imbalances, might delay construction in some areas, for example. So I would just add that.

Senator CLINTON. One thing that would be helpful, because we are reading a lot in the press today about the Japanese experience with deflation, and I know we do not have the time left to really go into this in any depth. But could you briefly describe, first of all, what are the structural problems that they have been coping with for a decade without any real success, best we can tell, and what is it that is different about our experience and their experience, so that the fear that some economists are expressing, that we may be going into an entirely different economic situation, closer to deflation, closer to the Japanese experience, which would require different kinds of responses than what we are talking about if we think we are in a short-term slowdown or recession that we can work our way out of and get back into positive growth? I mean, how should we think about that?

Mr. BAILY. I believe we are in a very different situation than Japan. There is a similarity in that there is a wealth effect, so the decline in the stock market, and to the extent that that affects housing wealth, too, that is going to affect people's wealth and make them a bit more reluctant to spend. So we are seeing that in the U.S. economy, and that certainly was a part of the Japanese experience, and the loss of stock market wealth in Japan is much greater than anything we have seen here, and I hope we do not see that value, and they also had a collapse of their real estate market.

Beyond there, I think there are huge differences. First of all, they have never really tackled their financial institutions, and they continue to have problems with their financial institutions. I think many of their financial institutions are sort of on the verge of collapse, and they have never been able to face up to the bad loan problem, to deal with it, to try to close down some of the banks that needed to be closed down and to restore confidence in the financial sector.

Second, their labor market is much less flexible than the U.S. Americans are used to changing jobs, and it is not great to lose your job, but in the U.S., people, in some sense, the institutions are there, people move, people find new jobs. There is much more rigidity in the Japanese labor market. Their investment decisions traditionally were not made on the basis of profitability. They sort of expanded capacity without looking adequately at profitability.

Their industries—we know their sort of strong, competitive industries, the ones that we compete with, like autos and machine tools, but much of their economy was not very competitive, and, again, rather rigid. They have a rigid set of regulations, local regulations. So I would be reassuring in the sense of saying I think our economy is much better able to handle this kind of shock than is Japan's. So there is a little bit of similarity, but not that much.

Mr. KRUEGER. I would concur completely. I would also add to what Martin said. I think a number of the Japanese problems are microeconomic in nature. They just have a very different setup to their economy, and I think that makes it much less dynamic, much less able to adjust to new circumstances. Another big difference, I believe, is that the age structure is different. The Japanese population is older than the American population. They do not have very much of a pension system, and when interest rates drop, peo-

ple there seem to save quite a bit more. It does not seem to stimulate spending.

So I think we are in a different situation. Japan serves as a reminder that capitalist economists do not always grow and grow, but I would not go very far with the parallel.

Senator CLINTON. So you would not agree with those who suggest that the drop-off in consumer confidence and the underlying drop-off in demand that we started seeing a year or so ago, and in an accelerated way recently, is not any structural problem—it does not reflect a structural problem in the economy?

Mr. KRUEGER. Well, I would say actually what is quite remarkable is that consumer demand did not drop-off more in the U.S. in the last year, and I do think that consumer demand is a major concern, the major concern now, and I would think about elements of the stimulus package as trying to address consumer jitters, how do we restore confidence. But I do not think that we have a structural problem in terms of consumer demand.

Senator CLINTON. Is there any economic theory or experience which suggests—and I know this kind of runs counter to all the economic theory that I am aware of—but at some point there is a saturation, that demand just hits a wall, that people just cannot keep buying, they cannot keep going out there, because for whatever reasons, on a personal or social level, it is just not attractive to them anymore?

Mr. BAILY. I do not think so, in general, but I think the thing we did see, we had such a strong boom, both on the investment side, as well as on the consumer side, there was a sense in which we were kind of overspent, and so some of this downturn we have seen was a reaction to the fact that we had bought as many computers as we could possibly use, and that we bought as many SUVs as we could drive, and we were in for a correction.

I do not actually think there is a saturation point. I think Americans know how to spend. That is one thing we know how to do, and I think once we have sort of worked our way out of this downturn, we will get back. So I do not see it as a long-term structural problem. Can I also clarify, if you will give me 10 seconds, I made a comment earlier about sometimes I think consumer confidence is overrated as an indicator; and what I meant by that is not that I do not think consumer confidence is important. It is very important, but we measure it through a couple of surveys, the conference board and the Michigan survey, and those give us a window into consumer confidence. I do not think they are 100-percent reliable as to what consumers are actually going to do.

Chairman CONRAD. Very well. I would like to, just before we end, ask you about something that Secretary Bentsen told me when he was Secretary of the Treasury in the Clinton administration. He told me—we had lunch 1 day down at the Treasury, and he told me that they had done a calculation at the time, and he indicated that for every 1 percent reduction in interest rates, that took a debt load off the economy of roughly $120 billion. Have you ever made a calculation like that or been aware of a calculation done like that?

The point that he was making to me is the importance of fiscal responsibility to the functioning of the economy, and to the extent

that you maintain fiscal responsibility and lower interest rates, you actually give more lift to the economy than almost any tax cut that anybody is talking about, because in effect that is a tax cut, has the effect, has the stimulative effect of a tax cut. Have any of you ever done a calculation like that, or does it sound reasonable to you that a 1-percent difference in interest rates would mean that much in terms of less of a debt load on the economy?

Mr. BAILY. I think it is reasonable. I mean, we would talk—when I was in the administration, we certainly would talk about those calculations; and if you basically look at the size of the debt at how much interest is paid, and then you see how much a reduction in interest rate would do for you in terms of lowering the debt burden, that is the kind of number you come out with. So I think that is right.

Now, it just honestly compels me to point out that I am a big believer in fiscal discipline, but lower interest rates do cut two ways. There are people in our economy that receive interest, a lot of older people who are living on interest.

Chairman CONRAD. So there is a cross-cutting effect there?

Mr. BAILY. There is a cross-cutting effect there.

Chairman CONRAD. But, on balance, that lifting of debt burden——

Mr. BAILY. On balance, I think it is positive, yes.

Chairman CONRAD. Dr. Krueger.

Mr. KRUEGER. I would just add there certainly is this mechanical help that the budget has because of lower interest payments in the future. I suspect, however, that the big boost that we got from lower interest rates in the early 1990's would not be the same today. Some of that came from consumer refinance of mortgages. A lot of that has taken place already. We were also starting from higher interest rates than where we are currently. So I would suspect that the number is probably smaller today.

Senator CLINTON. Mr. Chairman, could I just ask one other sort of speculative question? I mean, I support the chairman's continuing concern about fiscal responsibility and discipline for the long-run, and we are in a position now where this additional stimulus, whatever it is, $50 billion to $100 billion, is certainly going to push us back into deficits. I mean, there is no—I do not think—any way around it; is there? Am I mistaken? So this time next year, we are running a deficit. OK. What then?

Assume that we go forward with this stimulus—I have less confidence, frankly, that this stimulus at this time, given the mood in the country, is going to do what people hope it will do. So we put it out there holiday season, whatever it is we decide to do, and see what happens. But we know one thing that will happen, we will be back in deficits. Then what? How do you see us recovering back to the extent of moving toward fiscal responsibility again, trying to deal with our long-term problems? Do you have any final thoughts on that?

Mr. KRUEGER. Yes, I think your diagnosis is right. I have two responses to it, and it is a lot easier for me to respond from this table; one is to revisit the tax cuts that have already been enacted, especially the bit cuts in the outyears. The second, which is even easier to say from this side than the other side, is to look at some

of the entitlement programs, and to look at Medicare, maybe. And, looking at the long-term budget, Medicare, I think, is a much bigger concern than Social Security. How do we restrain the growth in cost of Medicare, yet provide sufficient protection for the elderly for health-care risks?

Mr. BAILY. Well, I think as long as the economy recovers, and I am optimistic that it will, not in the very short run, but over the next year I think it will recover, because I think the fundamentals of the economy are strong, then I think we have choices again. But I have said what Alan said. I agree with what Alan said. We should revisit those tax cuts and see if we can still afford them, because the budget arithmetic has changed.

Chairman CONRAD. Maybe I can just go to that question as we end here. We have been working, actually since the morning after the attack, on reassessing our situation and where we are headed; and in many ways this chart sums up where I think we are. And what this chart does is it looks at our trust funds, it looks at the revisions that have been made to defense spending, and to the rebuilding effort. It looks at the airline assistance package, other disaster aid that we have done in previous years. It extends the expiring tax provisions. It looks at the other budget resolution policies that have not yet been enacted, but were in the budget that was passed earlier this year by both houses of Congress. It looks at a possible $60 billion tax and spending stimulus for 2002. It looks at an economic adjustment, because we have a sharper downturn than was earlier forecast.[21]

So it looks at all of those changes, and then it looks at, not only the effect on 2001, but 2002 out to 2011, and the conclusion is very sobering. Now, not only do we see—you know, we have got substantial red ink in this year and next year, and, in fact, that we would be in deficit next year—on a unified basis, we would be in deficit. But also it shows that we would be using, over this 10-year period, $373 billion of payroll taxes for Medicare to fund other government programs, and almost $1 trillion of Social Security payroll taxes to fund other government operations, for a total of $1.3 trillion being used—of payroll taxes—to fund other government operations.

This is much more than a short-term dip. This is a very fundamental change in policy, taking money from people on the basis that it is used to pay benefits and secure the future of those programs, and then taking substantial amounts of it and using it to fund tax cuts and other government programs. To me, this is something that requires our very serious attention as we move forward.

Clearly, we have got to do whatever it takes now in the short-term to defend this Nation. Obviously, that is a long-term concern, as well. But the immediate, urgent need is for these additional defense dollars, to do whatever it takes to defend ourselves, to take the attack to those who have perpetrated criminal acts on this country, to rebuild. But we have also got to keep our eye on the ball, on the long-term fiscal condition of the country. These are my calculations, and I am happy to stand by them and have my credibility attached to them.

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[21] CHART NOT AVAILABLE AT PRESS TIME.

I believe we have a very serious long-term problem here. I believe it is totally inappropriate, in the long-term, to be taking payroll tax money and using it for other purposes, especially in light of the fact the baby boomers start to retire in 10 years. I do not know if you would want to react to that, and again I am not attributing these numbers to anybody else. These are numbers that I believe are in the ballpark of what we face, but I would just be interested in your observations.

Mr. BAILY. Well, I basically agree with you. I think that we do have a long-run fiscal problem, which is the baby boom generation, Medicare and Social Security. So the long-run fiscal situation of the U.S. is not good. I think even now we are borrowing from oversees substantially, so that is another sign that we are spending or consuming more than we are producing. So for all those reasons, I think it is important to increase national saving and not to decrease it; and that is why saving those Social Security surpluses, or even running additional surpluses, is helpful for our economy and will stand us in better stead going forward. If we can pay down the debt, we will be in a much better position to deal with the baby boom generation. So I agree with you.

Chairman CONRAD. Dr. Krueger.

Mr. KRUEGER. Well, I agree, also. I think one thing which your chart demonstrates is how variable and unpredictable our budget forecasts are, and I think it is important to bear that in mind when we do budgeting. One small point I would make, though——

Chairman CONRAD. I might just stop you on that point and say, you know, I do not know how many times I tried to warn our colleagues, how many times I put up that fan chart from the Congressional Budget Office about the uncertainty of the forecast that we were using when we were writing the previous budget. I must have used that chart 50 times here in this committee, on the floor of the Senate, in the Finance Committee, because I used to be responsible for forecasting the revenue of my State, and I used to have to forecast for 30 months, and I knew how uncertain those forecasts are.

You are talking about 10 years. It is so uncertain, and just very small changes now make huge differences over time. That is what we are seeing now. So, unfortunately, I believe the budget policy we put in place earlier this year was fatally flawed when it was done. I thought the tax cut—while I supported a significant tax cut, I thought the one that we put in place was simply unaffordable. It was too large. It was too risky, and I think that has all proven to be the case, unfortunately. None of that helps us now.

We have got to go back to the drawing boards and reconsider previous actions in every part of the budget, and think very carefully about their implications for the economy now. This is not just a matter of some green eyeshade concept of, gee, it is important to maintain integrity of trust funds. Absolutely, that is important, but it has a much bigger significance, and that is the effect on the economy.

Dr. Krueger, you had additional thoughts.

Mr. KRUEGER. Well, I had trouble seeing the exact numbers, although I could tell that some of them were red long-out. One small comment I was going to recommend is to try to scale them by GDP, which might make the situation look at little bit less dire. But I

wanted to conclude by saying I was on CNN last week, and they asked, "Well, what do you see as the bright? What is on the positive side?"

And I think there are some things on the positive side. One of the things on the positive side is that we entered this year with a surplus, and the fiscal discipline in the past has put us in a much better position to handle this kind of crisis than where we were before.

Chairman CONRAD. Hopefully, there is a lesson in that going forward; that fiscal discipline in the past really paid enormous dividends now. My God, can you imagine the situation we would have been in if we had not gotten our fiscal house in order by the actions we took in 1993 and 1997? If we had not taken those actions, what kind of circumstance we would be in today?

Mr. KRUEGER. We would certainly be looking at a lot more red. The second issue I would raise on the positive side is that the Federal Reserve Board had already started lowering rates, and the effect of interest rates on the economy take place with a lag. So that was already in motion, which is positive, and I think another thing that is positive is the Congress is acting quite quickly to respond to the current economic downturn.

In the past, the problem with stimulus packages has been that they are enacted after the economy has already begun to recover, and I think that the Congress is to be commended for taking such quick action in this case.

Chairman CONRAD.: Thank you very much. Thank you, again, for being here. Thank you for your patience. Thank you for all of the effort and energy you put into your remarks here today. We appreciate it very much.

[Whereupon, at 12:30 p.m., the committee was adjourned.]

ECONOMIC STIMULUS

THURSDAY, OCTOBER 25, 2001

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee convened, pursuant to notice, at 9 o'clock a.m., in room S–211, United States Capitol, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Nelson, Stabenow, Clinton, Corzine, Domenici, and Hagel.

Staff present: Mary Ann Naylor, Chief of Staff and Chief Counsel; and Bill Hoagland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The committee will come to order.

These early morning starts are very unlike the Senate.

I want to thank our witnesses especially for being here today for this hearing on the question of an economic stimulus.

This morning in The Washington Post business section, there is a headline that reads: "Economic Rebound is Weak, Fed Finds." In the article, what they are reporting is that the "beige book" which the Fed puts out has noted economic weakness across the country, a deepening weakness since the attack of September 11.

The Fed notes very clearly that there was weakness before the attack. We all know that that was occurring. If we look at the civilian unemployment rate, which is a good indicator, we had seen that that ticked up substantially in August, and it was at the same rate in September, at 4.9 percent. I think we all anticipate that when the October data is available to us, we will see another surge in unemployment.

On another measure, if we look at economic growth, we see that there was already developing weakness before the events of September 11. As we look at the quarter-by-quarter results, we can see that 2000 ended on a fairly weak note, and in 2001, we saw continued decline. And in fact we are seeing virtually no growth by the third quarter.

So the circumstance we faced was one in which we had a weakening economy before September 11th; September 11th has been another blow to the strength of the economy, and that is why we have an important discussion about what we could do by way of fiscal policy to stimulate the economy. And that is really what this hearing is about.

Noting that we face this problem, the leaders of the Budget Committee, Republicans and Democrats, from the House and the Sen-

ate got together and in early October issued a statement of principles to use in measuring any stimulus package. This was bipartisan and bicameral. It involved not only the Senate and House Budget Committee leadership on the Democratic side but on the Republican side as well.

We issued this statement of principles, and I would like to just briefly review them. The overall principal—"that an economic stimulus package should be based on the recognition that long-term fiscal discipline is essential to sustained economic growth. Measures to stimulate the economy should be limited in time so that as the economy recovers, the budget regains a surplus that is at least equal to the surplus in Social Security. Any short-term economic stimulus should not result in higher long-term interest rates."

"Objective—An economic stimulus package should restore consumer and business confidence, increase employment and investment, and help those most vulnerable in an economic downturn, and do all of the above without converting a cyclical deficit into a structural deficit."

"Timing—Congress should assemble an economic stimulus package deliberately but with dispatch, aiming for passage within 3 to 4 weeks, based on the best economic data available."

We issued this on October 4th.

"Rapid impact—A substantial portion of the fiscal impact on the economy should be felt within 6 months."

"Sunset—All economic stimulus proposals should sunset within 1 year to the extent practicable."

"Targets—Economic stimulus should be broad-based rather than industry-specific. Policies should achieve the greatest possible stimulus effect per dollar spent and should be directed to individuals who are most likely to spend the additional after-tax income and businesses most likely to increase investment spending and employment."

"Size—The economic stimulus package should equal approximately 1 percent of GDP, roughly $100 billion, but should count the budgetary effects of policies implemented since August which at present total roughly $40 billion."

"Offsets—To uphold the policy of repaying the greatest amount of national debt feasible between 2002 and 2011, outyear offsets should make up over time for the cost of near-term economic stimulus."

Let me repeat again. This was the statement of principles agreed to in a bipartisan manner by the Chairman of the House Budget Committee, Congressman Nussle; by the ranking member of the House Budget Committee, Congressman Spratt; by myself and Senator Domenici, the ranking member of the Budget Committee here. So it was completely bipartisan, bicameral, and it was an agreement that we were able to reach without rancor and without even a raised voice. That is truly remarkable in this town.

I think those principles are the correct principles to judge any stimulus package.

We are going to have a hearing this morning, and we have three very distinguished witnesses. The ranking member is joining us, and I am going to give him a moment to collect his thoughts. We

would like to hear from him if he is ready; if not, we will turn to our colleague from New Jersey for a statement.

Would you like a moment, Senator Domenici?

Senator DOMENICI. No. I have a 9:15 meeting with the Republican Leader and about seven Senators. I am going to go there, and I would very much like to inquire of our witnesses, so I will come back as soon as that is finished. If not, I will give you a prepared statement. Nice to see you.

Chairman CONRAD. Thank you very much. It is good to be with Senator Domenici as always; and as he has indicated, he will come back to inquire and make whatever statement he feels appropriate at that time.

Given our numbers this morning, I will turn to my colleague from New Jersey and ask if he would like to make any opening comment.

Senator CORZINE. First of all, I have a statement that I will put in the record, Mr. Chairman. I very much appreciate you holding the hearing, because I do not think there is an issue that seemingly is going to draw out more debate. Where we are generally in agreement on our national security and homeland defense issues, there is certainly a wide difference of views being debated with respect to a stimulus package, and I think having the kind of light shed that this hearing will hopefully bring on this subject is important.

I agree with the principles that you and the leadership have talked about. I guess I would only add that in a situation where the economy has great risk of being weak, that we already understand probably even prior to September 11th, it strikes me that we ought to be erring on the side of proactive, aggressive actions, maybe slightly larger than we otherwise might take, to ensure economic growth; but I think that ought to be done in the context of temporary, and I think most of the kinds of principles that you outlined are very, very important.

So I look forward to having a dialog with our friends from the economic field, and let's move forward.

I will just submit my written statement for the record.

Chairman CONRAD. Very well. Thank you very much.

Chairman CONRAD. This morning, we have three distinguished witnesses—Dr. Gale, Dr. Orszag, and Dr. Hassett. We welcome all of you.

We will start with Dr. Gale, who is Senior Fellow in the Economic Studies Program at the Brookings Institution. His areas of expertise include tax policy, budget and fiscal policy, public and private savings behavior, pensions, and intergenerational transfers of wealth.

So, Dr. Gale, you come with the right background to discuss the issues we have before us when we are considering a stimulus package.

Welcome, and please proceed.

STATEMENT OF WILLIAM GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. GALE. Thank you very much, Mr. Chairman, Senator Corzine.

Before I start to discuss the economics of this, let me just say that I applaud the choice to actually have this hearing and to move forward in the face of the threats that are all around us. I think it is exactly the right thing to do, to continue moving forward.

Turning to the economics of the situation, I want to basically lay out a few principles and then talk about how that applies to the current situation. Then, I want to suggest in particular an innovative way of designing a temporary investment incentive that has not been discussed so far.

I think the right place to start is the economic and budget outlook. Currently, we face a slowing short-term economy, but there is no argument that long-term prospects are still good. Everyone seems to feel that the economy's long-term strengths are intact.

In contrast, the long-term budget situation has deteriorated rapidly. Based on data in the bipartisan bicameral statement that the chairman referred to, the 10-year budget surplus outside of Social Security appears to have shrunk by about $3 trillion in the last 6 months. It was $3.1 trillion in May, and based on my estimates from the bipartisan bicameral statement, it is less than $100 billion and probably around $50 billion now. That is the non-Social Security surplus over the next 10 years if Congress does nothing else.

The bipartisan statement listed a whole series of consensus or likely spending and tax packages that are likely to move through. If those are enacted, the non-Social Security surplus is negative $1.5 trillion over the next 10 years; thus, we have a deficit of $1.5 trillion over the next 10 years even if there is no stimulus package.

So the economic and the budget outlook suggests that we want a short-term boost, and we want to minimize the long-term cost. As my colleague, Peter Orszag, and I have written, this goal should be to maximize the bang for the buck; that is, we should get the most short-term boost for the least long-term cost.

To do that, we want to do four things. One is encourage new household spending; the second is encourage new business investment. Both of those increase aggregate demand; the short-run economic problem is a demand problem, not a supply problem.

The third thing we want to do is minimize long-term costs, and the fourth thing we want to do is keep all of the provisions temporary.

Let me add that these principles are quite similar to those endorsed by what I wrote in my testimony is a remarkable bipartisan statement by the Democratic and Republican leaders of the Senate and House Budget Committees. The only difference between what I am saying and the bipartisan statement is a matter of emphasis. Basically, the principles that Peter and I have laid out in the work that we have and that I am talking about now are completely consistent with what the bipartisan statement says.

Let me emphasize a couple of aspects of that. One is that minimizing long-term costs serves both short-term and long-term purposes. In the short term, lower budget costs translate into smaller boosts in interest rates.

There is a big debate in the economic profession about how big this effect is. The point I would like to emphasize, though, is that regardless of the impact on interest rates, a bigger stimulus pack-

age will result in a bigger budget deficit, and that will exacerbate a long-term budget situation. That is, even if there is no effect on interest rates—and I do not think there is no effect; I think there is a positive effect, but that is a judgment—even if there is no effect, we are still digging our way rapidly into a long-term budget problem.

I mentioned the potential deficit over the next 10 years. Of course, the next 10 to 15 years are supposed to be the good times, and then, things turn around in 2015 in a serious way when the boomers start retiring. So if we do not accumulate surpluses in the next 10 years, the long-term situation is that much worse regardless of the impact on interest rates.

Keeping all items temporary is critical for several reasons. First, it raises the bang for the buck. Temporary business incentives typically have larger short-run impacts than permanent incentives, for the same reason that a store that has a sale for a weekend will likely have more sales that weekend than a store that permanently cuts its prices. In the store example, people know that if they do not come in that weekend, they do not get the benefit of the sale. Likewise, with a temporary provision, firms know that if they do not invest within the time horizon, they will not get the subsidy.

Research by many scholars—Alan Auerbach at Berkeley, Andrew Able at University of Pennsylvania, Ken Judd at Stanford, Glen Hubbard, with the Council of Economic Advisers, and my colleague and co-witness here, Kevin Hoist—have provided evidence that temporary incentives typically have as big and often bigger short-term impacts than long-term incentives.

Besides that, the temporary incentives also have a smaller long-term cost, so if the short-term effect is as big or bigger, and the long-term cost is lower, a temporary incentive has to be a better short-term stimulus and have a bigger bang for the buck than a permanent incentive.

Let me turn to two other issues, in particular the design of a temporary incentive.

The House bill that just passed has a partial expensing for 3 years. There are three problems with that provision which can briefly be categorized into the beginning, the middle, and the end.

The problem with the beginning is that firms often do not know when the subsidy will kick in, so they might actually delay investments right now to be sure that any investments they make are made after the qualifying date. That is an easy problem to solve. Congress can just announce that any action that is taken will be effective date "X" or September 11th, for example. So that problem can be minimized.

The second problem with the House provision is that it is too long. Three years is a long time. We do not need to be encouraging investment in 2004 right now. We need to be encouraging investment now or in 2002, and the temporary sale effect that I was talking about that comes into effect at the end of the provision would get firms to move investment from 2005 to 2004—but that is not what we want to do. We want to get them to move it from then into 2002 or 2001.

So I think the temporary provision—the length of the provision should be shortened.

The third issue is that when you have a temporary investment incentive, and you turn it off at the end, you have raised the price of investment, and that causes two things. One, it causes investment to shrink then; and second, it causes firms to lobby Congress to extend the provision.

So we have all these temporary expiring provisions in the tax code right now that get extended every time they expire.

I would like to propose a way to deal with both of those last two problems, and that is to first shorten the time period for partial expensing for 15 months—that is, end it at the end of 2002. And second, adopt a sliding scale for the subsidy; so give a 50 percent write-off for investments made between now and the end of the calendar year, 40 percent for investments made in the first quarter of next year, 30 percent in the second quarter, down to 10 percent in the fourth quarter of 2002, and then turn it off.

That does two things. One, it encourages firms to invest now rather than waiting until the end of 2002 to shift up their investments; and second, by ratcheting the subsidy down, Congress both shows its credibility in making this a one-time effect—that is, we are cutting the subsidy—and Congress is minimizing the air pocket at the end, because at the end, you are just turning off the subsidy from 10 percent to zero. That is not all that big, and it is much less than turning off from 30 percent to zero.

So I think that shortening the time horizon and adopting a sliding scale would get you more investment and get you more investment now and would make it more likely that the investment would stay as a temporary subsidy.

The reason this is particularly important is that the decline in investment right now seems to be that firms are taking projects that they were going to do, and they are putting them on the shelf. It is not that firms have to design new projects and get them invested—that takes time, and if that were the problem, we would need 3 years. But right now, there are studies out that show that a lot of firms are just delaying the investment that they had already planned to undertake.

So if you can get firms to actually go ahead and make those investments instead of putting them off, that will provide an investment boost. That is the reason to give the big incentive now and to taper it off at the end.

Let me conclude with just a couple of other issues regarding a stimulus package.

I do not want to comment on the magnitude of the economic downturn. I am not a macroeconomic specialist; I am a tax specialist. But I will say that whatever the magnitude of the short-term problem, it is worth noting that a lot of stimulus has already been provided—the $40 billion in rebates; the $40 billion in spending for defense, rescue and recovery; the airline bailout; the Federal Reserve has cut interest rates nine times and several hundred basis points since the beginning of the year; and even if Congress does nothing, there is another $70 billion in tax cuts coming as of this coming fiscal year because of the tax cut enacted last spring.

So there already is a lot of stimulus in the pipeline. This is not necessarily an argument to do nothing, but it is an argument to say that whatever we do should be shaped by the economic and

budget outlook that we face, and the stimulus that is already in the pipeline is a crucial element to that.

Let me stop there, and I would be happy to take questions.

Chairman CONRAD. Thank you very much, Mr. Gale.

[The prepared statement of Mr. Gale follows:]

Perspectives on the Tax Stimulus Debate

Testimony submitted to:

Committee on the Budget
United States Senate

October 17, 2001

William Gale*

*Joseph A. Pechman Fellow, Brookings Institution. This testimony is based largely on recent analyses undertaken with Peter Orszag and Gene Sperling, but the views expressed herein are solely my own and should not be attributed to the staff, officers, trustees of the Brookings Institution. I thank Samara Potter for exceptional research assistance.

October 17, 2001

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present my views on the tax stimulus issues currently facing the Congress. Congress faces several key issues: whether to provide a stimulus; the size of any stimulus package; the composition between spending and tax cuts; and the design of the spending and tax cuts. This testimony focuses mainly on the most effective design and the potential impact of tax cuts.

The Economic and Budget Outlook

If a stimulus package is desired and if tax elements are a part of the package, the tax elements should be designed with the current economic and budget outlook in mind. The short-term economic outlook is uncertain, as the terrorist attack on September 11, 2001 having disrupted the workings of an already slowing economy. Despite the short-term uncertainty, there is widespread agreement that long-term economic prospects remain strong.

In contrast, the long-term budget outlook has deteriorated rapidly. Based on data from a recent bi-partisan statement from the Senate and House Budget Committees, the 10-year baseline budget surplus outside of social security appears to have shrunk by about $3 trillion (or 98 percent) since May, and currently stands at just $50-$100 billion, not counting any stimulus package or any other new proposals that Congress may wish to consider over the next decade.[1] Reasonable allowances for new spending that is widely supported (including defense, education, and prescription drugs) the extension of expiring tax provisions, and providing a fix for the AMT puts the non-social security budget in deficit to the tune of about $1.5 trillion over the next decade.

Principles for Design of an Economic Stimulus

Because the economic outlook suggests the possible need for a short-term boost, while the budget outlook suggests that the long-run revenue impact of any stimulus should be limited, the key guiding principle for a stimulus package, should be to maximize the "bang for the buck." That is, the goal should be to get the most short-term boost at the least long-term cost. To achieve these goals, policy makers should focus on provisions that:

- Encourage new household spending.
- Encourage new business investment.
- Minimizes long-term costs
- Are temporary—that is, expire within about one year.

[1] For further analysis, see Appendix A, "The Changing Budget Outlook: Causes and Implications."

These principles are quite similar to those endorsed in a remarkable bi-partisan statement by the Democratic and Republican leaders of the Senate and House Budget Committees earlier this month.[2] The principles represent sound policy in a number of key dimensions.

New household spending and new business investment provide direct stimulus to the economy. In contrast, raising household saving would reduce current aggregate demand. Likewise, subsidizing investments made in the past (and currently showing up as corporate income) does not provide any stimulus. To state what may be obvious, making tax cuts retroactive to before September 11, 2001, not only has no benefit whatsoever in stimulating the economy, it is plainly wasteful.

Minimizing the long-term costs serves both short-term and long-term purposes. In the short-term, lower budget costs translate into smaller boosts in interest rates. Increases in interest rates would serve to reduce business investment, housing purchases, and other interest-sensitive consumption and thus would choke off part or all of the direct effect of any stimulus package. Minimizing the revenue costs is also important for the long-term, *even if government budgets have no effect on interest rates*. It is clear that the underlying fiscal situation has changed dramatically over the past six months. Whatever one thought of the affordability of the tax cut last spring, it is evident that the nation now has to devote substantial resources to fighting terrorism over the next decade. The deteriorating budget outlook means that, after resolving the stimulus debate, policy makers will need to rethink the long-term fiscal picture and thus should not do anything now that will make the long-term situation significantly worse.

Keeping all items temporary is critical for several reasons. First, it raises the bang-for-the-buck. Temporary business incentives typically have larger short-run impacts that permanent incentives, and cost much less. Temporary household tax cuts may have somewhat smaller short-term impacts than permanent cuts given to the same people. Even so, the bang-for-the-buck for temporary household cuts is likely to be much larger than for permanent cuts, since temporary cuts cost much less. Second, focusing on temporary items is equitable (why should some groups receive permanent tax cuts as part of stimulus package, while others receive only temporary tax cuts?). Third, focusing on temporary cuts reduces the likelihood of enacting permanent changes that are not related to economic stimulus and that may not be good tax policy in any case.[3]

It is also worth emphasizing that stimulus can be provided via new government spending on purchases of goods and services or via increased government transfer payments, such as unemployment insurance.

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[2] "Revised Budgetary Outlook and Principles for Economic Stimulus," Senate Budget Committee (Senator Kent Conrad, Chairman; Senator Pete K. Domenici, Ranking Member) and House Budget Committee (Rep. Jim Nussle, Chairman; Rep. john M. Spratt, Jr., Ranking Member), October 4, 2001.

[3] These issues are discussed in depth in Appendix B, "Why the Stimulus Package Should Contain Only Temporary Items" and Appendix C, "Stimulating the economy through tax policy: principles and applications."

Applications to proposals for household tax cuts[4]

A rebate to low- and middle-income households would be the most effective way to provide a tax stimulus. These households are more likely to spend any new income than high-income households are. The rebate checks this summer do not appear to have generated much in the way of new spending, perhaps because they were not targeted to low-income households.

Accelerating the previously enacted tax cuts is a poor way to provide stimulus. Most of the costs occur in years beyond 2002, when most commentators believe the economy will already have recovered. Almost all of the benefits go to higher-income households, who are less likely to spend the funds. The proposed accelerations would be expensive relative to the stimulus "budgets" proposed by President Bush, Fed Chairman Greenspan, and former Treasury Secretary Rubin. Finally, enacting the previously enacted tax cuts will have the effect of locking in a tax cut whose wisdom will need to be re-examined in the near future, in light of the substantial deterioration in the budget.

Capital gains tax cuts are at best an inefficient way to stimulate the economy in the short-turn, and could well be counterproductive. Capital gains tax cuts are usually advocated on the grounds that they will stimulate saving and long-term growth, not a short-term consumer spending boost.

Applications to proposals for business tax cuts

Temporary incentives for new business investment (e.g, accelerated depreciation or an investment tax credit) are the business tax cuts most consistent with the principles listed above. These tax cuts target new economic activity and, given their temporary nature, they would have a bigger short-term impact and a smaller long-term cost than permanent incentives.

Corporate tax cuts are, in general, a poor way to stimulate the economy. Almost all of the funds would go to providing windfalls to current corporate income, which is the return to old investment, rather than giving incentives to new investment.

Repeal of the corporate alternative minimum tax is mainly a subsidy to old investments, and even advocates of repeal have shown that it would generate virtually no stimulus in the first two years of its existence.[5] Even if the AMT is repealed, there is no reason why such a repeal should be retroactive, as discussed above.

Temporary expansion of the carryback provision for net operating losses is also mainly a subsidy to old investments. It is different from corporate tax rate cuts or AMT repeal, however, in that expanding the lookback provisions is better targeted to helping firms that are currently losing money.

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[4] For further analysis of both individual and business tax policies, see Appendix C, "Stimulating the economy through tax policy: principles and applications."

[5] See "The Case for AMT Repeal,," American Council on Capital Formation, 1996. The paper estimates that aggregate investment would rise by just $2 billion (in 2001 dollars) in the first year of complete repeal and by less than $5 billion in the second year.

Issues in the design of a temporary investment incentive

Although temporary investment incentives are much more appropriate than permanent incentives for stimulus purposes, temporary tax cuts raise a number of issues worth considering in detail and applying to the current situation.

First, the historical record suggests that it is difficult to time fiscal interventions accurately and that past interventions have destabilized rather than stabilized investment flows over the business cycle. In addition, *discussion* of temporary incentives by policy makers may create a decline in investment before the incentives come into existence, as firms wait to see when the incentives will take effect. For both of these reasons, Congress should announce immediately that any investment incentives that are eventually included in a stimulus package would be apply to investments made as of today (or as of September 11, 2001).

Second, temporary incentives may also create a decline in investment after they expire. This may create demand for extending the expiring provision, which adds uncertainty to the tax system. But if it is known (or suspected) that Congress will extend the incentive when it expires, then the temporary incentive loses some of its appeal. A third problem is if temporary incentives are placed to stay in operation for too long, they will provide little incentive to invest *now*, when the investment is most needed. For example, the 3-year period for partial expensing passed by the House Ways and Means Committee is much too long. It provides little reason for firms to invest more now, and gives them plenty of reason to hold off for a year or two to gauge the economic landscape before investing. Casual evidence suggests that businesses are putting off projects they already had in the works, and the immediate goal should be to encourage businesses to undertake those projects in the immediate future, not 2-3 years from now.

To address the second and third problems, Congress should (a) shorten the time period for partial expensing to 15 months and (b) adopt a sliding scale for the amount of the investment that can be partially expensed. Suppose, for example, that Congress stipulated that firms making qualifying investments could write off 50 percent of expenses immediately, if the investment is made before the end of calendar year 2001, 40 percent if made in the first quarter of 2002, 30 percent if made in the second quarter, 20 percent if made in the third quarter, and 10 percent if made in the fourth quarter of 2002. This would focus firms on making new investments now, rather than delaying. And by phasing down the expensing portion slowly over time, Congress would make much more credible its intention to keep the incentive temporary.

Other issues regarding a stimulus package

At least three additional issues bear on choosing the magnitude and nature of any tax stimulus program. The first, of course, is the likely depth and duration of the current economic decline. As a specialist in public finance issues, I will leave macroeconomic forecasts to the experts in that field.

Second, whatever the magnitude of the short-term problem, it is worth noting that a significant amount of economic stimulus has already been provided, including $40 billion in rebates during the summer, $40 billion in spending for defense, rescue and recovery, and the

airline bailout. In addition, the federal reserve has cut interest rates 9 times and by several hundred basis points since the beginning of the year. More stimulus is on the way, even if Congress does nothing. The tax cut passed last spring provides for about $70 billion in individual tax cuts during fiscal 2002.

Third, it would be appropriate to be realistic about the likely economic impact of the tax stimulus proposals being discussed. A rebate to households of, say, $20 billion, would only amount to 0.2 percent of GDP in stimulus even if the entire amount were spent, which seems unlikely. The proposed 30 percent partial expensing of new investments would reduce the user cost of capital by about 4.5 percent. Applying investment elasticities of between –1/3 and –2/3 suggests that investment in equipment and software would rise between 0.15 percent and 0.30 percent of GDP. The effect may be even more limited during times like the present—when firms already have significant cash-on-hand and significant excess capacity.

Appendix A: The Changing Budget Outlook: Causes and Implications

William Gale, Peter Orszag, and Gene Sperling[1]
October 11, 2001

After more than twenty-five years of deficits, the federal budget began to show cash-flow surpluses in the late 1990s. By May 2001, the official baseline projections even suggested that the publicly held debt would be eliminated over the coming decade. To be sure, the longer-term deficits in Social Security and Medicare were clouds on the fiscal horizon, and the methodology used to construct the official projections continued to exaggerate the likely surpluses. Nevertheless, as of spring 2001, the short- and medium-term budget outlook was relatively auspicious.

A scant five months later, the situation has deteriorated dramatically. The rapid and substantial deterioration in the budget outlook has important implications for both short- and long-term policy debates. This paper examines these changes, their causes, and some implications. Our main findings are as follows:

The budget outlook

- The projected unified surplus for fiscal year 2001 fell from $275 billion in May to $121 billion in October.[2]

- In May, the projected unified surplus for fiscal years 2002 to 2011 was $5.6 trillion, including $3.1 trillion outside of the Social Security Trust Fund. By October, those figures had fallen to $2.6 trillion, and about $50 billion, respectively. In other words, *virtually the entire projected non-Social Security surplus for the coming decade had disappeared by the time the decade was a week old.*

- A realistic budget assessment is even more pessimistic than these official figures suggest. The official figures omit the effects of any new stimulus package Congress may enact after the beginning of October, other items for which Congress has expressed strong support, a series of adjustments that generate more realistic baseline projections, and the long-term deficits in Social Security and Medicare.

Causes

- The tax legislation enacted earlier this year accounts for the majority (55 percent) of the deterioration in the 10-year official outlook over the last six months. The response to the terrorist attacks and the slowing economy have also played significant roles.

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[1] William Gale is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution. Peter Orszag is Senior Fellow in Economic Studies at the Brookings Institution. Gene Sperling is Visiting Fellow in Economic Studies at the Brookings Institution, and served as chief economic advisor to President Clinton.

[2] See Congressional Budget Office, *Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May, 2001, table 3, and Congressional Budget Office, *Monthly Budget Review*, Fiscal Year 2001, September 26, 2001.

Implications

- The long-run revenue impact of stimulus policies should be limited. This would reduce any adverse impact on interest rates.[3] But *even in the absence of an interest rate effect*, stimulus policies with significant long-term revenue costs could do substantial damage to long-term budget discipline, especially since the non-Social Security surplus is already virtually zero over the next 10 years.

- The ability to use the previously accrued surplus to finance emergency war efforts underscores the wisdom of having accumulated surpluses in the first place as a cushion against unexpected events.

- Under the current crisis circumstances, the bi-partisan Congressional agreement not to use Social Security and Medicare trust fund surpluses to finance current spending or tax cuts has sensibly been set aside to pay for the war. But the longer-term budgetary challenges facing the nation have only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential.

- The underlying fiscal situation has changed dramatically. Policy-makers need to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled or at all.

I. Evolution of the budget baseline

In estimates published by the Congressional Budget Office in May, the projected unified budget surplus was $5.6 trillion for the next 10 years (Table 1). That figure fell to $3.4 trillion in the CBO estimates released in August, and then to $2.6 trillion in a bi-partisan estimate released on October 4 by the House and Senate Budget Committees (hereafter referred to as the "October baseline").

Because the Social Security Trust Fund has been relatively unaffected by these changes, the changes in the rest of the budget have been proportionally much larger. The 10-year non-Social Security surplus has virtually disappeared, falling from $3.1 trillion in May to $846 billion in August and to $53 billion by October.[4] Under the October baseline projection, the non-Social Security budget is expected to run a deficit of $370 billion over the next five years, with deficits of about $125 billion projected for 2002 and for 2003.

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[3] See William Gale, Peter Orszag, and Gene Sperling, "Stimulating the Economy Through Tax Policy: Principles and Applications," http://www.brook.edu/views/papers/gale/20011005.htm and "Tax Stimulus Options in the Aftermath of the Terrorist Attack," http://www.brook.edu/views/articles/gale/20011008.htm, or *Tax Notes*, October 8, 2001.

[4] The "non-Social Security" balance is slightly different from the "on-budget" balance because the latter excludes the Postal Service in addition to Social Security. The August projection for the on-budget surplus between 2002 and 2011, for example, was $847 billion – slightly larger than the projection for the non-Social Security surplus. Our estimate of the non-Social Security surplus in the October baseline is predicated on the assumption that the projected Social Security surplus did not change from the August to the October baseline.

What accounts for these changes? The vast majority of the decline from May to August is due to the tax cut enacted last spring. The tax cut was estimated to reduce revenues between 2002 and 2011 by $1.275 trillion, and create interest costs of $383 billion.[5] The total cost of the tax cut—$1.658 trillion—accounts for almost three-quarters of the deterioration in the projected surplus through August. Changes in economic and technical assumptions explained slightly more than 20 percent of the reduction between May and August, and increases in government spending (plus their interest costs) had a very small effect (5 percent of the total deterioration).

It is worth emphasizing that the budget situation had deteriorated substantially even before the terrorist attacks on September 11. The combination of the tax cut, the slowing economy and small changes in discretionary spending were sufficient to reduce the overall 10-year surplus by $2.2 trillion, and push the non-Social Security baseline budget into a deficit of $10 billion for 2001, with deficits also projected for 2003 and 2004.

The terrorist attack implies a further deterioration in the federal budget outlook for three reasons. First, in the short run, the federal government has already committed substantial resources to defense, rescue, and recovery efforts, as well as the airline bailout, and additional stimulus measures seem likely. Second, the attack seems likely to have slowed the economy, which would result in lower revenue and higher spending. Third, the longer-term policy response to the attacks is likely to involve changes in the nature and level of government spending.

The vast majority of the decline in the 10-year budget projection from August to early October -- which does not incorporate the tax cuts that have been proposed as part of an additional stimulus package -- is due to increased spending since the attacks. This spending includes additional defense expenditures, the projected cost of an emergency anti-terrorism bill that was passed, and assistance for the airline industry. The rest of the decline in the projected surplus since August is due to economic and technical adjustments, mostly reflecting the slowdown in the economy.

All told, the tax cut accounted for 55 percent of the change between May and October, the spending response to the terrorist attack accounted for 21 percent, economic and technical changes accounted for 20 percent, and new discretionary spending not related to the attacks accounted for just 4 percent (see Table 2).

II. Adjusting the baseline

The Congressional Budget Office is careful to point out that its budget baseline reflects one definition of continuing "current policy" into the future. The baseline is in no way intended to be a prediction of *likely* budget outcomes.[6] To obtain a more reasonable measure of likely budget outcomes, one must consider additional items. For example, the October 4 budget committee estimates include a list of "consensus" items and others that have been passed by one or both Houses of Congress, but that have not been enacted into law and therefore are not

[5] We obtained this estimate using the Congressional Budget Office's interest rate matrix.
[6] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January, 2001, p. 5.

reflected in the official forecasts. The budgetary implications of passing these items are shown in Table 3. They total an additional $1.5 trillion in reduced surpluses, inclusive of interest payments.

If just those items were enacted—and no other changes were made—the unified budget surplus would fall to $1.1 trillion over the next decade. The non-Social Security surplus would be in *deficit* to the tune of $1.4 trillion, and the budget aside from Social Security and Medicare's Part A trust fund, which Congress has voted in the past not to invade, would face a deficit of $1.85 trillion. The balance outside all the retirement trust funds would be a deficit of $2.3 trillion.[7]

III. The budget outlook beyond the next decade

The Social Security and Medicare trust fund balances and projected revenues fall far short of what would be needed to meet future liabilities under current policy. This longer-term imbalance is temporarily masked by the asymmetry in unified budget accounting practices that counts assets for these programs but not liabilities. Placing the assets off-budget – which would cause the projected surplus over the next ten years to become negative – represents an improvement, but still ignores the fact that the accruing assets are insufficient to finance the projected liabilities. An alternative way of recognizing these entitlement liabilities is to extend the planning horizon, to include the future years in which the liabilities come due and thus can no longer be ignored, even under the cash accounting method.

The use of long-term planning horizons is now standard for Social Security and Medicare. In the context of an aging population and rapidly rising medical care expenditures, such a long-term horizon is the only way to get an accurate picture of the fiscal balance of these programs, and hence the government's budget as a whole. To take these and other factors into account, analysts have estimated the long-term "fiscal gap" under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a share of GDP) that would be required now to keep the long-term ratio of government debt to GDP at its current level. Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio will not explode. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

Last fall, the CBO estimated a fiscal gap of 0.8 percent of GDP through 2070.[8] Long-term estimates are subject to considerable uncertainty, and their precise magnitudes are less

[7] Government pension funds for military and civilian workers are structured similarly to Medicare and Social Security in that the pensions represent obligations that are accruing to current workers. The pension trust fund is currently running surpluses in the on-budget portion of the budget of about $469 billion over the next decade. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August, 2001, table 1-9.

[8] Congressional Budget Office, *The Long-Term Budget Outlook*, October, 2000, table 5. Auerbach and Gale (2001) extend the CBO analysis and estimate a permanent fiscal gap -- what would be needed to prevent the national debt from exploding in the long run, rather than just through 2070 – of 3.33 percent of GDP. The permanent gap is so much larger because the budget is projected to be in substantial deficit during the years approaching 2070 (and those that follow). See Alan J. Auerbach and William G. Gale, "Tax Cuts and the Budget Outlook," Policy Brief No. 76, Brookings, April 2001.

important than the fact that the nation does face long-term budget pressures. Fundamentally, long-term estimates are inherently uncertain – and even more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues. Indeed, the serious consequences of a relatively bad long-term outcome should spur policymakers to take precautions now. Also, note that the sources of uncertainty differ in the long and short runs. Over the next ten years, the primary factor affecting surpluses will be the economy. Over the longer term, the demographic pressures of an aging population will play a more important role, although economic performance will remain relevant. The magnitude of this demographic shift is uncertain, but its occurrence is not.[9]

IV. Implications

The analysis above has several immediate policy implications. First, the budget outlook suggests that the long-run revenue impact of stimulus policies should be limited. Partly because the budget situation has already deteriorated so rapidly, a stimulus package with substantial long-term revenue costs could do more harm than good by raising interest rates, which would restrain business and housing investment and interest-sensitive consumption. But even in the absence of any effect on interest rates, tax cuts with significant long-term revenue losses would do significant damage to the long-term budget outlook.

Second, the rapid deterioration of the budget projections over the past six months underscores the benefits of surpluses as a cushion against unexpected events. The budget surpluses of the late 1990s meant that the nation was much better positioned to meet the costs of the recent terrorist attacks and the economic slowdown than otherwise would have been the case. As Ari Fleischer, President Bush's press secretary, has noted, the nation was fortunate to enter this period having money available from the surplus to work fighting terrorism and reinvigorating the economy.[10] The benefits of preserving projected surpluses for unexpected contingencies have been highlighted by recent events.

Third, under the current crisis circumstances, the Social Security "lock-box" (as well as the Medicare "lock-box") has sensibly been set aside. That is a necessary step right now, to pay for the war. But the longer-term budgetary challenges facing the nation have, if anything, only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential. The primary way to reduce the future burdens imposed by Social Security, Medicare, and other government programs is to raise national saving, which is the sum of government saving and private saving. Budget surpluses, which represent government saving, are one of the most auspicious approaches to raising national saving. The key point is that policy-makers must re-establish some guiding principle for budget discipline, as has been provided by the Social Security lock-box over the past few years. Indeed, the October 4 bi-partisan Congressional statement sets the goal of restoring the Social Security lock-box.

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[9] Because the CBO estimate is based on budget projections from last fall, the estimated fiscal gap would be even larger if the budget revisions since then were included.

[10] See Richard Stevenson, "In Rapid Shift, a Budget Surplus Is Expected to Turn Into a Deficit," *New York Times*, October 1, 2001, page A1.

Fourth, the budget outlook is affected by the need to respond to the terrorist attacks. There is significant talk now of a return to bigger, more active government. The first few weeks after the attacks showed new government initiatives for defense, rescue and recovery spending, an airline bailout, a push for new federal authority to regulate airport security, and expanded powers of law enforcement. All of these items have budgetary implications.

Finally, whatever one's view of the affordability of the tax package enacted last spring, it was passed before the nation realized it would need to finance a new war. After "the dust has settled" on the first round of stimulus packages, and the policy debate turns to focusing on longer-term issues, it will be clear that the underlying fiscal situation has changed dramatically – as the analysis above highlights. Policy-makers will therefore have to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled.

The potential savings from freezing parts of the tax cut are substantial. According to the Joint Committee on Taxation, for example, just freezing the 38.6 marginal tax rate would save roughly $100 billion between 2002 and 2011 (excluding debt service savings).[11] Such a freeze would not represent a change relative to current law until 2004, well after the nation's short-term economic challenges are likely to have passed. It would also affect only 1.1 million taxpayers, who have an average adjusted gross income of $1.025 million. Even those high-income taxpayers would only forgo a future marginal tax cut, rather than experiencing a tax increase relative to today's rates, and would still enjoy a reduction in average tax rates (since the tax rates applying at lower levels of income would decline). More expansive freezes of the tax cut will likely be necessary to preserve fiscal discipline over the longer term.

[11] Letter from Bernard Schmitt, Joint Committee on Taxation, to Senator Barbara Boxer, September 4, 2001. The Joint Committee estimate applies specifically to the projected cost of reducing the 38.6 percent rate to 35 percent, given the tax code prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001. The savings from freezing the 38.6 percent rate at this point may be somewhat smaller than this estimate, since other provisions of that Act interact with the marginal tax rate revenue effects.

Table 1
The Changing Baseline Budget: May, August, October 2001

($ Billions)

Ten-Year Baseline Budget Surplus, 2002-2011

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001[1]	5629	2485	3144	2751
August 2001[2]	3397	2551	846	442
October 2001[3]	2604	2551	53	-351

Five-Year Baseline Budget Surplus, 2002-2006

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001[1]	2002	1020	982	782
August 2001[2]	1082	1036	46	-162
October 2001[3]	666	1036	-370	-578

[1]Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001.
[2]Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001.
[3]House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001.

Table 2
Sources of Change in the Unified Budget Baseline, 2002-2011
May, August, October 2001

($ Billions)
[Percent of Change]*

	May-August		August-October		May-October	
Economic and Technical Changes	-460	[20.6]	-144	[18.2]	-604	[20.0]
Legislative Changes						
Tax Act						
Revenue Loss	-1275	[57.1]	0	[0]	-1275	[42.1]
Debt Service	-383	[17.2]	0	[0]	-383	[12.7]
Subtotal	-1658	[74.3]	0	[0]	-1658	[54.8]
Outlays						
New Spending	-83	[3.7]	-413	[52.1]	-496	[16.4]
Debt Service**	-34	[1.5]	-236	[29.8]	-270	[8.9]
Subtotal	-117	[5.2]	-649	[81.8]	-766	[25.3]
Total Change in Surplus	-2232	[100.0]	-793	[100.0]	-3025	[100.0]

*Percentages may not sum to 100 due to rounding.
**For the August-October changes, this may include debt service on economic and technical changes.

Sources: Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001. House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001, and authors' calculations using the CBO interest rate matrix.

Table 3
Implications of Other Possible Claims on the Budget, 2002-2011
as of October 2001

($ Billions)

	Cost	Remaining Surplus/Deficit
October 2001 Baseline Unified Surplus	-	2604
- Social Security Trust Fund	2551	53
Other Possible Claims on the Budget		
- Budget resolution policies[1]	67	-14
- Budget Resolution Reserve Fund policies[2]	431	-445
- House- and Senate-passed bills[3]	225	-670
- Natural disasters	55	-725
- Permanent extension of expiring tax provisions	142	-867
- Elimination of EGTRRA sunsets	113	-980
- Alternative Minimum Tax	208	-1188
- Debt Service on Possible Claims	258	-1446
- Medicare (Part A) Trust Fund	404	-1850
- Government pensions	469	-2319

[1]One-year extension of tax provisions expiring in 2001; veterans programs; other revenue policies; all other resolution policies.
[2]Prescription drugs; farm bill; expanded health coverage; Home Health, student loans, Family Opportunity Act.
[3]Faith-based initiative (House-passed); railroad retirement (House-passed); energy (House-passed); Patients Bill of Rights (Senate-passed); elementary and secondary education (Senate-passed).

Sources: House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001, and authors' calculations using the CBO interest rate matrix.

Appendix B:
Why the current stimulus package should have only temporary items

William Gale and Peter Orszag[1]
October 9, 2001

In the wake of the terrorist attack on September 11, Congress and the Administration are debating the best way to stimulate the economy through spending and tax changes. The general principle that a stimulus package should include only temporary items—that is, items that sunset after one year—has been endorsed by the Democratic and Republican leaders of the House and Senate Budget Committees.[2] In contrast, the Administration has proposed a series of options that would be permanent for firms and long-lasting (up to four years) for high-income individuals, but only temporary for low-income households. This note offers seven reasons why the most effective stimulus package would contain only temporary changes to tax or spending programs.

1. The economy is in a short-term downturn; long-run prospects remain strong.

The nature of the problem at hand is that the economy is experiencing a jolt, or temporary slowdown, and needs to return to its long-term course. No one is suggesting that the long-term course has been significantly altered from its previous path or that it should be. As Alan Greenspan noted in Congressional testimony on September 20, "as we struggle to make sense of our profound loss and its immediate consequences for the economy, we must not lose sight of our longer-run prospects, which have not been significantly diminished by these terrible events."[3] Thus, the right policy response would aim to get the economy back on its long-term path. It is hard to see why a temporary problem merits a permanent solution.

2. The best stimulus would generate the most new activity, at the least long-term cost.

The best way to stimulate the economy is to maximize the "bang for the buck" of any proposed policy change. The "bang" is the impact on the economy in the near term and should be maximized; the "buck" is the long-term cost of the policy and should be minimized. Policies that maximize the bang for the buck (a) focus on new household spending (such as through a household tax rebate) or (b) new business investment (such as through investment tax credits for new investment and/or accelerated depreciation of new investment). As the next two points indicate, temporary policies are a rare policy two-fer: they can have a bigger short-term effect and a smaller cost than permanent policies.

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[1] William Gale and Peter Orszag are senior fellows in the economic studies program at the Brookings Institution.

[2] "Revised Budgetary Outlook and Principles for Economic Stimulus," Senate Budget Committee (Senator Kent Conrad, Chairman; Senator Pete V. Domenici, Ranking Member) and House Budget Committee (Rep. Jim Nussle, Chairman; Rep. John M.Spratt, Jr., Ranking Member), October 4, 2001.

[3] Alan Greenspan, "The Condition of the Financial Markets," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 20, 2001.

3. Temporary policies can have a bigger "bang" than permanent policies.

Temporary investment incentives are generally considered more effective for short-term stimulus than permanent ones. The temporary incentives lead firms to substitute investment into the period in which it enjoys a larger tax benefit. This point is not controversial. It is endorsed, for example, by Glenn Hubbard, the Chair of the President's Council of Economic Advisers. In a paper he co-authored with Kevin Hassett, Hubbard argued that, "Temporary investment incentives can have even larger short-run impacts on investment than permanent investment incentives..."[4]

4. Temporary items reduce revenues by less than permanent items.

This has two important implications. First, it means that a temporary incentive will have a smaller impact on long-term interest rates. That is important because any increase in interest rates created by a stimulus package would hurt investment, the stock market, housing, and other sectors of the economy, and thus offset some of the direct effects of the stimulus. Second, for any given overall cost and therefore any given impact on interest rates, a longer-term package will be less efficient in generating stimulus in the short run than a temporary one, since more of its incentives are loaded for a period well beyond the likely downturn and therefore less is devoted to the immediate period.

5. Focusing on temporary changes limits the potential inequities that may occur.

The Administration, for example, would like to give permanent tax cuts to businesses, long-lasting ones (up to four years) for high-income households, but only temporary one-year cuts for low-income households. These patterns are difficult to justify on equity grounds.

6. Focusing on temporary changes limits the potential dangers from inappropriate policies.

Allowing some permanent tax or spending changes opens the door to consideration of a wider array of permanent changes that have little or no stimulative effect. It is much more straightforward to limit the stimulus package to temporary items than to evaluate the costs and benefits of a wide array of potential permanent changes. Policy-makers should not divert attention from more immediate needs in order to debate the merits of various permanent changes in taxes or spending programs, when temporary changes are likely to be more stimulative in any case.

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[4] Kevin Hassett and R. Glenn Hubbard, "Tax Policy and Investment," in Alan J. Auerbach, Fiscal Policy: Lessons from Economic Research, MIT Press, 1997, p. 369. Hassett and Hubbard also note that policy-makers have difficulty effectively timing the applications of fiscal stimulus, and therefore argue that a temporary investment incentive could be applied at an inappropriate moment. That concern, however, raises questions about the Administration's support for investment incentives as part of it short-run stimulus package, rather than about the choice of a permanent versus temporary incentive as a stimulus tool. After all, a putative permanent investment incentive would begin at the same time as a temporary one would. From the point of view of stimulating the economy in the short run, the key question is which one would produce a larger effect over the next year or so.

7. Focusing on temporary changes avoids misleading or dishonest budget calculations.

The Administration has been proposing permanent changes but only reporting the one- or two-year costs. For example, eliminating the corporate alternative minimum tax would reduce revenue over the next 10 years by approximately $18 billion.[5] It is possible, however, that the Administration will want to count only the costs in the first year or two in determining the overall stimulus "budget." Limiting the stimulus package to temporary changes in tax or spending programs increases the chances that the accounting of the package will be transparent.

The conclusion, as both the Chairman and Ranking Members of the House Budget Committee and the Senate Budget Committee have emphasized, is that any stimulus package should contain only temporary items.

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[5] Heidi Glenn and Warren Rojas, "Column A, Column B: Washington Orders Up $50-$75 Billion Stimulus," *Tax Notes*, October 8, 2001, page 170.

Appendix C: Stimulating the Economy Through Tax Policy: Principles and Applications[1]

William Gale, Peter Orszag, and Gene Sperling

October 5, 2001

Congressional and Administration leaders are now examining the appropriate fiscal policy response to the recent terrorist attacks. Since the attack, the Federal Reserve has provided liquidity to financial markets, and has reduced its key lending rate twice, by a total of 100 basis points. Congress and the President agreed on a $40 billion spending package for defense, rescue and rebuilding efforts, and an airline bailout of $5 billion, plus additional loan guarantees.

The key short-term fiscal issues are whether additional stimulus proposals would help and what form assistance should take. Spending initiatives aimed at quickly stimulating the economy–including the rapid clean-up and rebuilding of New York City and efforts to attenuate the costs of economic slowdown–will likely form part of any stimulus package. Tax cut proposals, however, have now taken center stage in the debate.

This paper focuses on the stimulus potential of alternative tax cuts. We do not address whether a stimulus *should* be provided. Rather, we examine the principles that will lead to the most effective tax stimulus, should policy makers choose this path, and then examine some recent proposals in light of those principles.

The most effective stimulus proposal would maximize its "bang for the buck." That is, it would direct as much of the tax cuts as possible to stimulating new consumer spending and/or new business investment in the short run; and it would do the least possible damage to long-term fiscal prospects and hence minimize any upward pressure on interest rates. Temporary rebates to individuals and temporary business subsidies for new investment fit these principles. A package with substantial long-term revenue costs, on the other hand, could do as much harm as good: It would raise interest rates, which would offset much of the direct benefits of any stimulus by reducing business and housing investment, as well as consumption that is affected by interest rates or stock market values. Many of the stimulus proposals currently being considered do little or nothing to address the need to stimulate the economy in the short-run, and would exacerbate long-term fiscal problems. Proposals to cut tax rates on capital gains or on corporate income are particularly problematic along these dimensions. Such proposals may be worth discussing in other contexts, but they clearly represent the wrong policy response at the current time.

I. Principles

The appropriateness and effectiveness of a tax stimulus depends on the underlying economic outlook—to indicate what is needed—and the budget outlook—to indicate the

[1] This article will be supplemented periodically as new tax proposals are discussed in the policy arena. For further detail on these issues, see William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," Tax Notes, October 8, 2001.

financial constraints. The terrorist attack disrupted the workings of an already weakening economy, and many economists believe it pushed the economy into a recession. But the economy's long-term prospects remain strong. The 10-year budget outlook, which was relatively auspicious at the beginning of the year, has deteriorated rapidly due to the tax cut enacted this spring, the weakening of the economy before the terrorist attack, and the further weakening of the economy after the attack. The economic outlook thus suggests the need for policies that stimulate the economy in the short run. The budget outlook suggests that the long-run revenue impact of stimulus policies should be limited, so as to avoid exacerbating the nation's long-term fiscal challenges, which would raise interest rates and undermine the effectiveness of the stimulus. This reasoning suggests five principles for designing the most effective tax stimulus package. The first two relate to keeping the package focused on stimulating new behavior. The last three relate to maintaining budget discipline.

- Structure any business tax incentives to encourage new investment, not to provide a windfall for previous investment. This includes *temporary* provisions to provide accelerated depreciation, expensing, or tax credits for new investments in the near future.

- Design any household tax reductions to maximize effect on demand. Tax cuts should therefore be focused on low- and middle-income households who tend to have a higher propensity to spend out of their income than do high-income households. Timing any new tax cut for households to coincide with the holiday season may be an effective way to encourage it to be spent.

- Allow only temporary items. This will limit the long-term cost of the package and reduce the temptation for policy-makers to try to push through long-standing proposals that may or may not have merit for other reasons, but do little or nothing to stimulate the economy in the short run.

- Set an overall stimulus budget first. This will further reduce the likelihood of a run-away, "Christmas tree" spending and tax package. Fed Chairman Alan Greenspan and former Treasury Secretary Robert Rubin recently suggested a "budget" for the stimulus of $100 billion, including those items that have already been enacted since the attacks, and therefore new stimulus of roughly $50 billion. Subsequently, President Bush advocated new stimulus of $60 to $75 billion. (There appears to be some confusion as to the meaning of the overall stimulus ceiling. In our opinion, the overall stimulus budget should include all stimulus legislation proposed and enacted since September 11. It should cover all stimulus costs, as estimated by the Congressional Budget Office and Joint Committee on Taxation, over the next ten years.)

- Minimize the long-term costs. Combining short-term stimulus with long-term fiscal discipline provides more stimulative impetus to the economy than a stimulus package alone, since it restrains any increase in interest rates that could undermine the effectiveness of the stimulus.

II. Tax cuts for households

Another rebate for consumers

Declines in consumer confidence, spending, and employment have led to calls for a second round of consumer rebates to directly bolster consumer demand. Economic research suggests that households tend to immediately spend between 20 percent and 70 percent of any temporary income tax cuts they receive. Although it is too soon to fully evaluate the impact of the rebate checks distributed this summer, the checks appear to be generating only a small increase in consumption. In August, personal after-tax income rose by 1.9 percent, in significant part due to the rebate, but personal spending only rose by 0.2 percent. A survey undertaken by the University of Michigan in August and September found that only 19 percent of respondents said that they were going to spend their rebates.

To make another round of rebates more effective as a stimulus, policy-makers could target the rebates to lower and middle income households. Economic research suggests that these households have tendencies to spend a greater proportion of any new income than high-income households do – and the more the rebate is spent, the more effective it is as a stimulus. Furthermore, roughly 30 million lower and moderate income households did not receive a rebate earlier this year, even though they pay federal payroll and excise taxes. To better target such households, the rebates should be based on employee Social Security and Medicare payroll taxes. (Although the rebate would be *based* on payroll taxes, it should be financed through general revenues.) To maximize the stimulative impact and minimize administrative hassles, the rebates could be set as one amount for anyone with earnings in calendar year 2000 over a minimum level.

Another way to stimulate the spending potential of any rebate may be to time the rebate checks for the holiday shopping season. Holiday purchases of presents for friends and family are highly seasonal. Intuitively, putting more resources in the hands of lower- and moderate-income families during the holiday season seems likely to bolster the volume of shopping during the holiday season. Vendors -- who have already experienced one rebate round -- may now be particularly astute about marketing sales and deals based on the rebates.

Accelerate the previously legislated tax cuts

Another proposal for household tax cuts is to accelerate to January 1, 2002 the income tax rate cuts -- or some portion thereof -- currently scheduled to occur on January 1, 2004 and January 1, 2006. This proposal is problematic for several reasons.

First, and most importantly for its stimulative impact, the acceleration is not well-targeted to generating additional spending in the short run. The vast majority of the costs of accelerating the rate reductions would occur after 2002: The acceleration would also reduce revenue in 2003, 2004, 2005, and 2006. Since most of the cost would *not* go to providing stimulus in 2002, when it is needed most, the proposal does not maximize its bang-for-the-buck. A temporary one-year tax cut would generate the same stimulus in 2002 at much less cost. (There is also a good chance that, when any accelerated tax cuts become operative in years between 2003 and 2006, the

economy will already be growing rapidly. Thus, the proposal could very likely fall prey to the familiar pattern of the federal government's stimulating the economy at times when it does not need to be stimulated.)

Furthermore, the accelerated rate cuts would only apply to high-income households -- those who are in the top 25 percent of the income distribution. Most taxpayers are in the 15 percent bracket. The tax rate cut for such taxpayers has already been implemented through the addition of a new 10 percent bracket at income of up to $12,000 for married couples, and no further changes are scheduled before 2008. The majority of taxpayers would thus receive no benefit from the accelerated rate reduction. As noted above, the marginal propensity to consume income among the higher-income group who *would* benefit from the acceleration is below that of lower- and moderate-income groups. Since most of the cost would occur after 2002, and since the amounts that would flow to individuals in 2002 would be concentrated among those with relatively low propensities to consume, accelerating the tax cuts would have a low bang-for-the-buck.

The proposal has two other shortcomings. First, the equity of giving tax cuts to those in the highest-income groups, while ignoring those in lower-income groups (who are most likely to be the ones losing their jobs in a downturn), is questionable. Second, preliminary estimates suggest that accelerating the rate cuts would "bust the stimulus budget" figures noted by the President, Chairman Greenspan, and former Secretary Rubin.

In terms of longer-run considerations, accelerating the rate cuts would have the political effect of helping to lock in further tax rate cuts for the highest-income taxpayers. Yet in the near future, Americans will need to reconsider such further reductions in tax rates for high-income taxpayers, as the economic and budget outlook after the terrorist attack and the current slowdown become clearer. Regardless of one's views about whether the tax cut passed last spring was sound fiscal policy at that time, it is clear that the nation's finances are now much worse off than they were then. Careful consideration will have to be given to the policy adjustments necessary to maintain a sound long-term fiscal position (particularly in light of ongoing anti-terrorism costs).

III. Business tax cuts

Incentives for new business investment

An alternative set of proposals would aim to stimulate business investment. This could include an investment tax credit or accelerated depreciation schedules (or expensing, a form of accelerated depreciation) for new investments. Of the business-oriented tax proposals currently under discussion, such temporary investment incentives are the most consistent with the principles delineated above. These incentives would provide a relatively strong bang-for-the-buck because they are targeted on new investments and because they are temporary, thus minimizing the impact on interest rates. As discussed below, these features place them in sharp contrast to corporate income tax rate cuts.

It is important that any investment incentives be temporary for four reasons. First, making the incentive temporary would encourage firms to shift investments into 2002 – and therefore maximize the stimulus effect in 2002. Second, a temporary incentive involves significantly lower budgetary cost – and therefore less harmful pressure on interest rates – than a permanent incentive. Third, the costs and benefits of permanent tax incentives for investment are complicated, and debate over whether such permanent incentives would be advisable would divert policy-makers from the immediate task at hand. Finally, allowing permanent investment incentives would open the door to other permanent components of the stimulus package, which would undermine its effectiveness.

The precise form of a temporary investment incentive should reflect administrative and other issues. For example, some practitioners believe that accelerated depreciation or partial expensing may be slightly easier to implement than an investment tax credit. Moreover, whatever their form, it is also important to note that such incentives are not fool-proof. Their impact on investment may be limited, especially when firms already have significant cash-on-hand, there is excess capacity, and aggregate demand is falling. The various concerns should serve to reduce expectations about the impact of temporary incentives for business investment. None of them suggest, however, that either a permanent incentive for investment or a corporate tax rate cut would be more effective as a stimulus.

Corporate tax rate cuts

Some commentators and business leaders are advocating reductions in the tax rate on corporate income as the best method for stimulating the economy. Advocates claim the tax cut would raise stock market values (thereby stimulating consumer spending), reduce costs of goods to households, and increase investment. A corporate tax rate cut, however, is ill-suited to address the nation's short-run economic challenges.

A corporate tax rate cut is a poor stimulus for three reasons. First, it is an inefficient way to stimulate new investment because it provides a windfall to the income earned on investments made in previous years. Firms would benefit if they are profitable, even if they are making no current investments or are reducing their current investments. Second, the corporate tax rate cut provides little, if any, immediate assistance to firms that are currently facing losses and therefore are not currently paying corporate income taxes. These are, however, the firms that are disproportionately in need of assistance during the downturn. Third, permanent reductions in corporate tax rates are expensive – a 10 percentage point decline in the corporate tax rate reduces projected surpluses by about $900 billion over the next decade, including about $700 billion in tax revenue losses and $200 billion in additional interest on the public debt. This decline in the surplus would put upward pressure on long-term interest rates, which in turn would erode most or direct positive effects of a corporate tax cut on the stock market and on new investment.

Some have claimed that cutting the corporate rate would raise stock values and thus stimulate consumer spending. This chain of reasoning is problematic for several reasons. First, even if it were valid, the corporate tax rate cut would imply a very small short-term stimulus relative to its long-term cost. Our estimates suggest that consumption would rise by $36 billion to $60 billion in the next year, or between 4 and 7 percent of the 10-year cost if interest rates did

not adjust. Other tax reductions noted above could achieve a much larger short-term stimulus per dollar spent.

As noted above, however, the decline in the surplus would raise interest rates. Separate estimates of the relationship between the budget and interest rates by President Clinton's Council of Economic Advisers (CEA) and Harvard Professor Martin Feldstein (chairman of the CEA under Ronald Reagan) imply that the cut in corporate tax rates would cause interest rates to rise sufficiently to wipe out almost all of the stock market effect claimed by advocates, and hence also eliminate almost all the effect on consumer spending.

A second claim is that the tax cuts would be immediately passed along to consumers in the form of lower prices for goods and services. But most evidence suggests that the corporate tax is borne by owners of capital in general or owners of corporate capital, not by consumers. In addition, recall that firms that are currently losing money do not pay corporate income taxes. Thus, if savings were passed to consumers, survival would become even more difficult for those firms already hit hardest by recent events.

A third claim is that corporate tax rate cuts would raise investment by reducing the cost of capital investment. This argument is correct as far as it goes, but it ignores several critical factors. For example, for a tiny fraction of the cost of a corporate tax rate cut, a temporary investment tax credit (ITC) could generate the same or larger incentive to undertake new capital investment during the next year. The ITC is cost-effective because it only subsidizes new investment, while the corporate tax cut reduces burdens on both new investment and current income (which is the return to old investments). Also, because the ITC would be temporary, revenue losses would not extend into the future and the impact on interest rates would be much smaller. Accounting for all of these factors, a permanent corporate tax rate cut costs between 10 and 30 times the amount of a temporary ITC that generates the same reduction in the cost of new capital investment over the next year. (Other forms of temporary tax incentives for new investment would similarly be much more cost-efficient than a corporate tax rate cut.)

Some claim that a corporate tax cut would generate new investment by raising corporate cash flow. But from the end of 1999 to the middle of 2001, non-financial, non-farm corporations raised their liquid financial assets by $100 billion and their total financial assets by $700 billion. This increase did not stop a significant decline in investment earlier this year, but it does show that the decline was not due to any shortage of cash on hand.

A final claim is that corporate tax rate cuts would help reduce layoffs. Such an effect seems unlikely. After all, corporate income tax cuts do not help firms that are already losing money, and these are the firms most likely to lay off workers.

Capital gains tax cuts

Another proposal would reduce the maximum tax rate on long-term capital gains from 20 percent to 15 percent. Whatever its merits in other contexts, a capital gains tax cut has several crucial drawbacks under current circumstances.

A *permanent* capital gains tax cut is poorly designed to address the short-term economic problems at hand. Lower tax rates on capital gains are typically supported as a way to raise saving, but what the economy needs right now is more spending, not more saving. Lower capital gains rates are also claimed to raise economic growth, but the effect is probably tiny and certainly many years in the making. In contrast, what the economy needs right now is a short-term boost. In addition, a capital gains tax reduction is not an efficient way to stimulate *new* investment, because the tax cut would apply to capital gains on *existing* assets, and those gains are a return to prior investment. Finally, capital gains tax cuts would reduce long-term revenue and exert upward pressure on long-term interest rates.

A *temporary* reduction in capital gains tax rates is perhaps even more problematic, since it would encourage people to sell their stocks now. If people took the revenue from their asset sales and reinvested in the market, there would be little effect on any economic aggregate. If instead they spent their realized gains on consumption goods, the result could reduce stock market values, which could hurt consumer confidence and business investment.

IV. Conclusion

The current economic and budget outlook suggests the need to focus on policies that stimulate the economy in the short run and do not damage the long-term fiscal outlook. Policies that are not consistent with these principles will generate weaker economic stimuli than those that do. There are limits, however, to the effects of any type of tax cut in stimulating economic activity, particularly in times of uncertainty when people and firms are delaying major economic decisions.

Chairman CONRAD. Also with us today is Dr. Peter Orszag. Dr. Orszag is also a distinguished member of the Brookings Institution, a Senior Fellow in Economic Studies there.

His areas of expertise include: aging, budget policy and politics, climate change, demographics, education policy, income distribution, financial markets, macroeconomics, pensions, poverty, Social Security and tax policy.

Maybe we should just have you testify. [Laughter.]

Mr. ORSZAG. I think someone in our communications staff got a little overenthusiastic.

Chairman CONRAD. Well, actually, we have looked to you for advice in virtually every one of those areas, so I do not think it is an overstatement.

Welcome to the committee and please proceed.

Let me just indicate that we are going to be using the light system. We are asking witnesses to summarize in 7 or 8 minutes if you can, and we will do the same thing with members and their questioning period.

This is not the light system that we typically have in the committee; we do not have a yellow warning light here. But we are not going to be enslaved to the 7 or 8 minutes, but if we can do it in roughly that time—we do have to be out of this room by 11 a.m. We apologize for that, but I think you all understand the disruption that we are operating under, and I can say in all the time that I have been in the Senate, we have never had a hearing in this very historic room. So I think we are part of a "first," at least for the 15 years that I have been in the Senate.

Dr. Orszag.

STATEMENT OF PETER R. ORSZAG, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. ORSZAG. Thank you, Mr. Chairman, and thank you for inviting me to discuss short-term economic stimulus proposals.

In my written testimony, I analyze various stimulus proposals using some common sense principles. The principles reflect the idea that an effective stimulus package needs to do two things—maximize the extent to which it directly stimulates new economic activity in the short term and minimize the extent to which it indirectly restraints new activity and worsens the budget outlook in the long term.

These principles are very similar to the ones that have been endorsed on a bipartisan basis by the leaders of both Budget Committees and that were outlined by the chairman at the beginning of this hearing.

My testimony reaches two main conclusions. First, on the tax side, most of the proposals that have been endorsed by the Bush Administration and now by the House of Representatives are poorly designed from the perspective of stimulating the economy in the short run.

Let me take one example—repeal of the corporate alternative minimum tax or AMT. The corporate AMT applies when corporations owe no regular income tax because of substantial deductions or other tax preferences relative to their income. Unlike investment tax incentives, which only give tax breaks to firms that are under-

taking new investment, eliminating the corporate AMT would give tax cuts to firms regardless of whether they are investing at all.

In particular, the elimination of the corporate AMT is effectively a reduction in the tax rate on corporate income; but the vast majority of such income reflects the return to old investments, not new investments.

For example, the value of outstanding corporate capital amounted to more than $10 trillion at the end of 1999. Annual investment amounts to roughly $1.3 trillion. So under simple assumptions, roughly 90 percent of the benefits from a reduction in corporate taxes, like elimination of the corporate AMT, would accrue to old investment rather than new investment.

Furthermore, even supporters of eliminating the AMT acknowledge that any beneficial impact would be limited in the short run. They basically talk about it in terms of long run benefits.

The implication is that regardless of whether or not it would be warranted as part of a broader tax reform, elimination of the corporate AMT is an extremely blunt and inefficient approach to encouraging new investment in the short run. It would also cost $24 billion over the next decade.

I would similarly point to the Subpart F rule changes that the House made, and there is a variety of other permanent corporate tax changes that the House of Representatives makes that are basically flawed; they do not maximize their bang for the buck.

My written testimony provides a chart of the various tax proposals and their consistency with common sense principles similar to the ones that Senator Conrad outlined.

The second focus of my written testimony is on the spending side. Here, a distinction should be drawn between transfer programs such as unemployment insurance benefits and Government purchases of goods and services such as purchases of military equipment or new public construction.

Transfer programs are basically similar to household tax cuts, and the key issue is that they boost spending quickly among their recipients.

On Government purchases, the key issue, at least in terms of stimulating the economy in the short run, is simply how quickly we can spend the money.

Given the expected temporary nature of the current economic slowdown, the faster that any funds can be injected into the economy, the better. The most recent Blue Chip forecast from private economic forecasters suggests that the recession will end in early 2002, with real GDP growth reaching 4 percent by the fourth quarter of 2002.

The implication of this forecast is that any stimulus provisions, either spending increases or tax cuts, extending well beyond 2002 would be in effect long after the economic slowdown is expected to have ended. Those forecasts are not perfect, but these guys make their living trying to do them, and they are probably the best central forecast that we have at this time.

Based on these considerations, the most promising spending increases involve temporary changes to the unemployment insurance system, modifications in other low-income programs, and increased Federal support for State governments, all on a temporary basis.

The unemployment insurance system is a particularly important automatic stabilizer; it mitigates the severity of any economic downturn. For example, according to research by Professor Jonathan Gruber of MIT, the amount that a family spends on food, a key part of household living, falls by 7 percent on average when the head of the household becomes unemployed, but it would fall by 22 percent in the absence of any unemployment benefits.

Unfortunately, the UI system is not well-prepared for the current economic slowdown. The eligibility rules are outdated; some States did not accumulate sufficient trust funds during the recent economic boom; and benefit levels are relatively low.

Temporary changes in the UI system would represent an effective stimulus. Indeed, UI is particularly well-targeted to maximizing its bang for the buck since it is available only to unemployed workers who have experienced a reduction in income from the loss of their jobs and whose consumption expectations may therefore exceed their current income.

Unfortunately, the UI proposals put forward by both the Bush Administration and what has now passed the House of Representatives are woefully inadequate.

A variety of other programs for low-income families, including the WIC program which would otherwise have to turn away hundreds of thousands of people from its rolls because of inadequate funding, could also be temporarily expanded as part of an effective stimulus package.

Finally, States are suffering substantial fiscal stress as a result of the economic slowdown. In all States except Vermont, some form of a balanced budget rule forces counterproductive fiscal policies. When the State enters a recession, revenue naturally falls and spending increases, and the balanced budget rules then force the States to tighten spending or raise taxes, which is exactly the wrong direction from a macroeconomic perspective.

It is worth noting that the fiscal stress on States could be exacerbated by recent proposals at the Federal level. For example, some 44 States use Federal depreciation rules for their own corporate income taxes. They would be adversely affected by partial expensing of business investment such as is in the House of Representatives' legislation.

Preliminary estimates from the Center on Budget and Policy Priorities suggests that that legislation would reduce corporate income tax received by States by approximately $5 billion a year from 2002 through 2004.

To avoid restrictive fiscal policies at the State level in the middle of an economic downturn, the Federal Government should provide temporary financial assistance to the States. One mechanism for doing so would be to create a revenue-sharing mechanism like we had in the 1970's and early 1980's, but such an approach would take time to design and implement.

A more timely alternative would temporarily increase the Federal matching rate for the Medicaid program. That is the fastest way to get money quickly to the States. Federal assistance to State governments, regardless of how it is done, would then attenuate the restrictive fiscal policies that would otherwise be adopted at the

State level, and therefore, they would represent an effective stimulus also.

In conclusion, Mr. Chairman, the proposals put forward by the Bush Administration and the House of Representatives do not maximize their bang for the buck. The final part of my written testimony provides a much more promising alternative—temporary partial expensing for capital investments through the end of 2002—and I would embrace the sliding scale that Dr. Gale suggested for the design of that provision; a one-time rebate for low-income households, those who were left out of the first round; temporary UI expansions; temporary increases in WIC and other low-income programs; temporary revenue-sharing for State and local governments, perhaps through an expanded Medicaid match; and freezing the top marginal tax rate at 39.6 percent, which would more than pay for the entire package—in fact, as my written testimony shows, it would save about $30 billion over the next 10 years.

Thank you very much, Mr. Chairman.

Chairman CONRAD. Thank you very much.

Chairman CONRAD. Dr. Hassett, welcome. It is good to have you here.

STATEMENT OF KEVIN A. HASSETT, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. HASSETT. Thank you. It is a real honor to be here again, Mr. Chairman, and to be sitting next to my close friends from Brookings on this important occasion.

I would like to say at the outset that I commend the courage of each of you in the last weeks. You have been an inspiration to all of us, and it is very important that we have such strong leadership in Washington at a time of such national need.

If you look at my testimony, I did not pick a specific policy and argue that that is exactly what we should do right now, but rather, I tried to present the thing that I think is most important to think about right now, and even in my unprepared remarks, which I will make now, partially in response to my friends, I would like to say that on this particular occasion, the stakes are high enough that it is better to just use us as resources. And I would like to lay out the things that I think I know about and then encourage you to ask questions about specific policies. I do not want to create a "my policy is better than your policy" debate at this specific instance, because I think there are many good policies that we could adopt right now, and that the worst mistake we could make would be to do nothing because we cannot agree that A is better than B, when both of them are fine.

The urgency of a stimulus package, I think, is very strong. For example, this morning, we got one of the first pictures of what happened in September. We received the durable goods orders. Durable goods orders were one of a series that I relied upon very heavily when I was doing the forecast at the Federal Reserve before I moved to AEI. It is a very good leading indicator because it is an order for something that is going to happen next month. So if in September, it is weak in orders, that means the shipment, which is what really counts for GDP, is going to be bad in October. And

the release we got this morning was just about the worst one I have seen. It was terrible. September was an awful, awful month.

To put that into perspective, it is useful to think of our economic world as being two worlds that are quite different—the world on September 10th and the world on September 11th.

On September 10th, if we had met, I would have said to you that the odds are that we are going to avoid a traditional recession—it is not going to be great, but it is not going to be something that we would call a recession. And the reason is that the corrections to economic activity that were occurring through that date were all out-of-phase; we had an inventory correction over the previous 12 months that looked like it was about done. Consumers had continued to consume, and investment had corrected as well. So we did not get everybody deciding they were going to stop doing what they were doing, which is what usually happens in a recession.

The reason that did not happen on September 10th, or we thought that that was not going to happen, was that there was not a focal point event that signalled to everybody in the country, "Stop what you are doing." If you look at past recessions, very often that is what happened. A war in the Middle East has very often historically caused recessions, because people get nervous, ambiguity is very high, and folks stop doing what they are doing.

After September 11th, unfortunately, we have had exactly that focal point that we did not have in this recession event up to September 10th. A terrible event that dramatically increased ambiguity and made all economic decisionmakers decide to hold off their plans for a little while and see what is going to happen has occurred. And the potential for a very deep and lasting recession I think is higher than it has been since I have been watching this, which is since the late 1980's—before that, I was concerned with being a young man as opposed to looking at the economy.

So I think we do need to do something, and I think that——

Chairman CONRAD. Let me just stop you right there and ask you what was the durable goods order report?

Mr. HASSETT. It was minus 8-something percent. I do not remember the exact number; perhaps someone has it—minus 8 percent, not on an annual rate basis. So it is just terrible. I think that probably aircraft pulled that number down, and that excluding aircraft, which is the number that we always used at the Fed because aircraft was so volatile, was minus 5-something. But those are just terrible numbers.

There have been worse numbers—it is a volatile series—but usually when we have had numbers that bad, they came after a really great month, so the average was not so bad. But we did not have a series of great months leading up to this, so it is about the worst report that we have seen.

Now, as we think about what to do, given that we have to do something, the only thing that I am going to say in my statement about business tax cuts—well, I will say two things—is that they can definitely be extremely effective. As Mr. Gale mentioned in his testimony, that is one of the things I have spent my career working on, often with Professor Hubbard, who is now chairman of the CEA. We just completed a review of the whole literature for the textbook that all the graduate schools use to study business tax-

ation, and the one lesson that I am sure of from that literature is that business tax cuts stimulate activity; they really do. There are a lot of valuable things that you can do to the business tax code to stimulate things now.

The one thing from the literature that I think cautions about tradeoffs as we choose which business tax cut to adopt is that there is a tradeoff as always between temporary and permanent cuts. As Mr. Gale said, temporary cuts are often more effective at stimulating activity right now, but they are also more uneven in their stimulus compared to permanent cuts. The reason is that if you have a big thing that takes a long time to do—think about an electric power plant or something—if you have a 1-year cut, it does not really necessarily affect that decision very strongly, but if you have a short-term investment like a fax machine, that is something that might really respond.

So when you have a very temporary cut, you are kind of playing favorites between long-lived and short-lived equipment. About the longest delivery lag for a piece of equipment out there is 18 months, and that is for an airplane, the last time I checked, so that counsels for being a little bit cautious about being so short that you are really playing favorites with the tax cut.

The other thing that I wanted to point out is a concern that has been raised often, and it is an intuitive one but one that has not been supported by mountains and mountains of economic research. That is the view that we need to be really cautious about how aggressive we are in the face of this economic danger because of potential big offsetting interest rate effects, so if we have a really big tax cut that we think might have a big effect right now, that could be squashed by offsetting interest rate increases.

That type of relationship would hold if we had just a closed economy and the amount of Government debt that we issued was bought by domestic U.S. citizens, and interest rates were not affected by international capital markets. But in an open economy, it is sort of a question of is the U.S. big enough to affect things.

Economists have written a zillion papers on this as they have on just about everything, and basically, there is almost no evidence of the kind of interest rate effect that should cause us to be wary about being aggressive in the face of this economic danger.

As Professor Paul Evans of Ohio State University pointed out in a number of his careful studies between interest rates, even interest rate effects that look at very large deficits during war-time spending have found nothing.

And in my testimony, I provided—I will finish quickly; I see the red light—a chart which is meant to make a striking example of how powerful this sort of effect is, that it is just not in the data that there are big interest rate effects or deficits. Mr. Calamaris and I—a colleague at AEI and at Columbia—constructed a chart of the real interest rate in the U.S. and in Japan over the last 3 years or so, a time period when the Japanese debt-to-GDP ratio was increasing by about 40 percent to levels that we have not really seen since Weimar, Germany; it is just a terribly high debt-to-GDP ratio, and at a time when the U.S. debt-to-GDP ratio is decreasing—and the interesting thing is that the real interest rate in

Japan and the U.S. was the same at the beginning of this period and the same at the end and tracked fairly closely in between.

Anything that you folks might prudently adopt is going to be much smaller relative to GDP than the kind of fluctuation we have seen in these charts, so I would encourage you to use your imagination and do what you think is best and not be nervous about the short-term interest rate impact of those policies.

Thank you.

Chairman CONRAD. Thank you very much, Dr. Hassett.

Senator Clinton has an obligation in just a few minutes outside the hearing room. I am going to give her my slot for her questioning so that she has an opportunity to make whatever statement she would like to make and ask whatever questions she would like. Then, we will come back to Senator Hagel and go back in the order of appearance.

Please proceed.

Senator CLINTON. Thank you very much, Mr. Chairman.

Thank you for rescheduling this important hearing and for allowing me to question at this time.

I also want to thank each of the witnesses for being here and for your very helpful and, in some very stimulating way, the testimony about what we should be doing.

I have a very specific set of concerns that I would like to hear your answers on. Others I know will get into the larger issues. But my concern is the impact of "the focal event," in Dr. Hassett's terms, of the attack on September 11 on the New York City and New York State economy, which has been dramatic and I am afraid, whatever happens, long-term. We can look forward to the forecasts that Dr. Orszag referred to and think that by the last quarter of 2002, we are back on a positive 4 percent growth rate, or Dr. Hassett's more pessimistic view because of the long-term recessionary impact.

Whatever does happen, the effects on New York will be more long-lasting and deeper than the rest of the Nation. And given the engine of economic growth that New York City has been for the entire country, it is a matter that we have to pay particular attention to.

Just a few quick facts, and then I would like your responses. In the damaged and destroyed buildings alone, we lost around 850 businesses and 25 million square feet of office and commercial space and nearly 100,000 jobs. If you expand the ground zero impact zone to what is called the "frozen zone," which includes not only buildings that are destroyed but those that are completely blocked off because of the crime scene investigation and the clean-up efforts, you are up to 2,600 businesses impacted directly, 35 million square feet of space, and about 140,000 displaced jobs.

In the immediate downtown area, we had some of the most attractive residential living spaces in the entire country, I think, but only 30 percent of the tens of thousands of residents have returned to their homes in Battery Park or the financial district or elsewhere in Lower Manhattan, in part because of damage and clean-up challenges, in part because of the fears and anxieties that many families have.

I talked to a number of parents who just cannot bring themselves to return with their children while this huge pile of still burning rubble is outside their windows. And there is a great concern about health effects—although we have absolutely no evidence of any adverse health effects, that is something that people are worried about.

We are beginning to hear that if we do not come up with some immediate targeted fiscal stimulus for New York in addition to whatever we do nationally, we are going to be losing a lot of our existing businesses that are considering relocating and expanding not just in other places in the country, but now we are hearing London, New Delhi moving back office operations, even moving other jobs offshore.

So that most estimates of the financial losses that New York and our companies there have suffered exceed $100 billion. No one can put too fine a point on it, but probably the best estimate at this point is from the comptroller of the city, and it is $105 billion.

I think a lot of what we have to do is to build confidence, and how we stimulate that confidence, we take care of the needs of these displaced workers who have to have temporary help, unemployment insurance, COBRA extension, how we organize the charitable contributions, which is about $800 to $900 million, which is significant, and make sure they get to the right people, and how we send a message to residents and businesses that even though in the immediate zone, you are not going to be able to get in there any time soon—it is going to take a year to clean it up—we want to have it clear that business will be back going and that residents can look forward to returning.

Do you have, just briefly, any specific thoughts about the portion of the stimulus package that I hope will be directed to New York's needs? We were looking at a tax credit for employers to keep employees in businesses in the area; residents getting some kind of tax incentive—they have absorbed a lot of expense and intangible costs; obviously, some more triple tax-exempt authority for rebuilding. Any thoughts you have would be extremely welcome, in any order.

Dr. Gale.

Mr. GALE. Thanks.

Brookings was not as generous in listing all my areas of expertise as they were with Peter's, but one of the things I do is edit a journal on urban economics. This is a key issue in how the attack is going to affect the demand for agglomeration, the willingness of people or businesses to locate in highrise buildings, the cost of increased security, et cetera. So there are a lot of long-term issues facing cities in general and New York in particular. All of these issues hit with ten times as much force in New York City as in other major areas.

So that is one general issue that is overlaying this. The other general issue that is overlaying this is can the Government provide a useful role. One of the things that changed immediately after 9–11 is that people remembered, oh, yes, Government can be part of the solution. I think that is a very important lesson for us all to remember.

I do not recall all the details of the rescue/recovery package passed earlier, but I think it should be a very important Federal initiative to rebuild and revitalize New York City both on standard economic grounds, the crucial importance to New York City and the Nation's economy, but also on symbolic grounds. Not only was it the target of the attack, but in our history, it has also been the gateway to the country.

So I do not have any specific proposals to suggest, but I think that on both symbolic and economic grounds, it is a crucial Federal need to push ahead.

Senator CLINTON. Although we passed a very generous appropriation, we have not allocated it yet, so we are in the process of allocating the appropriated dollars and looking to see what kind of additional stimulus might be particularly suited to New York.

Mr. ORSZAG. I would just add two or three brief comments. Economists are often called "the dismal scientists." On the response to natural disasters and other things, the literature actually if anything is more optimistic than one would think just looking at all the destruction that is often so visible.

When one looks at the responses to earthquakes and other natural disasters here, in Japan, and elsewhere, the response is often that economic activity rebounds remarkably rapidly, much more rapidly than one would think looking at the destruction. So I would just put that in the back of your head to remember that this is obviously different, but what evidence we do have suggests that recoveries are often quite rapid.

I would also underscore the point that you made about unemployment insurance. New York's UI Trust Fund is not very high. The eligibility rules could be expanded. There is a lot that you can do to help in the short run the displaced workers.

And then, finally, on tax incentives, I guess I would just also introduce a brief note of caution, which is that I think it is unclear what that elasticity is, how much activity would actually be encouraged by tax incentives, especially if the tax incentives are temporary. Firms that are thinking about making permanent decisions about where they are located may not be all that responsive to temporary incentives. On the tax side, we may therefore be better off using the money for direct spending approaches.

Mr. HASSETT. I would just very quickly add that I think the difference this time—this is something that, oddly, economists have studied, too; I guess we can always say that—but there is a difference. Economists make the distinction between circumstances of uncertainty, kind of like flipping a coin—you know there is 50–50 chance that something is going to happen—and a circumstance that is ambiguous, where you just know that something might happen, but you do not know what the odds are, and you are not even sure what the full set of things that might happen are.

In circumstances that are ambiguous, if you assume that a person is perfectly rational and then try to model what their behavior should be, it turns out that they should do something called a "maxi-min" strategy. They should make themselves as well-off as possible if the worst thing happens.

That is exactly what everybody is doing right now. They are assuming the worst and preparing for that. That is because the ambiguity is so high, and it is especially high in New York.

So I think that, sadly, New York is going to have very strong problems until we have resolved a lot of the ambiguity about this. But I would encourage you to think about things, very visible things, that you could do to make people feel like they are safe and that the sort of odd, unknowable threats are not as severe as they might think. I think that things like buying the drugs, as we are doing, do that, but also making big public statements about how aggressively there is air defense or anything else that defense experts could give you that would resolve the ambiguity and make people think they can return to their everyday lives. Then, I think we could get what Mr. Orszag said, the kind of response that you usually see after a hurricane.

But if we leave the ambiguity lingering out there, things could be bad for a long time.

Senator CLINTON. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Gentlemen, thank you for being with us this morning.

It is my opinion, and it has been reinforced to some extent by your testimony this morning, that none of us, regardless of how wise we perceive ourselves—well, there are certain exceptions——[Laughter.]

Chairman CONRAD. You can take as much time as you like. [Laughter.]

Senator HAGEL. I am catching on on this committee, I think.

The enormity of the challenge before us is such that we are grappling with something here that the world has never seen before. And when you connect the economic and security challenges and, in your words, Dr. Hassett, the ambiguities, and as the three of you have laid out this morning, things like the durable goods report numbers—yesterday in the Banking Committee, we were dealing with the reinsurance issue; we have been dealing with confidence issues; we have been dealing with a list of things that not just the United States but the world has never, ever seen before in its totality—so if we have some sense of the enormity of this, realizing that there are no road maps and not answers that are easily accessible, then, we are doing what we must do, and that is starting to come at this with the tools that we have.

But hopefully, we will be wise enough to understand the point of the enormity here and that it is all connected and that whatever we do in a stimulus package and the airport security package and the anti-terrorism package—all are connected—as is connected to the military effort in Afghanistan, the coalition we are building, the long-term and short-term security relationships and foreign policy decisions that we are making now.

I would be interested in hearing your thoughts on a number—and I know the ambiguity of trying to frame up a stimulus package number is difficult, because nobody knows—should it be $100 billion, should it be $50 billion, should it be $200 billion—but I would be interested in your thoughts on maybe a general number and

then how you would break that out, each of you, in particular on tax cuts. Should we have any tax cuts? If we should, what should those tax cuts be?

So I would appreciate each of your thoughts on the kind of package that you would like to see, based on what you think would help address what we have before us.

Dr. Gale.

Chairman CONRAD. Could I say this—in view of the number of members we have here and the number of witnesses, let us not be bound by the light in your answers to these questions. Give as detailed answers as you think appropriate to Senator Hagel's thoughtful question.

Senator HAGEL. Thank you, Mr. Chairman.

Mr. GALE. In the same order? All right. I will lead off again.

I agree with you about the enormity of the problem and in particular that the nature of the problem here is different from the standard recession, downturn type stuff. The economy now is different than it was on September 10 because of all these added concerns. Not only are people to some extent more fearful and less confident, but if we are going to address these issues in the longer term, there are a whole bunch of costs that we need to incur in terms of adding security, making people safer, that we would not have had to incur otherwise.

Therefore, the spending programs, like on security, can have the direct effect that spending programs can have as a stimulus but can also have the indirect effect that Kevin was mentioning in terms of stimulating confidence, and that indirect effect could be even more important than the direct effect.

So in terms of thinking about your question about tax cuts versus spending and how much and what kind, I have a few thoughts. One, I do not think that the size of the package—I do not think we should blow the budget on this, in part because in some sense, we have already blown the budget. But I do not think that the size of the package within the range that we are talking about is anywhere near as important as what is in it.

What should not be in it is sort of the same old, same old, tax policy—the types of proposals that one was talking about under earlier circumstances—there is no reason why they are the most natural things to look at now. The nature of the problem is different, so the nature of the solution is different.

So if we do stimulus on the tax side, I think it should be temporary and aimed at aggregate demand to get the economy jumpstarted, to use a phrase of the phase.

But I think the spending side is equally if not more important, and I have hesitated to say much about that because I am mainly a tax specialist, but I think that both the economic and the psychological impact on the spending side could have a huge positive effect whereas the tax cuts that we are talking about—even the most desirable tax cuts—I would say are likely to have quite a limited impact. My testimony goes through some calculations, but basically, the economy's growth rate falls from 4 percent to about zero, or maybe negative. If you look at the impact of the investment incentive that the House passed, that is going to increase investment by about two-tenths or three-tenths of a percent of GDP, according

to standard estimates of the response of investment to the cost of investment.

That is in the right direction, but that is not going to fundamentally alter the nature of the economy. Spending programs, particularly ones that reinstill confidence, could fundamentally alter people's confidence and people's economic outlook. So I think there is a big up-side potential on that side, and I do not see a tremendously big up-side potential on the tax side.

Senator HAGEL. Could you give me an example of what kind of spending program you have just defined?

Mr. GALE. Generally, in the security, defense area. I do not have a specific——

Senator HAGEL. That is for right now?

Mr. GALE. Yes. I do not have a specific program in mind, but I am saying spending that has the potential to alter people's feelings about whether the world really is a scarier place or not has the potential to have a big impact. Tax cuts which let people keep a couple of extra pennies per dollar that they invest do not fundamentally change the nature of the work.

Let me put it this way——

Senator CORZINE. Are you using homeland defense or national security?

Mr. GALE. Right.

Senator CORZINE. Homeland or—which one are you using?

Mr. GALE. Either/or; both. I mean, both have the potential to do that.

I am just saying the reason why people are not flying on airplanes right now is not because of a lack of disposable income. It is because of other feelings. And addressing those attitudes and those uncertainties I think is the first-order economic effect, and I do not feel that aligning tax incentives more exactly is a first-order issue—but it just happens that I am a tax expert, so that is what I talk about.

Senator HAGEL. Would you see any benefit to any tax cuts in a stimulus package?

Mr. GALE. If we do tax cuts that are temporary and targeted toward aggregate demand, I think the net effect is positive; it is just a question of how big.

Senator HAGEL. Give me an example.

Mr. GALE. The temporary investment set-up, particularly the sliding scale that I mentioned earlier, I think would have a beneficial effect; a rebate——

Chairman CONRAD. Partial expends?

Mr. GALE [continuing]. Yes, yes, a partial expends, right—and I am not a big fan of rebates in general, but getting the money out in the relatively short run to a set of low- and middle-income households is likely to have a more stimulative effect than giving it to other households.

So I think it is pretty easy to rank the relative stimulative effects of various tax policies. If you want to stimulate demand, and you want it to be temporary, on the household side, you want it to go to low- or middle-income households because they are more likely to spend it.

The bigger issue is are all of these big-effect policies where some of are just bigger than the other, or are all of them modest-effect policies and some more modest than the other. My view, based on what I know about the evidence is that they are all modest-effect policies, and some are more modest than others, but I think the ranking is pretty uncontroversial.

Senator HAGEL. Dr. Orszag.

Mr. ORSZAG. First, I would agree with Dr. Gale that a specific amount is very difficult to determine and that it is actually more important that it be temporary. It is less important whether it is $70 billion or $80 billion or $90 billion this year than that it is not very expensive over the long term. I think that is a key point.

In my written testimony, actually, just to try to step up to the plate, I did put down a stimulus package that cost something like $70 billion or so in 2002. It included some investment incentives, tax incentives, and a one-time rebate for low-income households, and then it also included UI expansions, increases in other low-income spending programs that will have a very high bang for the buck—the money will be spent—including WIC; there are problems with the TANF contingency fund, and a variety of other things we could talk about if you are interested in them—and also, trying to shore up State governments. Basically, we want to avoid a situation—it is already happening in many States—where they are enacting spending cuts or tax increases to offset the slowdown, and that exacerbates the macroeconomic situation. So providing additional dollars to them which would then preclude what they would otherwise do or stop them from the cuts they would otherwise make is a very effective stimulus measure.

I also included a measure aimed at long-term fiscal discipline to demonstrate the credibility of the Congress in ensuring long-term discipline. So I packaged the short-term stimulus with a long-term fiscal discipline measure, and together, I think that that is a more effective package than, for example, the one that the House recently passed. That would get more bang, and I agree also with Dr. Gale that it is not clear exactly how much bang it is and how much it would help, but it is more than——

Senator HAGEL. Excuse me, Doctor. Were you the one who referenced matching Medicaid payments as a quicker direct assistance to the States, and revenue sharing—you mentioned that as well, but that is longer-term.

Mr. ORSZAG. I did. There is a little bit of debate over how quickly revenue-sharing mechanism could be put into place. The people who designed the one that existed in the seventies think that it could be put in place very quickly, but other budget experts think that the fastest way to get money to the States is just to increase the Medicaid match.

Also, Medicaid is a major component of many State budgets and also where they often look for cuts, so the extent that the money sticks there a little bit, it precludes cuts; to the extent it does not stick there, it provides additional resources for State budgets in general. Either way, it is an effective way of getting money to them quickly.

Senator HAGEL. Before we go to you, Dr. Hassett, just a quick comment on that. I think that that is an area that is going to cause

us some big, big problems. Most States, as you all know, are going into special session; I know that Nebraska is, and I think most are. Their revenues are way down; obviously, expenditures are over the top. I think you have locked onto something that is a very key component of whatever we do here that we ought to focus on.

Thank you.

Dr. Hassett.

Mr. HASSETT. I would caution about that, Senator Hagel, before I begin talking about the other aspects of this. I think the reason why States are having this trouble is that they have adopted a policy that we have long known is a foolish one——

Senator HAGEL. Not Nebraska. [Laughter.]

Mr. HASSETT [continuing]. Well, I do not know about Nebraska—but having an amendment that says the budget has to be balanced each year means that you have to do policies that exacerbate economic fluctuations. So you want to have a budget balance on average over time, but you do not want to make them do it every year, and if you do, then bad things happen.

I would hope that the States would get rid of those bad policies and that that would be one of the things that would come of this; and if they feel like the Government is going to bale them out in the bad State, maybe they will not do that.

As far as the size of the stimulus package——

Senator HAGEL. I am glad Senator Domenici is not here to hear this; he would probably have a comment.

Mr. HASSETT. Yes, we could argue about that, I am sure.

The way I think about the size effect is that about the worst economic year we have had, at least since the war, is in the minus 2 percent range for a year. And my back-of-the-envelope, old Fed model understanding/guess of what we have for monetary stimulus and fiscal stimulus already is maybe a percent and a half or a percent, somewhere in there. And usually policy has not been as good. I think you folks are to be commended for seeing things coming a little bit last spring, and the Fed has been moving aggressively early on, so we are in better shape going into this recession than we have been historically, so you could almost say, well, if we had the worst thing ever, minus 2 percent, then already we are going to have a percent or a percent and a half offset of that, and then, if we added another $100 billion of stimulus that had bite, that means that we would basically not have a negative year, which means it would not be a recession.

I think that that is how the $100 billion number—I think people have used that kind of thinking in the White House and elsewhere to think about why $100 billion or so is a reasonable number.

If you are looking for something to do, I think the bill that the House passed has some very worthy candidates. The expends provision is designed to help people invest. Investment has been one of the things that has gone down the most in the past year or so, and investment generally is the source, along with inventories, of about three-quarters of the decline in a typical recession, and it has already declined a lot, which is kind of good in the sense that maybe it cannot go down much farther—but also if we could stimulate it, then we could have a big effect, potentially, on the odds of a recession.

I think that the AMT provision is very poorly understood in the public debate. The alternative minimum tax was designed maybe to catch tax cheats, people who had too many deductions relative to their income. But what we found out in the last recession is that one of the odd byproducts of the code is that when times turn bad, you can look like you have too many deductions because all of a sudden, your income goes way down. So in the last recession, about half of firms and assets, by assets, were on the AMT. It is kind of like a tax fine, if you like, for being a tax cheat that we are imposing on people because there is a recession, and I think that the repeal of the AMT is a sensible response. We do not want to be increasing people's taxes and taking away the benefit of tax deductions for investment which happens under the AMT, a large share of it. We do not want to be doing that during a recession, and stopping it is a sensible policy.

One of the more contentious aspects of the AMT repeal in the House, or one of the more difficult problems, is that if you ever go off the AMT—because again, it is designed to catch tax cheats—you can take the AMT that you paid in the past and credit it against what you got—you folks understand that—and if we take away the credits when we repeal the AMT, to me, it is kind of like saying that if we went to expends, and you bought a machine last year and still have 60 percent of the depreciation to claim, we are not going to let you take that depreciation. It is something that happened in the past that firms are carrying now as an asset that they expect to receive when they can claim it.

So I do not think the AMT is a policy that you would want to support in a recess.

Senator HAGEL. So you generally would support what the House did last night?

Mr. HASSETT. I would generally support what the House did, yes, and I think the size agrees with my colleagues here; it is the size that they have recommended. I guess the total amount of the package is 86, if I am reading this document right that I have in front of me. Maybe that would change the focus some, and I am sure that that is something that you folks will be doing.

But to close on this ambiguity front, I would encourage you—and I know that you are uniquely qualified for that, Mr. Conrad—to very quickly try to find something that we can all agree on, because one of the things that would be most paralyzing for the economy right now would be the impression that we cannot get things done in Washington. We want to show that if something happens, we can respond quickly to it and agree on the right thing.

If I look at the debate and the statements that have been made, usually, everybody has something to offer that is kind of an OK idea, and there are pluses and minuses on it; and if we took some subset of the things that people proposed on all sides, that package would be an OK package—it would not make everybody happy, but it would probably get the job done.

Senator HAGEL. Thank you.

Mr. Chairman, thank you for allowing that to go on. I appreciate it.

Chairman CONRAD. I think it was very useful. We are going to show the same treatment to the other members as well when they have their chance to question.

Let me take my time now to question, if I can. Let me start by saying that I believe this economic downturn is more serious than has generally been recognized. In talking to business leaders all across the country in the last 3 weeks—and I was with a group of some of the leading—about 100 high tech company leaders—the other night at a dinner in which four of the leaders spoke. And I will tell you it was a very sobering discussion.

We heard from Neil Hendry, who headed Global Crossing; we also heard from Craig McCaugh of McCaugh Cellular, who is, as you know, deeply involved in a number of high-tech ventures.

I will tell you, to listen to their description of what has happened to business after September 11th and the overcapacity that they think existed, especially in telecommunications, prior to that time, was a sobering circumstance, and I think we have all got to take very seriously what we see happening.

I think it requires an immediate stimulus of substantial size—but we have also got to be smart about what the makeup of that stimulus is.

Part of judging what we are doing here I think has to be informed by our overall, long-term budget circumstance. We have just done another detailed look at our long-term budget circumstance, and let me just share it with you now.

We started this year with a forecast from the Congressional Budget Office of $5.6 trillion of unified surplus. That is all funds, jackpotted—$5.6 trillion of surplus over the next 10 years. That is what we were told.

Of course, the significant amount of that was trust fund moneys. Nearly $3 trillion was Social Security money. About $600 billion was Medicare Trust Fund money.

Let me just tell you that in the latest look that we did on a bipartisan basis to establish a new baseline, we were down from $5.6 trillion to $2.6 trillion. That was done just weeks ago. It had the agreement of the budget leaders in the House and the Senate, Republican and Democrat, and the Office of Management and Budget.

We have now gone back and done another cut, because remember, that baseline does not include budget resolution policies not yet enacted. When you take those out, when you take a look at major initiatives that have not yet passed one body but have passed the other, if you look at those initiatives—for example, the education bill that has passed the Senate, railroad retirement that has passed the House, the Patient Bill of Rights that has passed the Senate, the energy bill that has passed the House—if you add those, and on top of that, if you take out an adjustment for the alternative minimum tax problem just created by the last tax bill—not the whole alternative minimum tax problem, but just the one created by the last tax bill—and you make a further adjustment for reductions in productivity growth from what was forecast—and a very modest adjustment there, I might add, one that I think will be made in the January forecast—a modest additional package for New York—and by "modest," I am talking $10 billion over the next 4 years, and the economic stimulus package at $70 billion this

year, what you come down to is only $700 billion left. So $5.6 trillion goes down to $700 billion on a unified basis. Every dime of the Medicare Trust Fund surplus is gone, and a very substantial chunk of the Social Security money is gone—$1.6 trillion of the Social Security money.

That money was supposed to be used to pay down the debt. We will no longer have maximum paydown of the debt or anything close to it.

Senator NELSON. You will not have anything—$700 billion.

Chairman CONRAD. Seven hundred billion.

Senator NELSON. Over 10 years.

Chairman CONRAD. So a dramatic reduction—and again, I would say to you I think these are realistic kinds of looks at where we are and where we are headed. And I would say to you that I think one of the most important things is that when that January forecast comes in, we are not going to see productivity growth at 2.7 percent. I do not think we are going to see, regrettably, as strong an economy going forward as was earlier anticipated.

That takes me to the question——

Senator NELSON. May I ask a question?

Chairman CONRAD. Yes, certainly.

Senator NELSON. To get from $5.6 trillion down to $2.6 trillion over 10 years, we lost $3 trillion in projected unified budget surplus just on the basis of the revisions of the economy.

Chairman CONRAD. No—about two-thirds of it is actually the tax cut.

Senator NELSON. I see.

Chairman CONRAD. The tax cut and the interest cost associated with the tax cut. We did have substantial reductions as a result of weakness in the economy, but most of it was the tax cut.

Going forward, obviously, we have these other matters out there—these budget resolution policies that have not yet been enacted—now, some will say that some of those will never happen—perhaps not—but this Congress, just earlier this year, thought they were going to happen.

I do not think the pressure on many of these things is going to go away, and I would say to my colleagues that I believe spending demands on the kinds of matters that Senator Corzine has referenced—national defense, security issues, bioterrorism—does anybody believe we are not going to spend more money on bioterrorism this year than is in the budget? I can tell you I was in a meeting yesterday where the administration came up and asked for $1.5 billion. That number is now at $4 billion. And the people who are the scientists are asking for $30 billion to combat bioterrorism. That is the reality of what we confront.

I would like to just ask the three witnesses this. In economic terms, is there any difference between spending and tax cuts—if you had the same amount of money, put out in the same period, is there a difference in terms of the stimulative effect of tax cuts or spending?

Mr. ORSZAG. Can I mix up the order?

Chairman CONRAD. Sure.

Mr. ORSZAG. OK, I will go first.

In answering that, you do have to make the distinction within the spending category between transfer programs and direct purchases of goods and services. The transfer programs are basically sort of a negative tax, and they will have very similar stimulative effects to a tax that goes to the same people. On average, transfer programs go to lower-income people than many of the tax changes that we are talking about, and therefore, one would think that to the extent that lower-income people spend more of each additional dollar than higher-income people, that transfer programs would be more effective.

On the purchases of goods and services, simple models, the simple sort of Keynesian model that you learn as an undergraduate in economics courses would suggest that the spending increase is actually more stimulative than either the tax cut or a transfer program.

Chairman CONRAD. Why is that?

Mr. ORSZAG. The reason is that some of the tax cut or the transfer payment will be saved whereas all of the dollar that is spent on military equipment or new roads is immediately injected as demand into the economy, whereas part of the dollar that is given as a tax cut would be saved rather than consumed and therefore does not immediately contribute to the stimulus effort.

Chairman CONRAD. The problem with spending, just as with tax cuts—with spending, I can think of at least two problems. No. 1, it is hard to get it out there quickly enough to have an effect. No. 2, you have got to be concerned that it not be embedded in the base for the future, because of our long-term budget outlook as I have just described. That is also the problem, as I see it, with tax cuts. With tax cuts, you have got to be concerned that they are not embedded in the long-term budget circumstance, again because of what we see here as a very seriously diminished long-term situation.

But what I hear you saying is that on the spending side, if it is direct expenditure for goods and services by the Federal Government, to the extent that gets out there quickly, you actually get the biggest bang for the buck because none of that is being saved.

Mr. ORSZAG. That is again what one would think, yes.

Chairman CONRAD. Does anybody disagree with that?

Mr. ORSZAG. You could come up with theoretical curiosities under which it would not be true, but I think that that should be the baseline assumption.

The uncertainty around the effects is such that I could not make a statement that I would want to defend in front of Saint Peter on which effect is larger. It depends on which tax cut you are choosing, and so on.

Mr. GALE. The brunt of my testimony is that different tax cuts have different stimulative effects—some of them have none, some of them will have some, some will have more. The same is true for spending programs, as Peter said.

I do not think there is anything inherent about a spending program or a tax cut that makes it more—there is nothing about its nature as a spending program or its nature as a tax cut that makes it stimulus. It is primarily who it goes to and what incentives it

creates. You can create stimulus programs on either side, you can create programs that do not stimulate on either side.

If I can, I do want to add that fixing the real AMT problem, I think is another $533 to $400 billion, which pushes us further in the hole relative to the numbers that you mentioned.

Mr. ORSZAG. Individual AMT.

Mr. GALE. The individual AMT.

Chairman CONRAD. The individual AMT. I want to make clear and let me repeat that I was just talking about fixing the part of the individual AMT problem that is directly attributable to the last tax package. I am not talking about dealing with the whole problem. You know, we have a very significant problem there going forward that all of us know about that we have not budgeted for.

Let me go to the question of interest rates, and then I will stop and turn to my colleagues. On the question of whether fiscal discipline contributes to a more favorable interest rate climate, this is a news report from October 2. "U.S. Treasuries climbed at midday, pushing the 30-year bond yield to 6-month lows after President Bush said any economic stimulus package should be big enough to get the economy moving, but not so big that it would push up long-term interest rates."

The story goes on to report: "'The long end is rallying pretty strongly because Bush showed he was cognizant of the potential impact of excessive fiscal stimulus on long-term interest rates,' said the chief market strategist of A.G. Edwards and Sons."

I believe there is not only an economic component to this but a psychological market component to this and that long-term fiscal discipline does matter to interest rates and that it also matters to the psychology of markets.

I would just ask the witnesses for their response.

Mr. HASSETT. I guess I can respond first, both to mix it up, and since I am the one who was talking about interest rates.

I think there is no question that that statement is one that is very calming—the statement of the person who wrote the news article—and indeed, I have a great deal of respect for people who believe in these effects. Often, folks like Mr. Corzine, who have actually functioned in real markets—I trust their intuition more than that of economists. But I am disturbed—I could forward to you, Mr. Conrad—there have even been attempts by economists to very rigorously go through news accounts and look at events where there was obviously significant news about the long run surplus challenges and found almost no scientifically reliable evidence that things go the way that that story suggests that they should.

And let me again point to the Japanese experience. I think it is very striking. They went from having a little more than 100 percent debt-to-GDP ratio about 3 years ago to having over 140 percent debt-to-GDP ratio, and that level is the winner of the debt Olympics. We would be very upset if we were like that. We have gone over the same time period from above 40 to about 30—I cannot quite read it in my chart—maybe 37 debt-to-GDP ratio. And if what you say is true—and I have a great deal of faith in your ability to crank numbers accurately—then, the debt-to-GDP ratio would still decline over the next 10 years.

I do not want to seem like I am saying that means we should not be prudent about our long run challenges—the Social Security challenge is a very significant one—but I think that right now, our challenge is so great that that should be a secondary consideration, that this long run imbalance should not be so significant in your thinking that you do not go out and spend lots of money on homeland defense and pursue tax stimuli.

Chairman CONRAD. I agree with that. Let me just say that very early on here, the morning after September 11th when I was asked by the President, I said, look, this changes everything. Our country has been victimized by a sneak attack. Our No. 1 priority now is to defend this Nation. Our second priority is to rebuild that which has been destroyed, and in addition, we must strengthen this economy.

So I think we have a strong consensus on what our priorities are. I must say that we have differences. You indicated that you think the House package is one that can be endorsed. I do not believe that. Applying the principles that we agreed to on a bipartisan basis for that package yields these results. On the question of it sunsetting within a year, 70 percent of the tax cuts provided there are permanent, so it clearly fails that test. And on rapid impact, a substantial portion of the money should be out within 6 months—but nearly 40 percent of the 10-year cost of that package occurs after the first year.

The third test was size, approximately $60 billion, that we had then as a floor. This package is $160 billion.

On targeting, we said that stimulus dollars should go to those most likely to spend them and those most vulnerable in an economic downturn. In the first year, the House package has 35 percent of the benefit going to the wealthiest 1 percent; the bottom 60 percent only get 19 percent of the benefit—the very people who are the most likely to spend it.

And finally, on the long-term assessment—the package should not worsen our long-term economic situation and increase interest rates—this package, the House package, has a cost of $170 billion beyond 2002, when you include the interest cost.

I would say to my colleagues that whether you believe there is a relationship between deficits and interest rates—I do—whether you believe that or not, we have a fiscal condition as I have outlined this morning that I think requires us to be prudent going forward and to limit the duration of the stimulus package to the time that the administration is forecasting economic weakness.

Now let me say that my own conclusion is that we need to do a bigger package than $60 billion. My own conviction is that this situation is sufficiently serious that, from everything that I have been able to learn, I believe we need to do a bigger package than $60 billion—but I do believe very strongly that we need to give as much pop as we can do right now—not 2 years from now, not 3 years from now, but right now.

Senator Corzine.

Senator CORZINE. I wish I could disagree with my chairman on a lot of his comments, but I will not. The only comment that I would make certain is that the interest cost to the Federal budget

will go up no matter what happens—whether interest rates go up or not, the impact on our budgetary policy will be substantial.

Where shall I start? Isn't it the common view of most economists that we have an overhang of investment that existed in the economy that we have got well beyond productive investment prior to September 11th—overcapacity, if you would, was built into the system?

I was at the same dinner that the chairman attended and heard these discussions, and in that light, I have serious concerns about why we are so focused on stimulating additional business investment relative to other kinds of investments, particularly high-return public investments on public security, transportation, and other issues. I am concerned about how quickly we can put those into the economy. That would be the biggest problem I would have with those.

But given what I am hearing here, they seem like they have higher return profiles to the economy than additional business investment, which was already falling off dramatically prior to September 11th.

I would love to hear your comments on that.

Second, as it deals with blue chip forecasts, which almost everything I hear talked about in the economic world says, well, we have a 4 percent growth rate projected in the fourth quarter of next year—and we all know that those things have to have a probability assigned to them—but just as economists, do you believe that blue chip forecasts are based on economic models that were in place prior to September 11? Are they the kinds of things that have fully accounted for some of these ambiguities that we have talked about, and do they reflect the dynamics of what is going on in the economy in an uncertain world?

Then, I would just add a fact—Senator Clinton was talking about New York City—I will give you an example. We sat with the Governor of New York last night, and the projected budget deficit for next year in the State of New York is between $9 and $12 billion. They got another one of those balanced budget contexts. I know that the New Jersey budget deficit is projected at $1.5 billion.

I am very concerned—even though I would like to see us get away from those balanced budget amendments that are there—that we could be enormously in contradiction with ourselves and State budgeting procedures in just the two States that I know the most about, and I know this is happening across the country.

So I would love to hear your comments on that. I hear where you say we ought to go, but it seems to me that infrastructure and spending and support for State and Federal Governments—and then, I would love to hear your views on this forecasting.

Mr. GALE. I will go back to my customary spot and start.

On the business investment side, we are seeing three things happening right now. One is that you are having sort of a long-term shakeout in the tech industry and in the telecommunications industry. That would have happened regardless of anything else going on.

Second, you had the slowing of the economy——

Senator CORZINE. We were in a manufacturing recession before, so we were not typically putting a lot of money into steel plants and so on.

Mr. GALE. That is what I am saying. There was a slowing of the economy, particularly in the traditional sectors like manufacturing, that was going on before September 11. I think manufacturing had been declining for 12 months straight or something like that.

And third, there is the investment response to the attacks on September 11.

So all those things are going on. The shakedown in telecommunications and high-tech is in some sense the way the medicine is supposed to work. The typical life-cycle of industries involves a big period of investment and then some sort of shakedown and consolidation. That is one point.

The second point is you are right that capacity utilization rates are very low right now, so that raises questions about why we think we can stimulate new investment and what the best way to stimulate new investment is.

It was precisely those considerations that led me to propose the sliding scale with the big increase in the subsidy now, because I think the one investment issue that we can deal with is that firms have these projects that they develop, they have gotten financing, they are on the verge of implementing, and they have decided to hold off. Those are the ones that we want to say "Just do it"—get those things going again.

There is not anything we can do about the shakedown in high-tech. That essentially needs to happen. But we can try to get a turnaround on the things that people are postponing.

So I share your caution, the caveats that you throw up about the potential effectiveness of investment incentives at this stage, but if they are to be effective, they will be effective precisely in getting firms to do the things that they were already planning to do before 9–11 but chose not to after 9–11.

On the blue chip forecasts, it is undoubtedly right that the models that underlie the forecasts do not have in them many of the things that we think are going on since September 11. I do not know how anyone would ever have built those things into the model to begin with.

On the other hand, I am almost certain—not completely certain, but almost certain—that any good forecaster applies some judgment rather than simply reporting out the rote model result as fact. So I do not know the extent to which the various forecasters have adjusted, or what adjustments they have glommed onto the formal model, but I would think that any forecaster worth his salt would be doing something like that. I just do not know how much they have done that.

On the State issue, it is critical that the Federal Government do something at the very least to offset the impact of a Federal stimulus on States. As Peter mentioned, the tax cuts will impact State finances. At the very least, the Federal Government ought to be offsetting that impact.

I think there is a pretty strong case for expanded Federal spending via the States governments also, but—here in D.C. it is easy to ignore the States, but all of their economics are working in the

opposite direction right now, so I think there is a good case for the Federal Government to subsidize the States on a temporary basis.

Mr. ORSZAG. I will go in reverse order. First, on the States, as I emphasized, I think that some assistance to States is warranted in order to avoid counterproductive fiscal policies.

I share Dr. Hassett's concern about the balanced budget rules themselves—and this is thinking on my feet and therefore dangerous—but one could imagine that a program could be designed so that you offer temporary assistance to those States that are willing to do something about the balanced budget rule. So that basically, we would offer temporary assistance, and you would agree to get rid of your balanced budget rule, and that would work well.

Mr. HASSETT. That is a good idea.

Mr. ORSZAG. Something we agree on; that is great.

On the blue chip, I agree with Bill that those models generally do not—they do not—incorporate the types of other factors that we are worried about. Even without incorporating those, the models are not very good at predicting turning points in the economy, so even without any additional problems, the spread or the uncertainty surrounding the forecast is particularly high at this point.

Senator CORZINE. The point I am trying to make is that if I hear one more time that we are projecting in the fourth quarter of next year 4 percent growth, and therefore, we ought to act in certain ways—I think it is just hard to imagine that anybody has fully factored in all the changes that are occurring in our economy, and those forecasts, as risky as they are, as we already found out in the last 6 months, have to be enormously probablistic in the world that we face in the years ahead.

Mr. ORSZAG. I agree with that, although I would add that even if you look at the—and I do not want to be seen here as defending the blue chip forecast—but even if you look at the bottom ten for the most pessimistic forecast, the bottom ten are still projected to have—I think it is 3 percent—relatively rapid growth.

Now, I do not think that that is necessarily right, but in a world of uncertainty, we need some basis for proceeding, and I think the conclusion from that is not "Do not worry; do nothing." It is "Be careful about doing things that are going to take effect in 2004, because at least the central estimate of private sector forecasters is that we will be back on our long-term growth path by then."

And I basically agree with what Bill said on overcapacity, so I will just leave that.

Mr. HASSETT. I can go very quickly. On the capital overhang, that is one of the things that I have been working on the most to try to establish how big an overhang there is, and I am generally a fairly optimistic fellow, but my assessments of the capital overhang have been pretty depressing.

It looks like, for example, things are being scrapped. It is not that there is some other business that is buying the thing and using it because you did not know how to use it; it is that in fact they are just scrapping the thing. And that is a sign that there was a lot of extra capital out there. But that would be most concerning if capital were all the same and firms were all the same, and the way a credit would work would be that there are some businesses out there that are doing well that have different types of capital,

and they are going to be the ones that are buying. That is traditionally how it has worked.

On the blue chip forecast, the thing that came to mind when i saw that report—it reminded me of, of all things, the Cuban missile crisis, because they have very high growth coming in at the end of the next year. During the Cuban missile crisis, when it was first announced that the Soviets had missiles in Cuba, the stock market tanked, and it looked like the world was a much worse place, and everything stopped for a couple of weeks, kind of like things stopped in September. But then, when we resolved it, the market celebrated—I mean really celebrated—and it sort of made sense, because it seemed like somehow the fact that we could resolve it meant the world was a better place than it was before the crisis happened, because we turned it into a positive.

I think that that scenario is what is in the blue chip forecast. That is the only way I could get a number like that in any model that I have ever used, and I did this at the Fed, would be that we get this big celebration after a clear and decisive victory. Now, we are not military experts, but I think that that is what is in the forecast. So if you think that that is going to happen, maybe that is the kind of growth that we will see.

Senator NELSON. It is not.

Chairman CONRAD. Senator Domenici.

Senator DOMENICI. Mr. Chairman, first, I had a prepared statement; could I just make it a part of the record.

Chairman CONRAD. Absolutely.

Senator DOMENICI. And could I thank the three of you for coming and apologize for my being here only for a short time now.

I just want to ask of each of you just two questions. One, what is a stimulus in terms of the American economy? What is a growth stimulus? Can you describe it in words?

Mr. GALE. Sure. A growth stimulus I would say is a tool used in a situation where the economy has a temporary downturn but is basically all right in the long term. The goal of stimulus is to increase short-term activity, and that involves two things. One is getting people to do things that they would not ever do under current circumstances, and the other thing it involves them doing is getting them to do things that they would have done in the future, but having them do it now.

So it has both an increased economic activity aspect to it, and it has a timing aspect to it.

Senator DOMENICI. And would it be fair to say, Dr. Gale—and then I will ask the others—is it fair to say that since I did not hear you mention expenditures of money, it is true that not all expenditures of money during a downturn are growth, economic stimulus?

Mr. GALE. Different ways of inducing spending or different ways of reducing tax cuts can have different impacts on their ability to stimulate the economy. For example, if you give people money and they stick it under their mattress, that is not going to do anything to boost aggregate demand, and that can happen in a poorly designed spending or a poorly designed tax cut.

Senator DOMENICI. Dr. Orszag.

Mr. ORSZAG. I would describe a stimulus as a measure that is undertaken by the Government to try to move the economy back

to full utilization of its resources. So we face a situation in which firms or factories are not being fully utilized, workers are not being fully utilized because the unemployment rate is increasing, and the purpose of the stimulus is to increase the demand for the firms' products and move the economy back to full utilization. That could include putting more money in people's pockets to the extent it is spent; it could include direct Government expenditures on military equipment or roads or whatever, and it could include reductions in interest rates by the Federal Reserve which then encourage more home purchases, more interest-sensitive consumption, and other things.

Senator DOMENICI. How do we know one when we see it appear—that is, an economic stimulus. You all have said what its goal is, but how do we know—do we take each idea and ask a group of smart people is that a stimulus or not?

What I am seeing—and no aspersions on anyone—but there are a lot of people who see this as an opportunity to spend money. And of course, you can give a whopping speech on the floor that anything you want to spend money on, you can transpose it into this argument and say it is great economic stimulus. But we tried that in our history, as I recall, principally for public works projects, and most economists who studied them told us afterward that they were not good economic stimulus because they did not take effect soon enough. A new bridge-building program which did not spend money because it could not for 18 months and then it took 5 months to get the money spend would not be a high-priority recommendation as a stimulus expenditure; is that correct?

Mr. ORSZAG. I would agree with that. What you have been emphasizing is that we want to maximize the bang for the buck that we get from any dollars that are used as part of the stimulus, and as far as public construction goes, the key issue is does the money flow out the door fast enough. That is really the key issue there.

Senator DOMENICI. Thank you.

Dr. Hassett.

Mr. HASSETT. Senator, it is a very good question. I think a stimulus is something that makes the economy go up. And I guess there is this attempt now that we are trying to make it go up now.

I recall a statement about this that was made to me once by a former professor who worked as an advisor to President Nixon, and Nixon asked him to stimulate the economy before the election, and he studied it very carefully and determined there was no way that they could get the money spent fast enough to have that effect with spending.

I think that one of the problems with stimulus is that if it is something that very clearly and obviously, we are going to have to reverse soon—for example, let us say in the Japanese case, they borrowed money to build roads to try to stimulate the economy, but then they had this debt that they are going to have to pay back—then the stimulus can turn into a negative stimulus when it is attempted to be offset.

So I think that that is the risk of short-term things, that if it is spending, it might not come quick enough, and if it is something that you have to reverse quickly, then, you might make it go back down.

Senator DOMENICI. One last question. Are we in a recession, and is it going to be short-lived or long-lived?

Mr. GALE. I said earlier, before you came in, that I hesitate to forecast the American economy—but I will say that at sort of a concept targeted level that my impression is yes, but that is not an expert opinion. That is my impression from reading the papers, not from doing detailed——

Senator DOMENICI. Yes, what—we are in a recession?

Mr. GALE. Yes, we are in a recession. That is my opinion.

Senator DOMENICI. And what about a short recess or a long recession?

Mr. GALE. My guess would be relatively short.

Senator DOMENICI. OK.

Mr. ORSZAG. I guess the way I would put it is that it is very likely that we are in a recession, and if I were forced to guess, I would bet shorter rather than longer, but there is a lot of uncertainty surrounding both of those statements.

Senator DOMENICI. Dr. Hassett.

Mr. HASSETT. Yes, this is—I would be shocked if we ended up looking back and finding that there was not a recession. I think that it will probably be dated as starting in the third quarter and that it could go on for a long time, for more than a year, if bad things keep happening and disruptions keep occurring. And I do not know whether that is true or not.

Senator DOMENICI. I want to ask one other question, but first, I want to ask if Wayne Angell's testimony can be made a part of the record.

Chairman CONRAD. Absolutely.

Senator DOMENICI. He was going to testify; he has some very good points. If anybody wants to look at them, that is another view.

Senator DOMENICI. I guess I am going to ask this last question because I myself am wondering with reference to what effects our economy, and I am quickly coming to the conclusion that we were in a recession before the planes hit the World Trade Center and the Pentagon, and we were in a recession before we became aware that anthrax could be upon us in some way or another. As a result of this, I kind of feel that the security and confidence that the American people must have to invest in an economy like ours right now is put at risk by the conditions that impact on what the people think.

Would each of you tell me whether you think the economy has been impacted negatively by either of those two events, and how do we stabilize it enough for the American people to do what we hope they will do, and that is to invest—and/or spend.

Mr. GALE. I think that—obviously, this is the key question in all this—I think that the economy was weakening beforehand. Clearly, it has sort of jolted downward since then. The example I used earlier was that the reason why people are not flying is not because of lack of disposable income; it is lack of confidence, or that feeling.

I think, therefore, that in an environment like that, spending on things like homeland security, defense, all these improved security measures that can be taken, rebuilding the New York City area, et cetera, can have not only the standard direct stimulus effect, but it can have a big indirect effect on people's attitudes and feelings.

And I think that the spending side is much more likely to generate those types of changes in confidence and those types of indirect effects than relatively minor alterations on the tax side.

Mr. ORSZAG. I would also emphasize the role of consumer confidence. Actually, interestingly, when people go to study the impact of confidence on economic activity, the relationship between one of the measures of consumer confidence, the Michigan one, does not seem to be all that important; but another one, the Conference Board, does seem to be, and that conforms with our intuition that consumer confidence actually does, of course, matter, and therefore, the drops in consumer confidence that we have seen are troubling.

So in addition to what Bill said about trying to underscore or buildup consumer confidence, I would just note that there are things that are more likely to be spent than others, and part of consumer confidence reflects not just security but also economic conditions. Consumer confidence is going to be affected even if we solve the security problems by a macroeconomic slowdown, and trying to address that macroeconomic slowdown even on traditional grounds is important in addition to the security-type concerns that Bill had.

Mr. HASSETT. There clearly has been a big negative effect of the events, and I think that reversing that effect requires some kind of return to normal for the economy.

Despite the slowdown that was occurring through August, there were still plenty of signs that were very positive. Most importantly, productivity stayed high in the first half of the year, and it was really quite a miraculous thing that it did. And that meant that the new economy arguments had something to them, that people were getting a return on those investments.

So anything that can be done to return us to where we were on September 10th, I think can be viewed as being worth the investment, because that was a strong economy.

I actually disagree with you, Senator. I think we would have avoided a recession, because I think that the declines in the different parts of the economy were out of phase—they were not all happening at the same time—and some things have pretty much corrected already.

So I think that there is hope from that perspective.

Senator DOMENICI. Well, if we get a reading soon that the last quarter was negative 1.5 to 3.0, you are going to say but for the prices, it would have not gotten to 3.0, or 1.5, or 2.0?

Mr. HASSETT. Do you mean the second quarter or the third quarter?

Senator DOMENICI. The third quarter.

Mr. HASSETT. No, I think the third quarter would likely have been about minus half a percent. That is where it was running—that was my third quarter estimate as of September 10.

Senator DOMENICI. OK, thank you.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Mr. Chairman, I like your choice of committee rooms, but when are we going to move back into our normal room?

Chairman CONRAD. That is a decision at a higher level of power than I have.

Senator NELSON. And, Mr. Chairman, how much time do I have?

Chairman CONRAD. Take 10 minutes, whatever you would like.

Senator NELSON. Let me go over a couple of arguments that have been made to me, and I would like your reflection on whether or not this is worthwhile.

One of you had mentioned increased investment in telecommunications. What the telecommunications industry is saying is that they need to modernize; they need to go to, instead of the old copper wire, the new kind of materials, in order to be competitive, and they need the incentives in the tax code to be able to do that, not only loss carry back and forward, but the increased depreciation.

Give me your thoughts on that.

Mr. ORSZAG. Two thoughts. One, again, what we really want to be doing is stimulating investment now, and the telecommunications, the move to broad band—there are a whole bunch of long run issues that various different sectors of the economy face and that may or may not justify tax incentives in some sense. But the focus here should be on short run stimulus, and I think it is easy to go astray when we try to solve longer run problems in a short run stimulus package.

So I very much support investment incentive, but it should be temporary, and it should really try to target the period of weakness that we are seeing, and it should not be specific to particular sectors. It should not apply just to telecommunications, for example.

That is actually one of the problems I have with the Subpart F rules in the House Ways and Means legislation. The Ways and Means legislation would provide effectively a substantial tax break to firms in the financial services industry and not to others by changing the rules that apply to international income. Only about a percent and a half of the 10-year cost occurs in 2002. It may or may not be justified on other bases, but it is not a stimulus measure, and I would say the same basic response on telecommunications.

So there should be a general investment incentive, but it should be temporary.

Dr. Hassett.

Mr. HASSETT. I actually disagree on this one. You must be familiar what Senator Rockfeller is working on right now, which is something of a stimulus for the telecom sector.

One of the things that brought down the high tech sector was a kind of logjam in the last mile. There is plenty of long haul, high-speed stuff out there that is sitting dark because we do not have broad band connections to our homes, and I think the reasons that we do not are many, but one of the key ones is a regulatory failure. And I know that people who work on this are trying to find telecommunications tax policies that work to offset those things that we have done poorly elsewhere.

Given the upside potential and network externalities and all the other things that can happen, if we could get past that logjam, then I would take seriously such efforts as Senator Rockefeller's.

Mr. GALE. I understand the nature of the problem of telecommunications that this incentive is designed to address. I think almost every major industry has a list of the things they would like to see adjusted in the long run. But what keeps coming back to me

is that, yes, there is time and place to deal with this, but it does not strike me as an obvious candidate for a stimulus package.

Senator NELSON. OK. Another item. We want to get people back into the airplanes. In a constituency such as mine in Florida, we are having devastating effects on hotel rooms, restaurants, tourist attractions, etcetera.

What about a tax incentive to get people back in the airplanes, like a $500 tax credit per person, $1,000 for a couple, if you take a trip in the next 4 to 6 months, and that money can be used on travel and lodging. What does that do, in your opinion?

Mr. ORSZAG. Well, I suppose I would have two concerns about such a proposal. One is what you do about the fact that that credit would be much more beneficial to high-income taxpayers who are more likely to be traveling anyway.

The key thing you have to ask is how much of it is going to go to events that would have occurred anyway——

Senator NELSON. Yes. You would have to design it such that it was not the trip that they were going to take anyway.

Mr. ORSZAG. Right. So if it were an incremental travel credit, I suppose my major concern would become just how complex it would be to administer.

Mr. GALE. This is sort of Exhibit B, I think, and every industry would like the solution to sort of come through them.

On the issue of subsidizing all travel that would have existed anyway, plus subsidizing new travel, I think you would find that most travel that you subsidized was going to happen anyway.

Again, I do not think that the reason people are not getting on planes is an income effect right now or a price effect, and I think that efforts to assure people that the skies are safe, that the streets are safe, and that the country is safe will be much more beneficial in the long run.

Senator NELSON. Dr. Hassett.

Mr. HASSETT. Yes, I concur. Normally, targeting a tax break for some specific thing requires some very strong argument about why that thing is much more important than some other thing that we might want to stimulate, and on that one, for me, it does not meet that test. I think there are a lot of other things—folks want to pay for dentists for their kids, and that is good, too, so why would we want to favor one set of people over another with tax breaks?

Senator NELSON. OK. We have an existing law that says if you have an IRA, and you turn 70–1/2, you have to start taking money out of that IRA, and if you do not, you get penalized significantly—and of course, when you take it out, it is taxable—but if you do not, you are significantly penalized.

But now, a bunch of senior citizens do not want to take it out of their IRA because their IRA is significantly depleted in its value. What about a change in the law that would give them a little more maneuverability and time so that they do not have to take it out at the diminished value? What do you think about that?

Mr. GALE. That is a really interesting question. I have worked—in fact, Brookings held a conference a year ago on pension regulations—and the early withdrawal rules are a mess and need to be rethought more carefully.

Now, interestingly, if you forced people to take the money out, that presumably would have a more stimulative effect than letting them keep it in there. On the other hand, I certainly understand their concern that they got nailed—they basically turned 70–1/2 at the wrong time—but I do not buy it as a stimulus package, having said all that. One could say, well, they knew they were going to turn 70–1/2, and they should have diversified their portfolio in advance to cover that.

So again, with all these things, you can sympathize with the aggrieved party, but on the other hand, it does not strike me as—not only as not a good idea for a stimulus package, but in fact it actually goes in the opposite direction to some of the principles that the Budget Committee chair laid out in the bipartisan bicameral statement and that Peter and I have talked about.

Mr. ORSZAG. And I think the Senator was actually asking about the minimum distribution rules and not early withdrawal rules. It is important to remember that those rules were put into place in order to prevent people from using a retirement savings tax preference for other purposes, so the savings were supposed to go to finance retirement, and that is what those minimum distribution rules are going to do.

I would also note that IRS has recently changed the regulations that apply to the minimum distribution rules the way the life expectancies are calculated that somewhat loosens them, so people still have to take money out, but they do not have to take quite as much out as they would have otherwise had to take out.

I would be concerned about a permanent change, again, as part of a stimulus package. It may or may not be a good thing, and we can talk about optimal pension policy and all that, but as part of a stimulus package, it would not be my highest priority.

Mr. HASSETT. I agree with my colleagues.

Senator NELSON. All right. Finally, let us talk about this situation. I was shocked to hear from Jon Corzine or one of you that New York is running a deficit in the range of $9 to $12 billion. Florida is going to be running a deficit in the range of about $2 billion.

What should we think about in a stimulus package, if any, to assist the States?

Mr. GALE. Broadly speaking, there are two or three things. One is that any reduction in economic activity at the State level will tend to offset the impact of a Federal stimulus.

The second is that the Federal stimulus could actually make the State situation worse by impacting State budgets—for example, the depreciation allowances. Just to be clear, if Federal depreciation allowances were expanded, they would reduce State revenues. Normally, you think, oh, that is good, that is a tax cut, that would be stimulative—but the States have these balanced budget rules, so they have to cut back their spending or raise other taxes to meet that reserve.

The third thing is just direct Federal subsidy of States via either revenue-sharing or the Medicaid idea that Peter talked about or a variety of other means. But I think it is a first-order consideration in a stimulus package.

Mr. ORSZAG. Again, I would basically say that there are two ways of trying to—I think it is important to provide some temporary assistance to States, because otherwise we are partially frustrating the effort at the Federal level, or undermining the effort. You could resurrect revenue-sharing on a temporary basis, or the more direct and straightforward way of doing this would be to just change the Medicaid match rate—raise it—the percent that is paid for by the Federal Government in the Medicaid program. And Kevin and I after this hearing will have to go to work on how to design it so that it is only given to those States that are willing to get rid of their balanced budget rules. But I think that in terms of getting the money out quickly, the Medicaid match is probably the most effective thing to do.

Mr. HASSETT. Yes, I think they have made a mess with a bad policy and that in some sense they have to clean up, and I hope to see them doing that.

Senator NELSON. Thank you.

Chairman CONRAD. Could I ask each of you as we conclude the hearing for your two best ideas to go into a stimulus package. If you were in the room when the final decisions are made, what would you be most insist be included?

Mr. GALE. Start with Kevin. [Laughter.]

Mr. HASSETT. And am I in the Senate, so that I have the House bill before me, and I recognize that——

Chairman CONRAD. Yes.

Mr. HASSETT. OK. From the House bill, the things that I would not yield on if we were arguing in a room would be the accelerated cost recovery salvage appreciation, or one-third expensing, and the AMT repeal. I think that if you do not do something now—again, I know you want to compromise on things and so on, and maybe you could tinker with it—but the fact is there are going to be tax hikes out there for folks because they are hurting, and that is wrong. That is why I oppose just letting AMT sit there.

Chairman CONRAD. OK. Thank you for that.

Dr. Orszag.

Mr. ORSZAG. You are forcing me to choose, and it is so difficult. But if I were forced to choose two, I would focus on expansions in unemployment insurance, which I think will have a very high bang for the buck, and in particular changing the eligibility rules so that part-time minimum wage workers are more likely to get unemployment insurance benefits than they are now.

The second thing I would do is some sort of State mechanism, support for the States.

So those would be my two, and if I were in the room with Dr. Hassett, I would argue that if we are going to do some sort of AMT change, just make it temporary for the period of the downturn—don't permanently get rid of the AMT.

Chairman CONRAD. All right.

Dr. Gale.

Mr. GALE. I would focus on the spending side as well, the expanded UI benefits, and revenue-sharing via some mechanism with the States. I think that both of those would have bigger bang for the buck than anything we can do on the tax side, and I think they

address more fundamentally the problems at the fiscal level than anything on the tax side.

Chairman CONRAD. All right. Now let me go back and ask each of you what are the two things that you would most aggressively oppose.

Mr. HASSETT. I hate to not answer the question, but in the conversations that I have seen, there have been many good ideas, and there are costs and benefits to all of them. We could argue this one is a little better than that one.

But among the set of things that I have seen—for example, the tax refund checks being mailed out, so there are good arguments that they can be reasonably effective, and I just could not get up a lot of steam to oppose that—so there is nothing in the set of things, say, in the Ways and Means bill or that I have seen discussed in the newspaper that gives me——

Chairman CONRAD. That you would be adamantly opposed to.

Mr. HASSETT. That is right.

Chairman CONRAD. OK. Thank you for that.

Dr. Orszag.

Mr. ORSZAG. I am going to cheat and say one is permanent corporate tax changes, so I will include under that both AMT and the Subpart F rules, which I know is a little bit of a cheat.

Then, the second one is the reduction in the capital gains tax rate, which I think is just inappropriate. It may or may not be warranted on longer-term grounds, but it is just inappropriate as part of the stimulus.

Chairman CONRAD. Thank you.

Dr. Gale.

Mr. GALE. I would put the capital gains cut third, not because it is—it is a bad idea, but it is a small bad idea, so I will put it as third.

The one I would put first would be, again, permanent cuts in the corporate tax structure. Anything that one can do there on the permanent side makes more sense both in terms of bang for the buck and in terms of cost than on a permanent side.

The other thing, beating out capital gains for second place, is acceleration of the previously enacted tax cuts, and there are several reasons to worry about that. One is that it is expensive. Second is that most of the benefits are going in the year 2003 and out, rather than 2002. Third is that all of those benefits are going to go to high-income taxpayers who are not going to be consuming as much of it as low-income taxpayers might.

And the last reason—and this is something that you know, but I will mention it anyway—is when all the dust settles on the stimulus package, we are going to wake up and find ourselves in an atrocious budget situation; we are going to have to rethink from ground zero, including rethink the wisdom of allowing the previously enacted tax cuts to actually go through. If that is the case, the last thing we should do now is accelerate those tax cuts.

Chairman CONRAD. Thank you all.

Mr. GALE. Thank you, Mr. Chairman.

Mr. ORSZAG. Thank you.

Mr. HASSETT. Thank you, sir.

Senator NELSON. Mr. Chairman, the revenue-sharing recommendation—was that specifically for State spending, like Medicaid?

Mr. ORSZAG. One way of implementing revenue-sharing is through the Medicaid match. The Federal Government match varies by State, but matches 50 to 70 percent or so of Medicaid spending. If you increase that match rate, then, directly, it looks like you are increasing Federal Medicaid spending, but what it really means is that the State government does not have to spend as much of its own funds on Medicaid, and since money is fungible, it is effectively—fungible at least to some degree—it is in some sense like a general revenue-sharing provision.

Chairman CONRAD. Thank you; a very good question. I am glad we got an answer to that.

I want to thank you very much. This is a hearing that we had wanted to hold earlier. Unfortunately, it was right after a series of events that obviously closed down other hearing rooms. And here we are, in an unusual setting, at an unusual time.

I just thank you all very much for your help. I think you have done a real service here today. I think all of you have been thoughtful witnesses, and these ideas are going to help inform what I support and what I oppose.

I think it is critically important that we get together. Senator Domenici and I just had a conversation, and one of the reasons that we got together on a bipartisan basis, those of us who are responsible for the Budget Committees in the House and the Senate, is because we wanted to try to bridge the partisan divide; and we did that. We did it with respect to a new financial outlook for the country and a new set of projections for our colleagues. We did that with respect to a set of principles to apply to a stimulus package.

We are also very much united in the view that we need to now move to form a stimulus package, because that in and of itself will provide some boost to confidence. I think Dr. Hassett said it, that we are moving, and moving effectively itself is a confidence-building measure.

So I am very hopeful now that we do not get bogged down. We were just having a conversation up here about the danger of that. We see that danger growing; we see differences growing.

I met with a number of colleagues yesterday in the leadership on the Republican side and told them I think it is going to require Presidential leadership at this time to bring people back together, because what has happened unfortunately is that we were on a bipartisan path, and that has gotten interrupted, but that can be just a momentary interruption in what has been an incredibly positive coming together in light of this vicious attack on our country.

I think it is terribly important that we find a way to come back together and do it quite quickly, and I think it is going to take the President calling the combined leadership together and ask them to sit down and try to come up with a package that can be enacted quickly and effectively. And I just want to say that you have helped that process here today.

So thank you very much. With that, we will adjourn the hearing.

[Whereupon, at 11:15 a.m., the committee was adjourned.]

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