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ECONOMIC REPORT OF THE PRESIDENT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

FEBRUARY 26, 2003

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ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 26, 2003

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

The Committee met at 3:35 p.m. in room SD-628 of the Dirksen Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Members Present: Senator Bennett, Representative Stark and Senator Reed.

Staff Present: Donald Marron, Jeff Wrase, Dianne Preece, Wesley Yeo, Gary Blank, Colleen J. Healy, Wendell Primus, Chad Stone, Frank Sammartino, Diane Rogers, Matt Salomon, Sean McCluskie, Nan Gibson and Daphne Clones-Federing.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, U.S. SENATOR FROM UTAH, CHAIRMAN

Chairman Bennett. The Committee will come to order. I apologize for those who have had their previous schedules upset by virtue of the delay. We had Secretary Rumsfeld briefing the Senate, starting at the hour we would normally have convened, and I understand that immediately upon leaving the Senate, he will then give a similar briefing to the House, which may mean we will have fewer House Members attend this Joint Committee than is otherwise the case.

Nonetheless, I think it important that we move ahead, and I appreciate Dr. Kroszner and Chairman Hubbard, your willingness to appear. We have a full panel today, and I think we will get further insight into the Economic Report of the President.

The Employment Act of 1946, which created the Joint Economic Committee, also created the Council of Economic Advisers, and anticipated that the two organizations would work very closely together. The one explicitly-mandated task of this Committee is to review the one explicitly-mandated task of the Council of Economic Advisers.

That is, the CEA is required to issue a Report each year and officially present it to the Congress, and the Joint Economic Committee must review that Report and officially comment on it. So this is that official presentation by the CEA to the Congress, and our comment will come both in this hearing and in a formal document that we'll produce later.

We welcome members of the Council of Economic Advisers today, Dr. Hubbard and Dr. Kroszner. We appreciate having worked with

both of you in the past, and salute you for your service to the President and to the country.

We're anxious to hear your thoughts on the current state of the economy, the President's various proposals, and other policy proposals that may be included in your Report.

Now, what stands out in the Report, from my point of view, is its sheer breadth. The Administration lays out the current state of tax policy, regulatory policy, and the economy, along with corporate governance issues and international developments, and it does so in some detail. I don't know of a similar Report from a Council of Economic Advisers that has been quite so sweeping.

I don't say that in a derogatory sense, but in a congratulatory sense. The Administration has taken on an amazing array of reforms since the President's inauguration, and as I say, I think that is to be congratulated.

If there is one word that could be used to describe the Administration's approach, it would be bold or far-reaching. Bite-sized is not an adjective that comes to mind in dealing with this.

Now, the proposals have drawn the ire of a number of constituencies, and not only among those who are normally thought of as the President's political opponents. The Administration has resisted efforts to lard its recent growth package with dubious spending programs or temporary tax fixes that would produce excitement in one short-term area or another or one short-term constituency or another, and, in my view, it should be commended on that.

Nonetheless, the breadth of the Report means that you will be getting a number of questions here today, and some of them not necessarily friendly, and I think that is not only to be expected, but probably is the right way to go at this.

I feel particularly that the proposed economic reforms outside of the Tax Code are bold and far-reaching. The Administration's push for the Millennium Challenge Account may be a turning point in the efficacy of foreign aid.

I have had exchanges with Secretary Powell on this point and said I want to fund movement and not monuments. Too much of our foreign aid has produced a physical monument—"Look what the Americans paid for"—but no movement in the economy of the country in which it was placed.

Another interesting policy initiative, bringing greater emphasis on rigorous cost-benefit analysis and market forces in the regulatory arena, will ultimately result in policy outcomes that will help us to meet our common goals of improved workplace safety, a cleaner environment, and safe food and drugs and lower costs to the Government and the taxpayers.

And, of course, another policy innovation that we will expect to hear about is the introduction of personal reemployment accounts, a new approach to the question of those who are out of work. They will make it easier, we trust, for the unemployed to get training and get back into the workforce as soon as possible.

But, of course, the thing that is on everyone's mind is the macroeconomic situation. That is what everybody is talking about. I heard one of my colleagues on the Senate floor last week describe this as the worst economy in 50 years. I don't subscribe to that no-

tion, and I don't know of any numbers that would sustain that view.

But this particular Senator said it, and, presumably, this particular Senator's constituents are feeling some economic problems, so we would like to talk about the macroeconomic view, as well, as we go along.

I would just note that in a macro way, this economy has shown enormous resilience. In the last 3 years, we have sustained four major economic shocks.

The first was the collapse of the high-tech bubble, and with it, the entry into a bear market, which has gone on now for over 2-and-a-half, going on 3 years. That is something that would normally slow down the economy all by itself.

Then the 9/11 terrorist attacks, with the obvious impact on the economy there, and the amount that had to be spent for rebuilding and the amount that has had to go for creating homeland security and conducting the war on terrorism.

The third crisis of confidence started with Enron, but hit more seriously home with Worldcom, as investors decided they suddenly could not trust information they were getting out of Wall Street. That was a confidence crisis that would significantly damage any economy.

And then, of course, there is the military showdown in the Middle East, which puts uncertainty into the mix. Investors always flee uncertainty. Unfortunately that uncertainty is heightened by the instability in Venezuela, giving us higher oil prices.

So these four things, the collapse of the high-tech boom and the overpriced stock market, the 9/11 terrorist attacks, the crisis in confidence, and then geopolitical considerations that are beyond our control, hitting us virtually at the same time, and still the economy grew at 2.7 percent in 2002, and the forecasters say it will grow at a more robust rate in 2003, demonstrate the tremendous resilience of the American economy, particularly when compared to the rest of the world, where those who have not had those kinds of crises have growth numbers that are more anemic than our own, particularly those two countries in Europe, who shall remain nameless, who are constantly lecturing us on how to conduct our own affairs.

With that, I will turn to Mr. Stark, the Ranking Member, for whatever opening statement he might have.

[The prepared statement of Senator Robert F. Bennett appears in the Submissions for the Record on page 33.]

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, U.S. REPRESENTATIVE FROM CALIFORNIA, RANKING MINORITY MEMBER

Representative Stark. Thank you, Chairman Bennett. I welcome Dr. Hubbard back again, and Dr. Kroszner, welcome to the Committee. The numbers that we have been hearing show that the President's latest economic plan doesn't do much to inspire our confidence.

Consumer confidence has slumped to the lowest level in a decade. People seem to be worried at home about weak job markets,

falling stock values, $2-plus-a-gallon gas in California, the threat of terrorism, and the war with Iraq.

Even more astounding is that the Administration's fiscal policy has caused this country to go from a 10-year surplus of almost $6 trillion, to a projected 10-year deficit of $2 trillion. By my numbers, that's almost putting us upside down by $8 trillion in 2 years. What a job.

Well, the Administration would like to blame this budget on factors it can't control, such as the sagging economy, entropy, the war on terrorism, and faith-based economics. The fact is that the recent Republican tax cut contributed a third of that deficit in 2003 and 2004.

Making these tax cuts permanent would just make a bad situation worse. Moreover, President Bush's recent budget ranks right up there with "Harry Potter" on that left side of *The New York Times* Bestseller List, rather than the right side.

The budget costs don't take into account the cost of the war. We heard this morning that although your predecessor got fired for saying it would be $200 billion, somebody said this morning, $95 billion, and if they're still employed at the end of the day, I'll take that as the Administration's final word.

It is clear that the Administration's tax cut proposals are irresponsible, inappropriate, particularly in the context of future fiscal pressures on Social Security and Medicare, and we'll need further extension of unemployment to help those currently struggling in this economy.

When President Bush took office, he proposed an ambitious plan to reform Social Security in order to address the demographic challenge. This year's Economic Report of the President doesn't mention the challenge itself, much less the Administration's plans for addressing that. I presume that, Chairman Hubbard, you'll explain that to us today.

But with the retirement of the Baby Boom generation just a few years away, we should be taking steps to make sure that we have the budget resources to honor our commitment to Social Security and Medicare.

Once interest costs are taken into account, the President's new tax cuts will add almost $2 trillion to the national debt over the next 10 years. Large increases in public debt are, guess what? They're bad for interest rates; they're bad for investment; and they are bad for long-term growth.

So it's no wonder that consumers have a sinking feeling about the economy. I look forward, gentlemen, to your testimony today, to address these concerns, not only to us, but to the millions of Americans whose unemployment insurance just expired, and they're just going to get job training and a promise, and many of the other people who are worried about their retirement plans, educating their children, their healthcare, all those things that you have managed to dry up by creating this deficit. Thank you very much. Thank you, Mr. Chairman.

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

Chairman Bennett. Senator Reed.

Senator Reed. Mr. Chairman, I don't have a prepared statement. I think it's probably in order to go to the witnesses. Thank you.

Chairman Bennett. Thank you very much.

Chairman Hubbard, you may proceed.

OPENING STATEMENT OF THE HONORABLE R. GLENN HUBBARD, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, WASHINGTON, DC; ACCOMPANIED BY RANDY KROSZNER

Chairman Hubbard. Thank you very much, Mr. Chairman and Ranking Member Stark and Senator Reed. I'll be relatively brief in remarks. We have prepared testimony.

First, I'd like to thank you, Mr. Chairman, for the continuing partnership between the Joint Economic Committee here in the Congress and the Council in the White House. It's not simply our statutory requirement; it's our pleasure and a learning experience, and we're grateful.

You noted that the Report is somewhat sweeping, which reflects in large part, the many demands from the President's agenda. In my remarks, what I'd like to do is, yes, talk about the Economic Report, but in the context of the President's here-and-now agenda.

Following your request, Mr. Chairman, I'd like to begin in thinking about the current economic outlook, but look through two lenses which I think are useful in thinking about the President's economic policies.

The first lens is risk to the current recovery. The dominant role in the most recent recession and playing a factor in the nascent recovery is the behavior of business investment. Note the sharp decline in investment and equity prices that you referred to, Mr. Chairman, in your opening statements.

This prominent role for investment is not typical of a postwar recovery or recession. We believe in the Administrations that in the short term, while forecasts in the private sector are relatively optimistic for the balance of this year, there are important downside risks and those risks relate most prominently to investment.

A recent study from the Philadelphia Federal Reserve Bank noted that a key concern in business people's minds, in fact, concern greater in that survey than geopolitical risk, is just whether the economy's recovery itself is viable.

But there is a second lens in thinking about the economy, and I can be brief here, Mr. Chairman, because you already gave the story very well, and that is the flexibility and dynamism of the American economy. I often tell audiences, if I sat with them 2 years ago and told them that I was clairvoyant and could tell them all the events that you spoke of, Mr. Chairman, I think we all would have been rushing for the exits. Indeed, the economy did much better.

The secrets there are much the secrets that explain the productivity growth performance of the United States. They are flexibility in American institutions, which was the theme of last year's Economic Report of the President, and the dynamism of the American economy, which is the theme of this year's Economic Report of the President.

In a nutshell, the Economic Report of the President tries to make the point that public policy, like our economy, can't parse the world neatly into short-term and long-term or group individuals or classes in our economy on static notions.

These two lenses, the short-term risks and the long-term flexibility, really frame the discussion of public policy. The first discussion in the Economic Report is on corporate governance, and here, of course, corporate governance isn't simply an academic issue.

We know that it has been an area that has weighed on the economy in the short term, and it is also an important part of our economy's long-term success, the depth of American financial markets remains the envy of the world.

The Report talks about the ways in which the President's original ten-point plan for corporate governance and the ultimate Sarbanes-Oxley legislation were based on sound economics and on the notion that corporate governance is dynamic, reflecting changes in the market for corporate control, internal features of boards and so on, and laws and regulations.

You mentioned regulation, Mr. Chairman, in your opening remarks. We have a chapter which I think is an interesting one on the development of regulation in a dynamic economy. There are often unintended consequences of regulation when regulation does not anticipate innovation and response in the private sector.

The Report goes through distinctions between good regulation, trying to fix market failures in our economy, and bad regulation that simply represents rent-seeking from special interest groups.

The CEA and OMB have been involved in the preparation of new benefit-cost guidelines, which we hope will impose more economic discipline on the regulatory process, and a good case study, which is highlighted in the Report is the President's Clear Skies Initiative, in which both sound science and sound economics have helped shape an important topic in environmental policy.

Analyzing tax policy is also one of the chapters in the Report. Here, I might digress a moment. Mr. Stark, as to your question about Social Security, we had a major chapter on Social Security last year, and I know it is an awful academic habit to publish the same thing twice, and so we didn't want to do it again, but there is a great discussion last year and I'd be happy to talk to you about it.

The tax policy chapter centers on two things: One is the importance of pro-growth policy, but also the importance of analytical issues that get at this issue of dynamism.

One issue comes up in the context of the President's policy to remove the double tax on corporate income. The question is, who bears the burden of that tax? And there is, of course, much discussion about who gets dividends and who gets capital gains.

Economists, I think, would argue that that is not the right way to think of it. Who bears the burden of a tax has little to do with who writes a check to the IRS. And who bears the burden of the double tax are all of us, whether we get a dividend, a capital gain or not, in terms of our wages.

When you double-tax something, you get less of it. The "it" here is capital, which influences productivity, our economic growth, and all of our wages in the future.

The second issue, analytical issue raised in the chapter is the notion of mobility of individuals through income groups and tax rates. It's common in the analysis of the distribution of tax policy to group people in income classes or tax rate brackets where they now are.

This chart takes a family, just to fix an idea, a two-wage earner family with two children, starting at $65,000 in income for both workers put together, and follows them through their lifetime, if they had a typical wage earnings profile from microdata in our economy.

[Chart appears in the Submissions for the Record on page 45.]

You will notice that that couple with children, as their children age, as their income grows, as they retire, face very different marginal tax rates.

And as the Report notes, there is a significant amount of upward and downward mobility in the income distribution. And so in terms of thinking about the distribution of cuts in marginal tax rates or the acceleration of marginal tax rates, those points are important.

The Report also has a chapter on designing dynamic labor market policies and here again we know from the pretax wage data, there is enormous mobility. And one of the President's proposals, as noted, was the development of personal reemployment accounts.

These are data on the probability or fraction of workers finding work by number of weeks unemployed. The data make a simple and a well-known point that periods of expiration of unemployment insurance benefits are very closely correlated with the finding of a job.

And the point of the President's personal reemployment accounts is to make sure people have an incentive to obtain work and that that work is what leads to upward mobility in wages.

The final chapter, as you noted in your opening statement, Mr. Chairman, is, I think, in some sense the most exciting, even though it's not in the hearing now of the current policy debate over the growth package. And that's promoting global growth.

The President is not simply interested in the promotion of economic growth in the United States; we're interested in the promotion of economic growth around the world. That is, in part, of course, because of the concern we all have as Americans for our fellow citizens around the world, but, frankly, it is also in the economic interest of the United States to have more rapid growth around the world.

Empirical evidence from economic studies suggests that all countries can experience faster growth with a better economic environment. This chart, taken from the Economic Report of the President, plots real income, the log of real income per head on an index of the rule of law, making the point that the property rights features of an economy, the enforcement of contracts in courts, things that we sometimes take for granted as the matter of the rule of law, are very closely correlated with economic growth. These institutional features are every bit as important as endowments a country has as to how quickly it grows. There is, of course, the President's agenda for the Millennium Challenge initiative that you mentioned, the Millennium Challenge account, but also our trade pro-

motion initiatives and our attempts to reform the international financial institutions.

[Chart appears in the Submissions for the Record on page 47.]

To conclude, Mr. Chairman, in the short term I do believe we have a recovery underway. I think there are significant risks to the downside that warrant prompt consideration and passage of an economic growth package. But for the long term, what we must not lose sight of are the underlying flexibility and dynamism of the U.S. economy. That is not only our distinguishing characteristic among industrial economies. It is one to be celebrated.

Thank you, Mr. Chairman. If you have anything, I have nothing further to add at the moment.

[The prepared statement of Chairman R. Glenn Hubbard appears in the Submissions for the Record on page 35.]

Chairman Bennett. Thank you very much. Could you put the first chart back up and explain it to me?

Chairman Hubbard. The chart plots fixed investment.

[Chart appears in the Submissions for the Record on page 44.]

Chairman Bennett. I understand what the red line is and what the black line is, but what is the cause and effect which you're trying to show? Does the black line cause the red line or does the red line cause the black line?

Chairman Hubbard. We have a common feature you referred to in your opening remarks causing both. We were excessively optimistic perhaps about the economy's expected future profitability. The realization of that led to a decline in equity prices and destruction of wealth to which you referred and also to a sharp decline in business investment. That makes two points. One that a client in business investment is very central, but also these wealth effects are very large and will take time to work through. This again is not a typical cycle and the design for policy is somewhat more complicated than a typical cycle.

Chairman Bennett. Again the thing I'm trying to understand, the red line is the S&P 500.

Chairman Hubbard. Correct.

Chairman Bennett. You see the periods of exuberance, irrational exuberance.

Chairman Hubbard. We would expect, of course, from economics that equity value changes would be positively correlated with changes in investment.

Chairman Bennett. But the question is, when the bubble burst?

Chairman Hubbard. Then we have a sharp decline in equity values and a sharp decline in investment.

Chairman Bennett. It's the sharp decline in equity values that caused the sharp decline in business investment?

Chairman Hubbard. They are both manifestations of the same thing, Senator.

Chairman Bennett. One does not cause the other, but they just track together.

Chairman Hubbard. The realization that what we thought about future profits was likely too optimistic, both depress stock prices and tells business people we now have perhaps too much

capital so we need to go through a period of time with lower investment than we had in the past.

Chairman Bennett. So the black line going up is not meant to be predictive that the red line will follow.

Chairman Hubbard. It may be so, but no, Senator. This is just the beginning of a recovery for equipment and software investment. The recovery of the red line of course depends on expectations about future profits.

Chairman Bennett. Sure. Chairman Greenspan has said repeatedly that the red line's not going to come up until the situation in Iraq gets resolved one way or the other. He has made it clear that he feels the geopolitical uncertainties in Iraq and Venezuela are weighing on the economy, and he repeated that again this morning before the Banking Committee. Iraq and Venezuela are major depressants.

Chairman Hubbard. If I may, Mr. Chairman, I think it is certainly the fact that geopolitical risks figure prominently on business people's minds. I can tell you both anecdotally from talking to business people around the country and based on surveys like the Philadelphia Fed Survey to which I referred in my remarks. Business people cite many factors, sometimes ahead of the factors related to geopolitical risk, and those factors center on the viability of the recovery itself.

Chairman Bennett. We might as well get right to it because the manner in which the press reports Chairman Greenspan's statements is similar to the responses to the Oracle at Delphi, and Mr. Greenspan sometimes is just as opaque as the Oracle at Delphi. I think people need to try to understand and think it through. Republicans and the Administration are taking great comfort out of Chairman Greenspan's obvious endorsement of the double taxation on a dividends proposal. He says that will make the economy more efficient and produce sustained, long-term growth in a manner that may get us back to the numbers that Mr. Stark referred to in terms of tax revenues coming in as the economy recovers.

Democrats who oppose the President's program take comfort in Mr. Greenspan's comment about the fact that the recovery is robust enough that it does not need an immediate stimulus. Have I summarized it correctly in your view as to how the two have been playing off his comments?

Chairman Hubbard. I think that's correct, Mr. Chairman.

Chairman Bennett. Let's go to the second question which is whether or not the President's proposal would help the economy in the near term. Accepting Chairman Greenspan's statement that his proposal will help the economy significantly in the long term, let's go to the question that has been raised by some of my Democratic friends. He says the recovery is robust enough that it does not need any help in the near term.

Now making that argument flies in the teeth of those who say this is the worst economy in 50 years, but let's set aside that inconsistency and go to the fundamental question.

How do you answer the criticism that says that the President's program is not contributory to a near term recovery and that the recovery is, in fact, robust enough that it does not need any help at this particular point?

Chairman Hubbard. You actually raised two questions there, Mr. Chairman. On the effects of the President's plan in the short run, we've estimated as the council that if you take the entire package as a whole, quite substantial effects in 2003 and 2004 close to a percentage point of extra GDP growth in 2003, for example, that reflects contributions for accelerating the marginal rates and the child credit expending for more small businesses as well as the contribution from changing the double tax on corporate income. One way to see that is the very large cost of capital reductions which is made possible by a tax on corporate income. There's a powerful investment incentive and the showing up of consumer spending through the acceleration in rate cuts. There's a question of, even if it's effective, do you need it here. Of course it depends on what your counter factual is.

Think about the downside risk. The downside risk that I referred to has to do with the timing of the investment recovery. In our estimate, if you looked at conventional forecasts of the timing of the investment recovery, and assumed a delay of a few quarters, that is, just take the pattern, but shift it a little because of the uncertainty in the environment and even had very modest increases in precautionary saving by consumers in response to uncertainty. That could shave close to a full percentage point from GDP growth in the near term, very closely call as with the amount of the deposit effect from what the President was trying to do.

We view this in much the same way one views insurance. It's very good for downside risks. If you look at the balance of risks and whether or not you should act, we believe the balance of risks here is very favorable. The action is associated with very good long term tax policy at a time when the economy is also very weak and inflationary pressures are very, very low.

Chairman Bennett. Chairman Greenspan has made it clear that he believes the tax cuts should be made permanent; indeed he has said that the market has already assumed that they will be made permanent, and if we allow them to expire, there would be a major hit in the market as they change that assumption. So the question from his point of view is not should the tax cuts be made, but simply a matter of timing, and he is suggesting that the timing now is not necessary for the recovery.

Let me ask you the flip side of that question. If we were to move the timing up and have it take place this year, would that produce any, either short-term or long-term problems.

Chairman Hubbard. Making the tax cuts is obviously good tax policy. I would assume if Congress voted on something for 10 years it believed it was good tax policy. It's difficult to imagine that it somehow becomes bad tax policy. I think in that sense, it makes very good sense. Greater certainty about tax policy is very good for business planning and household planning.

Chairman Bennett. But I'm talking about the question. As I say, Greenspan agrees with that, but he's being quoted as saying we don't need it accelerated to this year; that the recovery is robust enough that that's not necessary.

My question is, is there any downside risk either to the deficit long-term to the recovery itself if they are, in fact, accelerated to this year.

Chairman Hubbard. I don't think so, Mr. Chairman. Accelerating those rate cuts provides support not only from consumption, but for business investment that's done through small businesses that pay taxes at individual rates. Ask yourself what's the price for that insurance? It's quite low fiscally because it's accelerating and they are already talking about an up front acceleration in which the many economists would argue the economy needs it.

In terms of additional pressure on interest rates, from such an acceleration, we view those, in fact, as being very modest compared to the positive effects from the rapid economic growth.

Chairman Bennett. One more question and then I'll turn it over to Representative Stark. Again back to Chairman Greenspan, as I understand his concern, it is that we accelerate the tax cut into this year without making commensurate cuts in spending. We would put ourselves on a course that would be somewhat destabilizing in terms of the future deficit and/or surplus. Therefore he says, okay, the tax cuts are fine, but you've got a problem on the expenditure side. Now I've heard him say you can set the expenditure level just about anywhere you want in Congress, but you can't set the revenue level where you want because the revenue level is dependent on how well the economy does.

And if you set your permanent expenditure level—now I'm using my words rather than his, but it's his concept—if you now set the expenditure level that is unsustainable over time in terms of what the economy would yield in terms of revenue level, you've built in long-term serious problems. I'm assuming that is what has caused him to say don't bring the tax cuts forward in this year unless you can find a way to bring your expenditures under control.

Now in a time of building a Homeland Security department from scratch and the war on terrorism is not over, in a time when in all probability, we will be in a shooting war relatively quickly, and in a time when the stock market has still not recovered for whatever reasons, geopolitical or otherwise, is there value in taking the position that we have to pay for within the next year or two the tax cut in terms of expenditure control?

Chairman Hubbard. It's certainly the case that for the long-term fiscal health of the country we have to focus on two things. One is economic growth, because that is what is going to promote revenues for the Federal Government as well as all of us as individuals. Yeah, there was spending restraint, no doubt about it. But given the short-term issues, the way you describe them, I think quite accurately, I just can't see the argument for not accelerating the tax cuts. Over the long term, it's the size of Government, of course, that will matter. The budget constraint must balance over the long term and I think we'd be much better as an economy having it balanced with smaller Government than a larger one.

Chairman Bennett. Thank you.

Representative Stark. Thank you, Mr. Chairman. I have a variety of Chairman Greenspan's quotes here and I've been looking at some that you paraphrased. The one that I notice, and I'm quoting this from his Senate Banking hearing on February 12, 2003, is that he supports the program to reduce double taxation of dividends as you suggested, but the last part of that statement was that, and the necessary other actions in the Federal budget to

make it revenue-neutral. I believe that the tax cut on dividends without any offsetting revenue raising would not meet Chairman Greenspan's test, and he has a bunch of other statements.

I ought to correct one other thing. I think that I can speak for the Democrats; I'm the only one in the room, but we don't think the recovery is very robust and we think a properly targeted stimulus is necessary. But that does not mean a stimulus targeted at the upper richest 1 percent of American individuals.

So I'll put these notes, if you like, in the record, just to try and set the Greenspan—you can interpret them I guess as you choose.

Chairman Bennett. Without an objection, they'll be in the record.

[The notes referred to appear in the Submissions for the Record on page 71.]

Representative Stark. Dr. Hubbard, the Administration and President Bush are fond of 92 million Americans who will receive an average tax cut of $1,083. I remember suffering through some course in economics somewhere, and when the Urban Institute or Brookings suggests that half of all the taxpayers would only see their taxes drop by less than a hundred dollars, then I guess the President could say that the average tax cut is $1,000 and change, and I could say the median is $100 and we'd both be correct. Would that be a fair statement?

Chairman Hubbard. I don't think it's exactly a fair statement on the numbers, but I take your point that averages start that Americans would receive less than $100 benefit from this tax cut, then the median is right around $100.

It depends. We're talking about all Americans in the population or all the taxpayers.

Representative Stark. You're quite correct. I'm referring to taxpayers.

Chairman Hubbard. I don't believe that's the case, Mr. Stark, but I can get you the percentages.

Representative Stark. That's what Brookings says and if you want to challenge them, that's okay with me. I'll let you guys fight that out.

Chairman Hubbard. May I respond to the spirit of your question Representative Stark? If you take a family of four with two children making $39,000, it's not an average, it's an example. It would be a $1,100 tax reduction.

I think the President's plan offers great benefits for moderate-income families as well as for upper-income families.

Representative Stark. Poop, that's all I can say. That's nonsense. And I hope you know it and if you don't, it's time you learned.

There was an article by Robert Novak, one of the great liberal columnists in the country.

[Laughter.]

Representative Stark. On the February 24, 2003, last weekend, he said that there's aggravation at the White House of Greenspan's comments on the Bush tax cuts. Do you think that Dr. Greenspan's comments were inappropriate?

Chairman Hubbard. Not at all.

Representative Stark. You weren't aggravated by them?

Chairman Hubbard. No, Representative Stark. The Federal Reserve and its Chairman and all of its representatives are independent. As you know, the Administration is both entitled to and respected for their opinions

Representative Stark. You notice that I jumped on Social Security. You did have a policy last year. That policy was privatizing Social Security, was is not?

Chairman Hubbard. The policy is the creation of personal accounts.

Representative Stark. Which we referred to as privatizing and which you aren't talking about this year, are you?

Chairman Hubbard. I think that's a sort of inaccurate term. There are many ways to do personal accounts.

Representative Stark. One of the great joys of being an economist. You can have inaccurate terms and still be economically accurate. But as we liked to say last year and as we said it articulately enough so the President dropped it, is that his plan of last year was privatization, if only partial privatization of the Social Security fund.

I'd now like to discuss just one more. Could we have that chart on unemployment? I love it. Did you ever read Jonathan Swift and his solution for welfare, eating little children? Did you ever read that story? A modest proposal. I would commend it to you because it's the Republicans to a T. And I've always said if that doesn't sound like the Bush proposal, I've never heard it.

But what you're telling me there, I think you're trying to sell me in fact, is that if there's a cliff that I'm going to fall off when I'm unemployed, I'll hurry up and get a job. Is that the sense that every time there is an expiration of unemployment benefits, people suddenly got jobs?

Chairman Hubbard. These come from actual——

Representative Stark. That's what you would suggest to me that that chart implies. How about then, Dr. Hubbard, why don't you just say if you don't get a job, you go to jail? Wouldn't that really get people to get jobs more quickly?

Chairman Hubbard. I think you're caricaturing, Mr. Stark, what's really a very important point for people who are on unemployment—that the longer that you remain unemployed, the more your skills deteriorate. The question is, what kinds of policies get people back to work?

Representative Stark. That's what I want to get to. I'm just going to take an example. You've got a million people who are out of work, right? On unemployment. They lost their unemployment on December 28th as a Republican Christmas present. Now——

Chairman Bennett. We restored that in the Senate. Didn't you pass it in the House?

Representative Stark. No, we didn't. It was controlled at that time by the Republicans.

Chairman Bennett. It was restored by the Republicans when we restored it.

Representative Stark. The million people who lost their benefits are going to get a $3,000 account to do things. They're going to get day care, carfare, and training. Isn't it correct that to be getting the unemployment benefits for 13 weeks they had to have had

a job for at least six months? I think that's the rule, right? It may be longer. So all of these million people have had jobs. They were doing something. They were plumbers, carpenters, painters, they worked at Home Depot, they were chiropractors, lawyers, accountants, CPAs. I bet there were a lot of them in there. But all these people had jobs.

So I gather what you're going to do is train the plumbers to be carpenters and the painters to be chiropractors and that's going to help them along the road, when, in fact, there aren't any jobs out there, because these people could all work. These are not people who were incapable. They are not dysfunctional employees. They're not people who are on welfare because they're incompetent to work or they need education. They are people who are holding down, one would assume, an economically efficient place in our economy and performing a task. What kind of training would you suggest they get?

Chairman Hubbard. Let me start with what I think was the thrust of your remarks and questions, Mr. Stark, about jobs not being out there. That is precisely the point—that jobs and growth package, if I might, Mr. Stark, that the President's proposals would in and of themselves lead to the creation of 1.4 million jobs.

Representative Stark. That $3,000 for training, daycare and carfare are not going to find a job for the plumber when the plumbing company closed up. And what I'm suggesting is that if he had the $3,000, he would pay his rent, buy clothes for his kids, all the things that would stimulate the economy. Instead of staying home and reading a book on how to be an economist, he would be spending that money. He'd be consuming, which would help the economy, and we would be doing something to help that family stay together.

Now the President is going to spend $300 million to promote stable families through marriage. These guys are either married or they're not, but they're certainly not going to get married if they're unemployed. That makes them look very unattractive in the matrimony market.

So what's wrong that two really good, solid, liberal Republicans like George Bush Senior and Ronald Reagan, extended the benefits for 33 or 36 weeks out of compassion? Why don't we?

Chairman Hubbard. The two-part answer to your questions, Mr. Stark. One is, again, the thrust of the jobs and growth packages is on the promotion of economic growth so that people have jobs. You may have different views on how many jobs.

Representative Stark. These million people don't.

Chairman Hubbard. On the personal reemployment accounts, I frankly think your question trivializes the problem of the long-term unemployed, who as you know well now are eligible for Government training programs. What the President is proposing, personal reemployment accounts, is a much more flexible solution that helps them get a job. What we know is that wage growth responds to the time and tenure you have a job, not the time and tenure on unemployment insurance.

Representative Stark. The job market has gone south in their particular community, and there aren't jobs even in their state. What are you going to train them for? I'm saying these are people, and they're a variety of people. Let's say in that million people

there's probably every skill you can dream of and they can't find a job because there aren't any. So what are you going to do, daycare?

Why can't you give them the money in terms of benefits and let them have the flexibility to go look for a job? You're limiting them, because then they can't pay their rent or keep their house or buy gas for their car, and that seems terribly arrogant, in my book.

Chairman Hubbard. The goal of the President's policies is to promote people getting a paycheck, not an unemployment check.

Representative Stark. The President may have forgotten this, and you may, too, there's an unemployment law in this country.

Chairman Hubbard. If I might continue, Mr. Stark. The question in employment policy is how best to promote getting people back to work. We can have reasonable disagreements on that, but one of the great hallmarks of our labor market in this country over the past 20 years is the flexibility. If people change industries, change jobs, the kinds of things your question precluded are the very factors of success in the American labor market.

Representative Stark. But there aren't any jobs, and you can't tell me what you're going to train them to do. People in this pool have every conceivable type of skill. I mean, why don't you just give them a ticket to where the job is? You are begging the question, sir. These people need money to live, and you're saying we're not going to give you any money to live, we're going to train you. You beg the question. Is it the economy is so lousy that there aren't jobs? If you didn't move them all to Mexico then for some reason, you got them so that they've closed down. Now what do you do with those people?

Chairman Hubbard. You've given me a lot to work with with that question, but I just want to take the part about your limiting people's choices. What the President has done in personal reemployment accounts is broadened them. There is money to use for whatever you want. You're not required to simply use this on a particular training program.

Representative Stark. As I say, I'm glad. I'm sure that a million people who have had their benefits expire and the ones who are going to come onto it will be happy to learn that they can have daycare, although they've got nothing to do during the day anyway, so they might as well stay home and get to know their kids a little better.

Carfare. I don't know where they're going to go. And training, I know not for what; as I say, they are all currently able to hold down a job. The fact that those jobs no longer exist, it could be that you've got a few buggy whip makers out there, and I'll stipulate that maybe 1 or 2 percent could learn to do something else. But it seems to me that toilets still get stopped up all over the country and if the plumber is out of work, why train him to do something else? You train him to be a surgeon, but he'd make more as a plumber. And it seems to me that this is an excuse.

I know that it's compassionate conservatism, and I'm just trying to understand how we can get that compassion to some of those people in the 98th percentile and down rather than give it all to people like the Chairman and myself in the upper 1 percent where we really don't need it. But thanks for your efforts. And read that

Jonathan Swift thing. It'll probably give you some other ideas for how to help the poor.

Thank you, Mr. Chairman.

Chairman Bennett. Thank you. Let's go to the second panel. I think we've probably exhausted this one. We're now going to hear from Henry Aaron, who is a Senior Fellow for Economic Studies at The Brookings Institution; Eric Engen, a Resident Scholar at the American Enterprise Institute, and Daniel Mitchell, a Senior Fellow in Political Economy at The Heritage Foundation.

Dr. Aaron, I'm sure you are tired of hearing people say they think you're a baseball player, but it was too easy a shot not to take it. We thank you for being here and appreciate your willingness to comment.

OPENING STATEMENT OF HENRY J. AARON, BRUCE AND VIRGINIA MACLAURY SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. Aaron. Thank you very much. If you don't take it out of my time, I could tell you some stories about being asked to sign baseballs and submit items to some celebrity auctions, even once being invited to a celebrity golf tournament by Phyllis George. Unfortunately, I don't play golf.

Thank you very much, Mr. Chairman, for the opportunity to testify today. This Economic Report, like most, is the product of first rate professionals, good economists. It contains a good deal of solid and very sophisticated analysis. In my opinion, however, no Report can be better than the Presidential program that it's defending. And in this case, the Economic Report fails to address the central fiscal challenge of the Federal Government, the central challenge for this decade and probably some more to come. That challenge is the need to prepare now, not later, for the fiscal burden that will be imposed on us by the retirement of the baby-boom generation.

In fact, the President's program aggravates that problem very significantly. I have tables in my testimony to try to document that specific point. The Economic Report itself largely skirts this question. In fact, I was hard pressed to find any specific reference to it.

The Congressional Budget Office projects that over the next decade, the Federal budget will run a surplus of a bit more than $1 trillion. If one factors into that estimate the impact of the program contained in this budget as a whole, the projection reverses and becomes a projected deficit of something more than $1 trillion. That estimate itself is based on extraordinarily optimistic and unrealistic assumptions. In fact, if one builds in corrections for those unrealistically optimistic assumptions, the deficit balloons to something in the vicinity of $5 trillion.

Chairman Bennett. Unfortunately, we all understand what you're saying.

Mr. Aaron. The program that the President has put forward in this budget is touted as a pro-growth program. I believe that is flatly the opposite of its actual effect on the economy. You're quite right in the questions that you were asking Mr. Hubbard. Some fiscal stimulus in the near term could add to demand and help pro-

vide us insurance that our current economic capacity will be fully utilized rather than underutilized as it is today.

Over the medium and long term, however, budget policy that results in sizable deficits simply subtracts from national savings. Private saving that could have been used to invest in productive capital gets used to finance current activities of Government. Higher math is not needed to calculate the consequences of deficits as large as those that will occur under the President's program.

Based on published estimates of the productivity of capital, we can look forward to national income in the end of the 10-year projection period nearly half a trillion dollars smaller than we could have had if we had balanced the budget apart from the funds that are being accumulated for retirement purposes: Social Security, Medicare and Federal employees. If we balanced the rest of the budget, the Federal Government would be adding to capital formation rather than subtracting from it, and we could look forward as a nation to roughly half a trillion dollars a year more in gross domestic product in the year 2013 than we can do under the President's program.

Various people have been discussing, and I think correctly, the balance of the benefits and harm that would flow from the tax cuts that are proposed. I want to be quite up front. If you cut taxes, benefits always flow from that. But tax cuts are not free. One has to pay for them in some fashion. That realization was implicit in some of the questions in the preceding session. Either one has to raise taxes later on to make up for the revenue sacrificed currently, or one has to sacrifice public services that those taxes otherwise could have financed. It's a mathematical identity, as Mr. Hubbard said, the budget has to balance over the long run. You pay now or you pay later.

The final table in my testimony tries to give some indication of what we could have purchased with the revenues sacrificed by the tax cuts Congress has already enacted and those that the President's budget currently requests. It would have been possible over the long haul and over the next 10 years both with the revenues embodied in the tax cuts to do the following specific items:

There is enough money both to close entirely the projected long-term deficit in Social Security and to cover the entire projected deficit in the Medicare Hospital Insurance trust fund. In addition one could double the budget for biomedical research, an area where scientists from the National Institutes of Health agree that they are rejecting solid research proposals that would have been funded in the past.

We can try to reverse the downward trend in access to higher education by families from middle and lower socioeconomic groups if we doubled higher education assistance. We could do those things and still have money left over besides after those steps.

We could also enact a program to improve life chances for America's children. My colleague at Brookings, Isabelle Sawhill, together with a group of scholars, has put together such a program.

The reason I put this menu before you is not because I think each of these items is necessarily how revenues should be spent. Rather, I want to illustrate in specific form the size of the tax cut that has been enacted and that the President is now seeking.

Many people are duly impressed and quite concerned about the magnitude of the cost of funding Social Security and Medicare. I think they should be. My point is very simple, though. If you're concerned about those problems you should recognize that the revenue loss from the tax cuts enacted and proposed, are even larger.

[The prepared statement of Mr. Aaron appears in the Submissions for the Record on page 49.]

Chairman Bennett. Thank you very much.

Dr. Mitchell.

OPENING STATEMENT OF DANIEL MITCHELL, PH.D., MCKENNA SENIOR FELLOW IN POLITICAL ECONOMY, THE HERITAGE FOUNDATION, WASHINGTON, DC

Dr. Mitchell. Thank you very much, Mr. Chairman, for the opportunity to testify. With your permission, I'm just going to go through some of the highlights of my testimony, specifically Chapter 5, Tax Policy for a Growing Economy, then I'll comment very briefly on Chapter 6.

Chapter 5, the Tax Policy chapter, covers some very important issues that I think paint a road map for policymakers in terms of tax policy, including important issues such as the need to improve distribution analysis, as Dr. Hubbard talked about, when we take these snapshots of where people are today and look at the impact of tax policy, we're missing the upward and downward mobility that we see in our economy, and that gives policymakers I think a very incomplete and inaccurate picture of the potential benefits or lack thereof of different changes in tax policy.

The focus of the chapter, of course, is on what at least I would call tax reform. The Administration doesn't really phrase it that way, but obviously they're looking at what are the key guidelines for good tax policy, and there's a number of lessons that are in that chapter:

Lower tax rates to encourage more work and entrepreneurship.

Neutral tax treatment of savings and investment will increase capital formation.

Elimination of tax preferences will mean decisions are based on economic rather than tax-minimization factors.

Simplicity will free up resources for more productive uses.

These are all things I think are very good criteria for policymakers to decide tax policy. But then the chapter also focuses on, well, what are some of the practical issues that are raised when you look at these criteria? Should America shift to a consumption-based tax system? This could be a flat tax system where income is taxed once when it's earned. It could be a sales tax or VAT system, where income is taxed once when it is spent. What we're really talking about, though, is, should there be double taxation of income that is saved and invested?

The chart I have up shows that under current law, when a taxpayer earns money and then, of course, pays tax on that money, they then have a choice of what to do with their after-tax income. If they spend it, with a few rare exceptions, there's no additional tax liability from the Federal Government. But if you save and invest that money, depending on the circumstances, that same dollar of income can be taxed over and over and over again: Capital gains

taxes, corporate income taxes, the double tax on dividends, the death tax. And these things, of course, are changing the price of current consumption relative to future consumption.

[Chart appears in the Submissions for the Record on page 64.]

They're punishing people who would save and invest. Every economic theory of which I'm aware, even Marxist, they all believe that capital formation is necessary to long-run economic growth.

Some of the other specific aspects of the chapter that I think are worth looking at, should businesses expense new investment or depreciate new investment? Under current tax law, we treat some investment expenditures as if they were taxable profit, because businesses aren't allowed to fully recognize the costs in the year they occur. That chapter I think has a very important contribution to the international tax debate, looking especially in light of what the WTO has ruled on our FISC law.

The chapter looks at whether it might be better to replace worldwide taxation with territorial taxation, something that I think would be a pro-growth way of dealing with corporate inversions, instead of treating companies as if they were permanent captives of the Federal Government.

Let me go ahead and shift really briefly to Chapter 6. This is the Pro-Growth Agenda for the Global Economy. I think the Administration has done some very good work looking at how to transfer foreign aid programs, which right now oftentimes subsidize economically unworthwhile activities and instead reward the countries that actually get some of the basic policies right in terms of everything from rule of law to fiscal policy, openness to trade and investment. These are all-important things.

But one sin of omission, I guess I would phrase it, in that chapter, is the failure to address what I see as a very important long-run issue, which is the battle between those who want tax competition between jurisdictions and those who want tax harmonization. You have international bureaucracies such as the OECD, the EU and even the UN, who are trying to work with high tax governments in Europe to try to hinder the flow of jobs and capital from high tax governments to low tax governments. We saw beginning 20 years ago with the Thatcher and Reagan tax cuts that when nations had to compete, good policy in one nation triggers good policy in another nation.

We look at the facts that tax rates, both personal and corporate tax rates, have dramatically come down in the last 20 years. I think that would not have happened had it not been for fiscal competition between nations. So when I look at some of these international tax harmonization initiatives and the fact that they would in effect lock up the factors for production inside high tax countries that will both remove the incentive for the high tax countries to reform—we should want more countries to do what Ireland did when they lowered their tax rates. They had an economic boom. We want countries to do what Russia has done, implementing a low flat tax, which has led to 30 percent revenue increases in the first 2 years it's been in effect. But if countries aren't allowed to benefit from good tax policy, and if they're not punished for bad tax policy, I fear that we're not going to see the kinds of positive economic changes we've seen in the last 20 years.

So I think it would be very important to give some further consideration to some of these international issues. I say that recognizing that the Administration by and large has done a very good job in rejecting a lot of these tax harmonization initiatives. But I think any discussion of international economic growth is incomplete without some recognition that fiscal competition is one of the most powerful forces for economic liberalization we have today. We see it between U.S. states, we see it between national governments, and it's certainly something I think is necessary for international economic growth.

Thank you very much.

[The prepared statement of Dr. Mitchell appears in the Submissions for the Record on page 60.]

Chairman Bennett. Thank you, sir.

Dr. Engen.

OPENING STATEMENT OF ERIC M. ENGEN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Mr. Engen. Thank you, Mr. Chairman. I too will also just cover some of the main highlights out of my written testimony that I submitted to you.

In that I focused on essentially the proposals for tax relief for corporate earnings and the tax-free savings accounts that were both in the President's recent budget and discussed those in the context of the tax reform that was discussed in the Economic Report.

At the very end, I'd like to briefly discuss the issue of long-term fiscal imbalances.

My principal conclusions are as follows. First, the taxation of capital income, sometimes at very high marginal rates in the U.S. tax system, stands in marked contrast to the implications of optimal tax theory in the economics literature, which has generally concluded that the optimal tax on capital income is zero. As well, what is oftentimes not understood is that the costs of having high capital income taxes are not just borne by capital owners. Indeed, they are borne very much by workers who have less capital to work with, and thus have lower levels of productivity, and their wages reflect that also, and thus lower wages.

So the proposal to remove the double taxation of corporate earnings would lower the cost of investment for firms and increase the after-tax returns to savers that hold corporate equity, thus stimulate capital formation, and very importantly, boost the productivity of workers and raise their wages. As well, there are other benefits that I think are very timely, particularly at this point, looking at the events of the last couple of years in the economy.

First of all, exempting corporate profits from personal income taxation reduces the tax incentives for corporations to retain earnings instead of paying dividends. Higher dividend payouts would not only help improve the allocation of corporate capital amongst its different uses, but also help stockholders in monitoring corporate managers. Indeed, everyone is aware of the corporate governance and accounting problems that have manifested in the last year or so. If companies no longer can hide behind the tax reason

for why they have to retain earnings, and if they need to pay them out in dividends, then they need to have real earnings. They can't just have paper profits.

As well, another benefit from exempting corporate profits from the personal income taxes is it reduces the tax incentives for corporations to finance investments with debt instead of equity. Less corporate debt reduces the possibilities of default and bankruptcy in an economic slowdown and thus would lower the risk premiums that are included in the cost of financing corporate capital, so it makes it easier for firms to weather the type of economic slowdown that we had.

As Dr. Mitchell mentioned as well, the United States is also in the midst of a tax competition in terms of the corporate income tax with Europe and the rest of the world whether we like it or not. The United States currently has the second highest corporate tax rate among its economic competitors, second only to Japan, and is one of only three countries in the OECD that does not provide dividend tax relief. The other two are Ireland, which has a corporate rate of 12.5 percent, and Switzerland, which has a corporate tax rate in the low 20s, both quite lower than in the U.S. So although the corporate tax rate is not an issue that is being dealt within the current tax policy discussion, at least limiting the double taxation of dividends would help improve some of these competitiveness pictures for U.S. firms in the global economy.

The second issue is the other major tax proposal that's in the President's budget that deals with saving and investment. That is, proposals for expanding tax-free savings accounts. This would continue the kind of trend that we've seen for more than 20 years now when IRAs were first made universal and 401(k) plans came on board in the early 1980s. That 20-year trend has been toward moving the personal income tax more toward a consumption tax base, which I think many economists agree would have positive growth outcomes, and it's the basis for the optimal tax literature assigning a zero tax on capital income.

However, this would still not yet bring the Tax Code at the personal level to a full consumption tax treatment. That's very important to realize when we're looking at the potential effects of these accounts. In general, I think the important thing to realize here is that an important component of these tax-free savings accounts is that there still would be contribution limits. So particularly with some of the new accounts being potentially offered, the Lifetime Savings Account, in addition to the type of plans that are merely an extension of current Roth IRAs and 401(k) plans, one of the benefits is that this does raise the contribution limits and thus would affect more savers at the margin in terms of possibly gaining new saving.

However, there still are those contribution limits, and for very high savers, they could get the tax benefits of these accounts by shifting assets into the new accounts or for existing ones, merely putting in saving they would do otherwise.

So an important thing that is limiting the positive savings effects of these accounts relative to a consumption tax is that there are still these contribution limits. The lower the limits, the more that

would have a stifling effect on the savings effect. So raising the limits does help that, but those limits are still there.

Another important thing in this context is that for a full consumption tax treatment at the personal income level, not only would all capital income not be taxed, but interest paid should no longer be tax deductible to have full consumption tax treatment. So the benefits to net saving come not only from encouraging saving, but also not from subsidizing borrowing in the Tax Code, which counts against the net saving of households, and indeed that feature is not something that's being dealt within current tax policy proposals, which is not surprising.

The main tax deductible interest component to personal income is the mortgage interest deduction. That's very popular, and so no one wants to touch that, but that is a very important issue when we're thinking about moving the tax system more toward a consumption tax. That is a point I'd like to highlight.

The final thing I'd like to briefly talk on is just the issue of long-term fiscal balance. Whereas I generally support the tax proposals that are being offered by the President and the type of tax reform shifting to a full consumption tax that is in the Economic Report, one of the things that is of concern is the long-term fiscal balance. When I look at what would be the effect of even putting in all of the tax proposals that are in the current budget proposal, what that would do is leave over the foreseeable horizon tax revenues at the Federal level in the range of 18 to 19 percent of GDP. I have estimated those using earlier figures by the CBO and adjusting them for the more recent tax cut proposals that those tax figures would be in the range of 18 to 19 percent of GDP.

The average over the postwar period is 18 percent. So Federal revenues are not running at historically low levels. And indeed, what we're doing is coming off the historically high level of Federal revenues that we saw a few years ago. So in a sense, the revenue reductions that are taking place are pulling us back closer to the historical average.

The long-term fiscal imbalance is, in my view, a spending problem. What we see is because of the promised retirement and health benefits that all spending is going to grow primarily because of those programs, and indeed, with very conservative estimates going to the future on other spending, that spending is projected, which right now is currently in the range of 18 to 20 percent of GDP, close to taxes, would rise to 35 to 40 percent of GDP.

I don't see how we could balance that gap by raising taxes without having extremely detrimental effects on the economy. So I think in looking at the long term fiscal imbalance problem, it's not a tax problem, it's a spending problem.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Engen appears in the Submissions for the Record on page 68.]

Chairman Bennett. Thank you very much. Thanks to all of you, because we have some interesting dynamics now among the three of you, some of which I'd like to explore.

First, Dr. Aaron, purely parochial and a single little item, you made reference to NIH making less money available than they had in the past.

Mr. Aaron. No, I did not.

Chairman Bennett. That's what I understood, and I wanted to clear that up.

Mr. Aaron. Thank you very much for the opportunity. NIH has committees of scientists who review applications. They assign them point scores, and then they work down from the highest to the lowest until the money is gone. The quality of scientific proposals has been getting better. As a result, even with the growing budgets that NIH has enjoyed, its cutoffs have been rising. So scientific proposals of a quality that would easily have been funded in the past are now being rejected.

Chairman Bennett. That's because other proposals are better?

Mr. Aaron. That is exactly right.

Chairman Bennett. That was not the impression I got.

Mr. Aaron. I appreciate the opportunity to set it straight. The fundamental point is that this is a period of extraordinary opportunity for marvelous advances in science, and in my own view—this is not as an economist, but as somebody who reads this literature—as a society, we would do well to exploit these opportunities rapidly, because they promise enormous benefits in terms of extending life.

Chairman Bennett. I'm glad to get that cleared up, because the impression I got was that you were claiming that NIH didn't have enough money, and I've been part of the Republican group that has demanded that NIH's budget be doubled over a 5-year period, and we held to that and succeeded in that even though some in our conference, after we had done the first couple of years, said "Look, we've given NIH a 30 percent boost last year, why do you have to give them another 25 percent? Why can't we hold them to 6 or 7 percent like everybody else?"

We said, no. We made a commitment to double their funding over a 5-year period, and we are on track to do that. And we succeeded in doing that. Frankly, I feel very strongly about that. So I'm glad to get that one——

Mr. Aaron. I'm entirely on your side on that one.

Chairman Bennett. Maybe the only thing you're entirely on my side, but——

Mr. Aaron. I hope not.

Chairman Bennett. I hope not. I am on your side on another issue, the fundamental issue which you raised in the beginning. That the most serious long-term economic problem we have is when the baby boomers hit retirement and then have the temerity to live longer than was designed into the system when it was designed in the 1930s for Social Security or the 1960s for Medicare, thereby upsetting all of the actuarial tables that would have made those things viable if people had just been compliant and cooperative and dropped dead at 67, so that the retirement age of 65 would make economic sense.

Now I'm well past the 67 mark myself and running for reelection in 2004, hoping to extend a career as long as my parents. My father was 95, my mother 96, and I have better health care than they did. I am genetically programmed to live into triple digits. That is not good news for the Social Security system that has started already paying. So a recognition of the size of that problem is

something that should be highlighted as often as possible. And I agree with you absolutely that it should be highlighted as quickly as possible.

Because every day that goes by that we don't address it here in the Congress is a day that multiplies in difficulty for some future Congress when they finally get around to finding themselves in the midst of it and say, why didn't those people in the 1990s have the political courage to deal with it? Or those people in the early years of the 21st century have the political courage to deal with it? Why have they just kicked the can down the road and left us with the problem when it's upon us?

I see that happening in the Congress. I see that happening in the political arena, and it upsets me a great deal, and I agree with you that that should be the number one thing we talk about.

Having said that, I get the feeling from the projections you gave us of what would happen if the tax cuts were restored, how much money we would have, that you are almost viewing the circumstance as a sum-zero game, and that a tax cut that takes place now—and it can be calculated, the impact 10 years, 20 years from now with enough certainty for you to give us the numbers that you're giving us, is a straight matter of math, of addition and subtraction. You subtract here and it isn't there. I have a problem with that.

Mr. Aaron. I do, too. I think forecasts of specific levels of spending and revenues are fraught with dangers, to put it mildly. The Congressional Budget Office obligingly now includes a chart at the beginning of each of its baseline annual Reports, a fan chart that shows the range of uncertainty.

Nobody who looks at that chart can have anything but a clearer understanding of the dangers of long-term forecasting.

What can be forecasted, I think, with a much higher degree of reliability, although still not with certainty, are the consequences on the level of the deficit with specific policy changes.

If tax rates are reduced——

Chairman Bennett. We're talking about rates, not revenues.

Mr. Aaron. Revenues will be lower than they otherwise would have been. That fan, the entire fan, moves.

Chairman Bennett. I'm not sure I agree with that statement, that if rates are lower, revenues will be lower.

Mr. Aaron. This is a debate that's been going on for about 25 or 30 years. Many years ago, it was called supply-side economics. And supply-side economics got, I think, an unfairly bad name, because it failed so dismally when applied in the 1980s.

As you know, we cut tax rates, and it was anticipated that revenues would boom as result. What boomed were interest payments on the explosively growing public debt.

But there is no question that when tax rates are reduced, economic distortions are reduced. If tax rates are reduced on labor supply, on balance, there is some increase in the amount that people will work. I think that economists, both conservative and liberal, tend to agree on that.

There is a range of disagreement, but its professional disagreement about technical issues. But I don't know that there is any responsible economist at work today now who thinks that if you cut

rates, the supply-side effect will be large enough to restore revenues. And, in some cases, the supply-side effects can aggravate problems.

Let me give you a specific example here: Mr. Engen referred to the savings incentives that are contained in the President's budget. Readers of the journal of record for taxation these days, *Tax Notes*, have been welcomed to a barrage of articles discussing the consequences of such an increase in individual tax incentives on the willingness of employers to continue to have qualified pension plans.

If I'm a small employer and I want to shelter my personal savings from taxes, the way I do so is to create a qualified pension plan, if I want to save more than the amount currently deductible under IRAs. To get qualified pension plan coverage for myself I have to bring in my employees, because of, so-called non-discrimination rules.

But if I can put in $7500 for myself and my wife and for each of my two kids, and can shelter even more through the other elements of this program, I probably can dispense with the qualified pension plan and avoid the cost of spending money to support pensions for my employees.

What I'm worried about are the kinds of dynamic effects from this program that could actually go counter to the shared objective of the Administration and of the opposition, which is to increase national savings.

National saving is important. We want to encourage private saving. We, I think, should also encourage public saving. It was the public saving side of the ledger that I focused my testimony on, but not because that's the only thing that goes into national saving. Private saving counts, too.

Chairman Bennett. I want to come back to that, but if either of the other panelists want to comment at this point, go ahead.

Dr. Mitchell. I can't resist defending the Reagan Administration.

Chairman Bennett. I was prepared to do that, but go ahead.

Dr. Mitchell. The Reagan budget forecasts were almost insignificantly different from the CBO forecasts. They used traditional static revenue scoring for their tax cut.

What caught both the Reagan Administration and CBO by surprise were the economic conditions, the rapid disinflation that nobody foresaw. And even after all that happened, we did wind up with revenues in 1990 being almost 100 percent larger than they were in 1980, and that was during a decade when I think we had about 55 percent inflation.

As someone who still considers myself a supply-sider, I don't think that many of my colleagues would ever claim that all tax cuts pay for themselves. As a matter of fact, supply-siders go out of their way to distinguish between tax rate reductions that will encourage additional productive behavior, versus tax credits and exemptions and deductions that don't have any effect on people's willingness to work, save, and invest.

And depending on which of those pro-growth tax policies you're looking at, the revenue feedback, it may be 20 percent; it may be 40 percent. The revenue feedback can be bigger, certainly, in the

long-term, rather than the short-term, but that, in some sense, is a separate question from what is good tax policy at the end of the day.

Is it to have low rates? Is it to have a consumption base? And then if it turns out that you get some additional economic growth, which almost certainly is the case, there will be some supply-side effect. And I think it's very worthwhile for some revenue feedback. It's very worthwhile for policymakers to have a better understanding of what that effect might be.

Chairman Bennett. Dr. Engen, did you want to get into this?

Mr. Engen. Yes, sure. I guess, first, on the issue of forecasts, yes, they're uncertain, but we need them. We can't fly blind.

Having done this type of fiscal and economic forecast at the Federal Reserve before I went to AEI, although even on a shorter-term framework—typically, our forecasts are out only 2 years—it's easy to criticize forecasts. It's very difficult to actually do them, once you're in the trenches.

I think we need to keep in mind, in terms of forecasts, that they're better than nothing.

On the issue of tax cuts paying for themselves, I agree with the general sense of Dr. Aaron's comments that typically when we are looking at saving and investment by households within the U.S. and labor supply responses to tax cuts, that oftentimes the consensus of the economic literature is that they don't necessarily pay for themselves.

But the gains in economic growth are not inconsequential. They are debatable, and so the amount of revenue that is lost if we do cut rates, can be quite different, depending on what those responses are.

And I think Dr. Mitchell makes a very good point that's very relevant; that not all tax cuts or tax increases are the same. Some have incentive effects, and some do not.

One area where I think this issue is quite important, where it may be more responsive in terms of reduction in rates actually lifting revenue, is this area of international tax competition.

In *Tax Notes*, I had a recent article with my colleague, Kevin Hassett at AEI, looking at this issue of what has happened over the last couple of decades in terms of the corporate tax competition between the U.S. and its major economic competitors.

One of the things you tend to see is, because of this competition and because of the fact that it's now easier to move corporate profits across different tax jurisdictions, you don't have to do it by physically moving a plant from one country to another. You can now, through various financial arrangements, teams of accountants and tax lawyers all have figured out very well that you can move profits around.

So what oftentimes you're seeing now is that countries that are lowering their corporate tax rates are actually seeing increases in corporate revenues because they're getting more of that activity, either in their country or actually moving in.

Ireland is an example. They reduced their corporate tax rate from 50 percent down to 12.5 percent. Over that same period, their corporate revenues went from 1 percent up to 4 percent of GDP.

Chairman Bennett. The Prime Minister of Ireland told me it was 10 percent. Is he wrong?

Mr. Engen. My information is 12.5 percent.

Dr. Mitchell. Originally, it was a dual rate of 30 percent and 10 percent. The high-tax governments in Europe took them before the European Court of Justice, saying that was discriminatory, under, I guess, the Treaty of Rome.

Ireland—and, of course, as expected—France and Germany wanted to force Ireland to bring the 10 percent rate to 30 percent. Ireland pulled the rug out from under them and said, fine, we'll have one uniform low rate at 12.5 percent.

Chairman Bennett. I see.

Mr. Engen. That 10 percent was for manufacturing, but it's now unified at 12.5. But that is an area that I think tax policymakers need to be very aware of, because we're in this tax competition with other countries, as I said before.

Whether we like it or not, it's not one that we can sit on the sidelines and say, well, we're not going to worry about it. This is a problem that has a number of different symptoms, issues about the ETI and FISC are related to the high corporate tax in the U.S., issues of corporate inversions, issues of transfer pricing concerns.

A lot of these are symptoms of this issue that over the last decade, as our competitors have been lowering their corporate rates, the U.S. has maintained the same high rate.

Chairman Bennett. I could continue this seminar and learn a great deal from it, but I want to—and I sincerely thank you all three for helping add to my education—but I want to come back to what I consider to be the main focus of where we ought to be going, and get your reactions and comments on it.

Specifically, with respect to the President's plan, because, after all, this is a hearing about the President's Economic Report, not a seminar on educating Senator Bennett in his areas of ignorance, which are vast. My take, after a career in business, as well as exposure now to the activities in politics, is that the most important thing we can do for the future is to increase the efficiency of the economy.

Productivity figures are important. Productivity means a more efficient economy. As you look around the world—and the international issue has been raised—you see inefficiencies built into many economies in most countries of the world, to a degree that Americans simply do not comprehend.

One of these fundamental inefficiencies is corruption. Corruption is a form of inefficiency and a very high form of taxation. If you have to bribe someone to get anything done, it slows everything down and, as I say, it's a high form of taxation. It adds to your costs.

So, we want to get the most efficiency we possibly can into the system. Unfortunately, our tax system right now is not built on that philosophical basis.

Our tax system right now is a relic of the thinking of the 1930s, which says we use taxes as incentives or punishments in order to drive behavior. And, yes, a byproduct of that is, we get enough money to run the Government.

But we get all excited, as Mr. Stark does, about, quote, "fairness," unquote, and we get all excited about who is benefitting and who is not. There are people he wants to punish; there are other people he wants to benefit, and he wants to use the tax system to do it.

My philosophy is that the tax system should be structured solely for the purpose of raising however much money you need to pay for NIH and the other things you need to do, and it should not be used to have those of us in Government making decisions that the free market would make better.

So, I want the system to be as efficient as possible, the economy to be as efficient as possible, which means it's as low-cost as possible, which means it produces the most money that it possibly can.

If you can clear its arteries out, it will produce the most revenue for the American people. I made the comment to the first panel and repeat it here, in my conversations with Alan Greenspan, he said you can set the level of expenditure anywhere you want. You can't set the level of income, because the level of income is a factor of what's going on in the economy.

So if the level of expenditure goes too high by virtue of Congressional action, you become an African nation where they will adopt a budget that has something in the budget for absolutely everybody. They just don't have any money with which to pay for it.

So, with that philosophic underpinning, we come back, for my benefit, please, and analyze the key points of the President's program against that question. Will the economy become more efficient or less efficient if we end the double taxation on dividends? Will the economy become more efficient or less efficient, if we advance the effective date of the marginal tax rates?

Or, tip of the hat to Dr. Aaron, would the economy become more efficient or less efficient if we repealed the reduction of marginal rates, and went back to the levels that we had in the Clinton Administration?

Would the economy become more efficient or less efficient if we adopted child tax credit, elimination of the marriage penalty, savings activities, depreciation activities? Don't go into each on in specifics, but address the general categories of the President's tax program, without regard to forecasts.

I have never seen a Government forecast, including those that were favorable to the position that I took, come true. I agree you have to do it; you have to go through the exercise, and it's a very useful exercise, but be a little humble when you get the results.

So that question is for each of you, and we'll start with you, Dr. Engen, and go back and give Dr. Aaron the last word. How do you feel about the key components of the President's program, measured against the matrix of does this make the economy more efficient or less efficient? Does this increase productivity or decrease productivity? Will this clear the arteries or clog the arteries in terms of the structural nature of the impact on the economy as a whole?

Mr. Engen. I think the two key elements of the President's proposal that are the most efficiency-enhancing are: One, as I touched on in my testimony, the reduction in the double taxation of dividends proposal. I think that has a number of different efficiency-

enhancing aspects, as I went through, not just in terms of investment, but also in terms of the allocation of that investment, in terms of corporate governance, in terms of corporate financial policy.

One thing, though, that we see, even in the discussion about the dividend tax proposal, is the issue that you brought up of all of the different social policies, if you will, that have been undertaken within the Tax Code.

One of the things that's been used to criticize the dividend proposal is that it changes the relative prices, if you will, between using deductions and tax credits within the code. Some people like that because it reduces incentives to tax shelter. Other people don't like it. Those are people that put in the credits and deductions to start with.

But what it shows is that once you have a lot of these targeted tax credits and tax deductions, it makes tax reform more difficult because you run up into these various policies that people have put in for social reasons, that maybe in years past, were done on the spending side and are now in the Tax Code and make tax reform more difficult.

The other thing is the tax rate cuts. I think the lowering of marginal rates increases economic incentives, and I think those are the two most important components of the President's proposal that are the most efficiency-enhancing.

I would though like to touch on just one thing that I would have liked to see better proposals, so to speak, in the budget. That is on the side of spending restraint. It's obvious to most the need for increased spending for Defense and Homeland Security, but a lot of other spending programs and the growth in spending that I see on that part of the budget, looking at the long-term imbalance that I talked about before in my view that's a spending program. I view that as a concern with the President's proposal on how to restrain spending both on existing programs of various new programs such as the prescription drug benefit that is a big part of the spending increase as proposed.

Chairman Bennett. Thank you. Thank you for your being here.

Dr. Mitchell.

Dr. Mitchell. Mr. Chairman, there are sort of two competing theories. One theory says that fiscal balance drives everything and that if you have an increase and the deficit rates go up, I don't think there's evidence for that. We live in world capital markets that are immense. Even a big shift in U.S. Government fiscal balance is unlikely to have a significant effect on interest rates even more than I go dump a glass of water in the Potomac River that I'm going to significantly affect the water level of the river.

That's why I think we need to focus on good tax policy. I agree with you completely. We want a Tax Code that raises whatever amount of money we have to raise with the minimum distortions possible. That means a low-rate consumption-based system. If you look at the President's agenda, lower tax rates, lower marginal tax rates, he presumably eliminated the death tax last year. If we ever make that permanent, he's eliminating the double tax on dividends. He has asked for the lifetime savings account Dr. Engen talked about. Those are all things that in an incremental fashion

are moving us in the direction of tax reform. I don't think the Administration likes to characterize it that way, but I'd like to think of it that way.

Those things I think are good policies. There are other things, the child credit, that's not going to do anything for the economy. It doesn't mean it's bad policy, but it's not along the lines of supply-side policy to work, save and invest more.

So I think the Administration's policy is good tax policy and it's good economic policy, because I think the need to get the Tax Code right trumps the very insignificant evidence about fiscal balance. Plus I think there's an interconnection. Government spending grew a lot more rapidly when we had a surplus in the late 1990s, and it was free money. There was a lot of blood in the water with hungry sharks around. In some sense, I almost harken back to what Senator Moynihan accused the Reagan Administration of, which was deliberately running a deficit to get Government spending to grow smaller. I don't know whether that was the secret plan of the Reagan Administration, but that probably does work.

We do know that spending certainly grew very, very rapidly when we did have a surplus, so I view it almost a serendipity that we now have a bit of a deficit because: (1) I don't think that it has any real significant negative impact and; (2) it's probably going to promote some much needed expense and frugality in Washington. Thank you very much.

Chairman Bennett. Dr. Aaron, you have the last word.

Mr. Aaron. Thank you very much. First of all I want to point out that the Administration's program is not moving us to a consumption tax, it is moving us to a wage tax. I can go into more detail if you would like subsequently. But it has been mislabeled seriously and that's not a minor question.

[The additional information as referenced appears in the Submissions for the Record on page 48.]

Chairman Bennett. If you want to send us something on that, we'd be happy to receive it.

Mr. Aaron. The second point is I was not advocating here that we go back to the tax schedule that existed before 1981. My point was only to underscore that one is making social choices with far reaching implications when one chooses to use one's revenue generating capacity for tax cuts rather than to deal with other problems. These are matters on which honest people can and do disagree.

But one should not focus only at the tax side and say, "Gee, tax cuts are nice." You've got to pay something for tax cuts. And what we have done with the tax cuts we've enacted is use up all of the fiscal elbow room that we would have had to deal with the problems in Social Security, Medicare hospital insurance, and other areas besides.

Maybe the tax cuts are a better way to go; maybe they're not. That's a debate for another day. My point is simply put both items on the scale. When one considers the virtues and flaws with respect to your specific question, I believe it's not even a close question. This is an efficiency reducing proposal for the following very specific reason.

As a Nation, we're saving too little. The most important element contributing to efficiency is the intertemporal distribution of our

capacity to consume and our capacity to take advantage of the productive opportunities that we have. Prudence suggests that we should be saving more now because we are going to face some difficult fiscal challenges in the future. Whether we do so through public programs or private programs, there are going to be more retirees that active workers are going to have to support.

The way to get ready for that future burden is to build up capital stock and worker productivity today so that future workers can produce more and sustain their own standards of living while producing a surplus that will go to support health and pension benefits for retirees and the disabled.

The second reason why I think the evidence is pretty clear that we're saving too little is one of the points you mentioned; namely the productivity opportunities that the Nation faces. There has been a flowering of opportunities for productive investments. We talked about biotechnology for which your support is firm and clear.

The Nation had a bubble in computers and in technology, but there is a new world out there as a result of those technologies. To deprive ourselves of the capacity to invest and increase output by not saving enough today, is first-order inefficiency. Everything that the gentlemen to my left have been talking about are second-order questions.

Chairman Bennett. I wish we could continue the seminar. This has been very helpful. I thank you all for your presentations. I guess I can exercise one last prerogative of the Chair.

I was the CEO of a company that was founded and flourished in what *The New York Times* has labeled the "decade of greed," when the top tax rate was 28 percent. This was an S corporation, so that all of the money that we earned in the corporation flowed through our individual tax returns and therefore was taxed at 28 percent. When the corporation was founded in 1984, I joined it as the CEO. They had four full time employees. The amount of taxes those employees were paying was very, very small.

The amount of taxes the corporation was paying was zero because the corporation wasn't earning any money. We funded the growth of the corporation entirely from internally generated funds. We did indeed have a line of credit at the bank. But it was what was known as a 30-day clean up, which means that every 12 months, you have to bring it to zero and leave it at zero for 30 days before you can go back into it.

That was the kind of credit we had and those 30 days were a hard 30 days. But we were able to do that. Today that corporation has over 4000 employees. You figure the income tax of those 4000 employees and what it is, you figure it has over $500 million in sales. You figure the supplies it purchases and the corporate taxes paid by its suppliers, not to mention the corporate tax that it used to pay. It's now in a deficit. That's the sole cause and effect because I left.

[Laughter.]

Chairman Bennett. Let the record show that's a facetious remark.

[Laughter.]

Chairman Bennett. You figure in the employees of the suppliers and their tax payments. You figure in the sales taxes that are paid off of $500 million in sales, you figure the property taxes that are paid off of the excess of the 100 different stores that are operated there plus the corporate headquarters plus the manufacturing plant, plus all the rest of that.

I think the country got a pretty good return on the investment it represented in cutting the effective tax rate down to 28 percent in the decade of greed. As I look back on it, if the company were founded in 1994 as opposed to 1984, when the effective tax rate on us would have been 42.5 percent, following the Clinton tax increase, I can't be sure, you can never be sure, but my guess is that we would not have been able to fund the growth of that company. We could very easily not have survived. Now, that is a single example. I recognize there are all kinds of other circumstances around it. But in my gut, having lived through that circumstance, I have to say that there was something to the Laffer curve.

I understand that the Laffer curve was not invented by Arthur Laffer. I learned it in Econ 1. I'm old enough that it was before the days of 101 and it was called the Law of the Optimum price. I learned it in Econ 1, and I saw Arthur Laffer build a whole career on something that was a question on my first midterm back as a college student.

But having had the experience I just described to you, my bias is that a lower marginal tax rate over time will produce really good things for long-term forecasts.

With that again, I thank you all for coming. I would be happy to receive any additional papers that you want to send either to corroborate me or to correct me. Both will be equally welcome.

The hearing is adjourned.

[Whereupon, at 5:25 p.m., the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT,
U.S. SENATOR FROM UTAH, CHAIRMAN

Good afternoon and welcome to today's hearing. The Employment Act of 1946 created the Joint Economic Committee and Council of Economic Advisers, or CEA, and explicitly mandated one task for each: That the Council of Economic Advisers issue an Economic Report every year and officially present it to the Congress, and that the Joint Economic Committee issue a response to the Report. Today's hearing is the official presentation of the Economic Report to the Congress by the CEA.

We welcome the members of the CEA to Congress today. Dr. Hubbard and Dr. Kroszner, we have enjoyed working with you and your team and we look forward to continued cooperation between the CEA and our Committee. The other members of the Committee and I are anxious to hear your thoughts about the current state of the economy, the President's various tax reform proposals, and the numerous other policy reforms presented in the Economic Report of the President, or ERP.

What stands out the most about the Economic Report of the President is its sheer breadth. In the Report the Administration lays out the current state of tax policy, regulatory policy, the current state of the economy, corporate governance issues, and international development in great detail. What's more, in the Report the Administration clearly signals its short-term and long-term goals in each individual area.

The Administration has taken on an amazing array of reforms since the President's inauguration, and for this it ought to be commended. While political sensibilities suggest that an Administration focus on a small number of bite-size, stage-manageable reforms that play well to swing voters, the Administration rejected any thought of this early on in the term. Its efforts in the area of tax reform bear testimony to that; it has moved to lower the marginal tax rate for all workers, reduce the tax on capital income, expand and reform tax-preferred savings accounts, eliminate the death tax, remove tariffs on goods imported from developing countries, and has signaled its intention in upcoming months that it will attempt to introduce personal accounts to supplement Social Security. "Bite-sized" is not the adjective that comes to mind when looking at these proposals. "Bold" or "far-reaching" are more appropriate.

Politically, every single proposal draws the ire of a substantial constituency, and not just on the left. However, the tax reforms proposed by the Administration all contribute to higher savings and investment, the necessary ingredients for increasing growth in the long run. The Administration has resisted efforts to lard its recent growth package with dubious spending programs or temporary tax cuts designed to produce a short-run impetus to the economy, and for that it should be commended. When the Bush plan is enacted I believe that it will usher in an extended period of exceptional growth, not just here but abroad as well. And as I've said before, economic growth is a wonderful elixir that can cure a wide array of problems.

The proposed economic reforms outside of the Tax Code are just as bold, in my mind. For instance, the Administration's push for the Millennium Challenge Account may prove to be a turning point in the efficacy of foreign aid. To cite another interesting policy initiative, bringing a greater emphasis on rigorous cost-benefit analysis and market forces to the regulatory arena will ultimately result in policy outcomes that allow us to meet our goals of improved workplace safety, a cleaner environment, safer food and drugs, and less government intrusion into the market, with a lower cost to the government and the taxpayers. A third policy innovation worthy of mention is the introduction of personal re-employment accounts, a tool that should make it easier for those out of work to get new training and re-enter the work force.

We also eagerly anticipate your discussion of the macroeconomic situation. My personal thoughts on the state of the economy are well known. In the last three

years the U.S. economy has sustained a number of economic shocks, any one of which should have been enough to send the economy into a tailspin. The collapse of the internet bubble, corporate malfeasance, the 9/11 terrorist attacks, wildly oscillating oil prices, and a military showdown in the Middle East more than offset the relatively sanguine decade following the Persian Gulf War. Despite the massive uncertainty, fear, and caution injected into the economy we still managed to grow at a rate of 2.75 percent in 2002, a feat that I believe bears testament to the amazing resilience of our country and its people. Dr. Hubbard and Dr. Kroszner, again welcome to the Joint Economic Committee. We also extend a welcome to our second set of panelists, who will testify on the Administration's Economic Report and the current state of the economy following the testimony of Drs. Hubbard and Kroszner. Our second panel consists of Dr. Henry Aaron of the Brookings Institution, Dr. Eric Engen of the American Enterprise Institute, and Dr. Dan Mitchell of the Heritage Foundation. We look forward to your thoughts as well.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK,
U.S. REPRESENTATIVE FROM CALIFORNIA, RANKING MINORITY MEMBER

Thank you, Chairman Bennett. I also want to thank you for holding this hearing, which continues a JEC tradition of having the Council of Economic Advisers present and discuss the Economic Report of the President. I want to welcome Dr. Hubbard, who testified before this committee last month, and Dr. Kroszner. I look forward to continuing our discussion about the Administration's latest economic plan. Our second panel of witnesses will also provide useful perspectives.

Yesterday it was reported that consumer confidence has slumped to the lowest level in nearly a decade. Consumers are worried about the weak job market, falling stock values, rising gas prices, the threat of terrorism, and war with Iraq. I think it's fair to say that the President's latest economic plan does not inspire confidence.

Instead of a plan that would put money into the hands of those who need it and would spend it immediately, the President has proposed to eliminate the individual income tax on dividends paid by corporations and to speed up the rate cuts that go to a relatively small number of high-income taxpayers. The Administration is proposing something that doesn't help in the short-term and undermines budget discipline in the long run.

The President's latest budget, released earlier this month, shows the startling effects of the Administration's fiscal policy agenda. In January 2001, the President inherited a 2002-11 surplus of $5.6 trillion. The latest Congressional Budget Office (CBO) projections show that even if no further policy actions are taken, this surplus has shrunk to $20 billion. The Administration's own projections show that if the President's policies are enacted, there will be a cumulative deficit of $2.1 trillion over that period—an astounding $7.8 trillion reversal in only two years.

The Administration continues to argue that the deterioration is due almost entirely to events beyond its control—mainly the economic recession and the war on terrorism. But the facts are that the tax cuts already passed are responsible for a third of the deterioration in the budget outlook for 2003 and 2004. If the 2001 tax cut were to be made permanent, this share would only increase over time. In addition, the budget ignores the cost of deploying troops and the cost of a war with Iraq, which the Administration continues to push upon us. Today's *Wall Street Journal* reports that the President will request supplemental spending totaling as much as $95 billion for war, its aftermath, and new terrorism expenses.

The budget situation is actually much worse, because these projections contain glaring omissions, such as the cost of extending other tax breaks that are scheduled to expire but which Congress has repeatedly extended; the cost of fixing the alternative minimum tax; understating the growth in discretionary spending, particularly for defense and homeland security; and the cost of a war with Iraq. These factors could easily add more than $2 trillion in costs over the next ten years.

The Administration's tax cut proposals seem especially large and inappropriate in the context of the future fiscal pressures on the Social Security and Medicare systems. Permanently extending the 2001 tax cut alone would cost 1.3 percent of GDP by 2012 and the President's other new tax proposals would add another 0.6 percent, for a total taxcutting agenda worth 1.9 percent of GDP. By comparison, the 75-year shortfall in the Social Security trust fund is currently 0.72 percent of GDP, and the 75-year shortfall in the Medicare (HI) trust fund is 0.96 percent of GDP, adding up to less than 1.7 percent of GDP.

When President Bush took office, he touted ambitious plans to reform Social Security in order to address the demographic challenge. But this year's Economic Report

of the President does not mention the challenge itself, much less the Administration's ideas for addressing that challenge.

With the retirement of the baby boom generation just a few years away, we should be taking steps to make sure that we have the budget resources to honor our Social Security and Medicare commitments. During the Clinton Administration, growing budget surpluses were considered prudent preparation for the looming demographic change. But the Bush Administration has squandered the Clinton surpluses at a time when the certain demographic change is ever closer, and when new pressures and uncertainties associated with the war on terrorism and the possible war with Iraq are before us.

The President's plan is stunningly irresponsible. It drains budget resources that could be put to better use—such as really improving Medicare—and it increases the deficit. Once interest costs are taken into account, the President's new tax cuts would add almost two trillion dollars to the national debt over the next 10 years. Large increases in the public debt are bad for interest rates, investment, and long-term growth. It's no wonder that consumers have a sinking feeling about the economy.

I look forward to Dr. Hubbard and Kroszner's testimony, and l hope they address these concerns:

PREPARED STATEMENT OF R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS AND RANDALL S. KROSZNER, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Chairman Bennett, Vice Chairman Saxton, Ranking Member Stark, and members of the committee, it is a pleasure to appear before you to discuss the release of the *Economic Report of the President*, along with the economic outlook for the United States and the Administration's policy agenda.

The events of 2002 brought new challenges for the U.S. economy and for America's economic policy. Efforts to strengthen homeland security and prosecute the war against terrorism placed new demands on the economy. The recovery from the 2000-01 economic slowdown continued, but with an unsatisfactory pace of job creation. These developments make it all the more important to undertake policies that promote growth, both in the United States and in the global economy.

Reliance on markets is key to enhancing growth. Thanks to the flexibility of markets, consumers, businesses, workers, and investors can continuously adapt to changing economic circumstances. Markets constantly reshape and redirect economic activity and economic output in response to changes in producers' supplies and costs and in consumers' incomes, demands, and the prices they face. In turn, the market itself evolves, as new information, new technologies, altered supplies, and other changes in the economic and physical environments pose new problems and open up new opportunities. Put simply, markets are dynamic.

The *Report* emphasizes the importance of dynamic markets in the U.S. economy and the need to design public policies so as to preserve and build on this dynamism. In particular, it discusses recent developments and policies in the areas of corporate governance, regulation, taxation, labor markets, and international economic development. It describes the lessons that have been learned from recognizing the dynamic flexibility of the U.S. economy, and how the President's policy initiatives are putting those lessons into practice.

A fundamental theme in this year's *Report* is the need to craft short-run economic policy with a long-term perspective. An example is the President's Jobs and Growth Package, which is designed to assist the recovery of 2002 in gaining momentum in 2003. A key feature of this package is ending the double taxation of corporate income. In the short run, the positive effect of this policy on equity-financed equipment investment would be equivalent to an immediate investment tax credit of 4 to 7 percent, according to CEA calculations. Higher investment will raise job creation and insure continued economic growth in the next few years. In the long run, the additional investment encouraged by the proposal would raise the nation's stock of productive capital, which in turn would increase the productivity and wages of the nation's workforce. Another important component of the President's plan is the acceleration of marginal tax rate reductions that have already been approved by Congress. In the short run, these reductions will support consumption by bringing forward permanent tax relief. In the long run, marginal rate cuts reduce disincentives to risk-taking and entrepreneurship and thereby help the economy grow. The package also includes two other important components: an expansion of expensing allowances for small businesses and an innovative program "Personal Reemployment Accounts," which will give workers money to fund job search or job training expenses, as well as a cash incentive to find work quickly.

In my testimony, we will first discuss the economy's performance in 2002 and discuss both the short-term and long-term outlooks. We will then discuss specific areas in which the Administration's approach to economic policy promises to foster economic growth and prosperity in the United States and around the world.

ASSESSING MACROECONOMIC PERFORMANCE

The U.S. economy solidified its forward progress in 2002, with the fourth quarter of the year marking the fifth consecutive quarter of economic growth. (GDP data from the fourth quarter of 2002 were not available as the *Report* went to press, but will be referenced in this testimony.) This progress followed a contraction in 2001 that was deeper and longer than initial data suggested, but still mild by historical standards. Real gross domestic product (GDP) declined by 0.6 percent during the first three quarters of 2001, about one-fourth the average percentage decline over the previous seven recessions. Growth resumed in the fourth quarter of 2001—despite the terrorist attacks in September—and real GDP rose 2.8 percent over the four quarters of 2002. Although economic activity weakened in the fourth quarter relative to the other three quarters of the year, ongoing improvement in productivity growth, together with lean inventories, foreshadows a return to more normal levels of production and job growth in the quarters ahead.

The economic recovery of 2002 resulted from a constellation of factors, including the resiliency of the economy after the terrorist attacks and the lagged effects of stimulative monetary and fiscal policy in 2001. Although the Federal Reserve lowered the Federal funds rate only once in 2002—by half a percentage point on November 6—the 475-basis-point reduction over the course of 2001 continued to stimulate the economy throughout the year. (A basis point is 0.01 percentage point.) Monetary stimulus was complemented by fiscal stimulus, in the form of the tax rate reductions included in the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (EGTRRA) and the investment incentives in the Job Creation and Worker Assistance Act (JCWAA) of 2002. In the long run, EGTRRA's reductions in marginal tax rates will raise potential output by increasing labor supply and encouraging the entrepreneurial activities that are the building blocks of economic growth. In the short run, the tax cuts also buoyed disposable income and helped maintain consumption. Robust consumption, in turn, was a crucial locus of strength in the overall economy, contributing an average of 1.8 percentage points to real GDP growth during the four quarters of the year. Additionally, the tax incentives in JCWAA, which the President signed in March, provided needed support to investment at a time when stability in this component of final demand was especially important.

In 2002, discussions of both economic activity and economic policy paid particular attention to the valuation of the economy's stock of productive assets. One of the more favorable developments for many Americans in 2002 was the continued appreciation of their most important investment: their home. Housing prices rose 6.2 percent from the third quarter of 2001 to the third quarter of 2002, following an 8.7 percent increase in the same period a year earlier. As discussed below, housing values were buoyed not only by low mortgage interest rates, which reached levels not seen in more than a generation, but also by rising demand, continuing strength in purchases of second homes, and ongoing improvements in mortgage finance. Strength in housing values contributed to robust increases in residential investment, providing another important impetus to final demand in 2002.

In the aggregate, however, the appreciation in housing wealth was overshadowed by continued losses in the stock market. Like those for all of the world's major equity exchanges, U.S. stock indexes lost ground in 2002, continuing a general slide that began in the spring of 2000. From the market's high point in the first quarter of 2000 to the fourth quarter of 2002, stockholders lost nearly $7 trillion in equity wealth. These losses continued to weigh heavily on economic growth and job creation in 2002, by reducing the wealth of consumers and raising the cost of equity capital for investing firms. The precise reasons for the bear market of 2000-02 are subject to debate, but the market's three-year decline was probably influenced by two general factors—a decline in expected profit growth and an increase in the premium that investors required to hold risky assets. These factors continued to play important roles in the first three quarters of 2002 as the stock market continued its decline. Specifically, corporate accounting scandals called into question the reported profits of some firms, while risk premiums (as measured by the difference, or spread, between the yields of corporate bonds and those of U.S. Treasuries) rose to near-record levels. Although some observers attributed most of the market's decline to the corporate scandals, it is worth noting that equity prices fell around the world, even in countries with different accounting systems and governance institu-

tions. In any event, asset markets played important roles in the determination of the components of GDP in 2002, which we will now discuss in turn.

Consumption. Consumption continued to be the locomotive for the recovery in 2002. Expenditure on consumer durables was especially strong, in large part because of motor vehicle sales that were sparked by aggressive financing offers. Additional strength in consumption stemmed from robust increases in incomes, as low inflation, tax relief, and steady nominal income growth kept real disposable incomes high. Another positive determinant of consumption growth in 2002 was the strength of the housing market, which was supported by low mortgage rates as well as continued growth in housing demand. Housing wealth is more widely distributed among American families than stock market wealth, and housing equity continued to rise in 2002. A common way for this equity to support consumption is through borrowing against home equity, the outstanding value of revolving home equity loans at commercial banks rose from $155.5 billion in December 2001 to $212.4 billion in December 2002. Another way for homeowners to tap the equity in their homes is by refinancing their outstanding mortgages. Many refinancers chose to remove equity from their homes by taking out a new mortgage with a larger principal than the amount outstanding on the original mortgage. These "cash-out" refinancings boomed in 2002 as a result of the continued appreciation in housing prices and declining long-term interest rates. All in all, the positive effects on consumption stemming from higher incomes, higher housing wealth and lower interest rates helped to counter any negative influences on consumption than resulted from declining stock market wealth.

Non-residential investment. The stock market was a depressing influence on business investment in 2002, as lower equity values make it more difficult to finance investment projects (Chart 1). Business investment was one of the weakest components of demand in 2002, declining by 1.9 percent over the four quarters of the year. The decline was heavily influenced by a precipitous decline in investment in structures, which fell 15.7 percent over the course of the year. The other, larger component of business fixed investment, equipment and software, was also weak, rising only 3.0 percent. In light of the rapid increase in investment in the late 1990s, many observers wondered whether the economy suffered from a capital overhang, built up by excessive investment in the years immediately before the 2001 recession. As discussed in last year's *Report*, this possibility is hard to verify, because it requires anestimate of the "correct" amount of capital relative to the economy's output, a figure that is hard to know with certainty. Yet, as the 2002 *Report* also noted, some empirical evidence had emerged in 2001 indicating that a modest overhang had developed the previous year for some capital goods, notably servers, routers, switches, optical cabling, and large trucks. Evidence that a widespread overhang continues to hinder overall investment outside of a few particular industries, however, is harder to find.

Residential investment. In contrast to the softness in non-residential investment, residential investment grew briskly in 2002, sparked by the lowest mortgage interest rates in more than a generation. After hitting a recent peak of 8.64 percent in May 2000, interest rates for conventional, fixed-rate 30-year loans fell to 5.93 percent by the end of December 2002, their lowest level since 1965. Low mortgage rates contributed to the 6.8 percent increase in single-family housing starts over their already high level of 2001, while boosting sales of new homes to record levels at the end of the year. The strength of housing construction during the past 3 years stands in contrast to past business cycles, when housing starts were not nearly as robust

Net exports. Although the output of the U.S. economy remained below potential in 2002, its growth rate still outpaced those of many other industrialized countries. Slow growth among many of the United States' major trading partners, in turn, contributed to slow growth in U.S. exports compared with that of imports. Exports rose 5.0 percent during the four quarters of 2002, while imports grew 9.2 percent. This discrepancy between the rates of growth in exports and imports led to, an increase in the U.S. trade deficit, so that net exports exerted a drag on GDP growth in three of the four quarters of the year. (Net exports were essentially unchanged in the third quarter.)

Government purchases. The war on terrorism continued to exert upward pressure on federal government purchases in 2002. In late March the President requested that the Congress provide an additional appropriation of $27.1 billion, primarily to fund this effort. More than half of this amount was allocated to activities of the Department of Defense and various intelligence agencies. Most of the rest was needed for homeland security (mainly for the new Transportation Security Administration) and for the emergency response and recovery efforts in New York City. Although most of this spending was required for one-time outlays only, it nevertheless contributed to the 7.3 percent increase in real federal government purchases in 2002.

State and local government purchases rose at a more moderate 1.7 percent during the same period.

THE NEAR-TERM OUTLOOK

The Administration expects that aggregate economic activity will gather strength during 2003, with real GDP growing 3.4 percent during the four quarters of the year. The unemployment rate, which was 5.9 percent in the fourth quarter of 2002, is projected to edge down about 0.3 percentage point by the fourth quarter of 2003. Although growth in equipment and software investment was low, several factors suggest a rebound in 2003. To begin with, any capital overhang that might have arisen during the late-1990s investment boom has been reduced, because the level of investment fell in 2001; expectations of future GDP growth have stabilized after falling during 2001; and the replacement cycle is approaching for the short-lived capital goods put in place during the investment boom of 1999 and 2000. At the same time, the financial foundations for investment remain positive: real short-term interest rates are low, and prices of computers are falling more rapidly than they did in 2000. (Computer investment accounted for a third of all non-residential investment growth from 1995 to 2000.) Less bright is the outlook for non-residential structures, which still appears weak even after two years of decline. Even so, structures investment is projected to stabilize around the second half of 2003, as the maturing recovery generates higher occupancy rates for office buildings and greater demand for commercial properties. The recent passage of legislation for terrorism risk insurance may unblock some planned investments in structures that were held up because of lack of insurance. Real exports, which turned up in 2002, are projected to improve further during 2003. Although real imports and exports are expected to grow at similar rates during the four quarters of 2003, the United States imports more than it exports, and therefore the dollar value of imports is expected to increase more than the dollar value of exports. As a result, net exports are likely to deteriorate further during 2003. Consumption should remain robust in 2003. The negative influence of the stock market decline on household wealth, and thus on consumption, should wane as this decline recedes into history. Consumption growth will also be supported by fiscal stimulus and the lagged effects of recent interest rate cuts. Finally, low interest rates will continue to support the purchase of consumer durables, just as they did for much of 2002.

LONG-TERM OUTLOOK

The Administration forecasts real annual GDP growth to average 3.4 percent during the first four years of the projection. As this is somewhat above the expected rate of increase in productive capacity, the unemployment rate is projected to decline as a consequence. In 2007 and 2008, real GDP growth is projected to continue at its long run potential rate of 3.1 percent. The growth rate of the economy over the long run is determined by the growth rates of its supply-side components, which include population, labor force participation, the workweek, and productivity.

The Administration expects non-farm labor productivity to grow at a 2.1 percent annual average pace over the forecast period, virtually the same as that recorded from the business cycle peak in 1990 through the fourth quarter of 2002. This projection is notably more conservative than the nearly 2¾ percent average rate actually recorded since 1995. In addition to productivity, growth of the labor force is projected to contribute 1.0 percentage point a year to growth of potential output on average through 2008. Taken together, potential real GDP is projected to grow at about a 3.1 percent annual pace, slightly above the average pace since 1973.

THE 2003 ECONOMIC REPORT OF THE PRESIDENT

The central goal of the Administration's economic policies is the promotion of economic growth. The remaining chapters of the Report illustrate ways in which pro-growth economic policies can improve economic performance at home and abroad by striking the right balance between the encouragement and regulation of firms, by promoting flexibility and dynamism in labor markets, and by reducing tax based disincentives to economic activity.

IMPROVING CORPORATE GOVERNANCE

Corporate governance is the system of checks and balances that serves to align the decisions of corporate managers with the desire of shareholders to maximize the value of their investments. It is a largely private-sector activity built on the bedrock of the nation's legal infrastructure. Good corporate governance can substantially reduce the costs to investors of delegating decisions to managers; as must inevitably

occur when corporations obtain external financing. Good governance also contributes to the ability of U.S. corporations to maintain dispersed ownership and to the existence of well-developed financial markets. It enables corporations to compete more effectively in financial and product markets that have become increasingly global. The economy then benefits through more effective use of the available factors of production, including managerial talent, external capital, and natural and human resources. Importantly, strong corporate governance improves the attractiveness of corporate investments to households and other investors by more closely aligning managers' actions with investors' interests, and by making information about the corporation and the quality and diligence of its management more transparent to outsiders. Chapter 2 of the *Report* examines the evolution of institutions for corporate governance in the United States. Last year was marked by important reforms in U.S. corporate governance, including new laws, government regulations, and private-sector initiatives. The reforms were in part a response to the failure of some managers and accountants to provide accurate information about corporate financial and operating performance—events that drew attention to possible weaknesses in the current system of governance.

In calling for reform in March of last year, the President articulated a plan based on three core principles of good corporate governance—accuracy and accessibility of information, accountability of management, and independence of external auditors. The plan recognizes both the complexity of modern corporate governance systems and their inherent flexibility. Its call for a careful reexamination of private governance customs and legal rules was followed by a series of private and public sector initiatives. These include stepped-up enforcement efforts by state and federal authorities, facilitated by the President's creation of a Corporate Fraud Task Force in July to focus on conduct by managers and accountants that has been a source of concern. The President also signed the Sarbanes-Oxley Act in July, which the Securities and Exchange Commission is now implementing through a series of new regulations.

Under the Sarbanes-Oxley Act, a new regulatory body is being created to strengthen the incentives of auditors to meet their legal obligation to serve the interests of shareholders and other investors. The Securities and Exchange Commission must issue new disclosure regulations, including rules designed to make it easier for investors to gauge the incentives and performance of corporate managers. State governments are also instituting changes; state law is fundamental to the governance structures of corporations. Private-sector organizations were among the first to respond to the President's call for reform. Self-regulatory organizations such as those that operate the nation's stock exchanges contribute in important ways to the quality of U.S. corporate governance. Along with individual investor organizations, corporate officials, and others, these organizations have taken steps to strengthen U.S. corporate governance.

Even in the midst of these reforms, it is important to remember that change is not new to U.S. corporate governance. The U.S. system of corporate governance is designed to be flexible. This flexibility indeed accounts for its capacity to support economic growth over the decades, and for its strong global reputation. The chapter highlights the three main components of the U.S. corporate governance system: external governance mechanisms, internal corporate governance, and laws and regulations. External and internal corporate governance mechanisms serve to align managers' interests with those of shareholders and can adapt to changing market conditions. The surety provided by the U.S. legal system in upholding the contracts that investors enter into when they supply capital to corporations contributes to the flexibility of the corporate governance system. This framework, which relies on both the flexibility of private institutions and the integrity of public institutions, remains in place throughout the present reforms and provides a model for other economies to follow.

DEVELOPING REGULATION FOR A DYNAMIC ECONOMY

Competitive, efficient, and equitable markets are the cornerstone of a flexible and dynamic economy. Regulation of economic activity is an essential element of a market economy, but regulation can hinder economic growth and well-being just as it can advance them. Well formulated regulation can lead to improved market outcomes, but regulation that is ill-conceived or that is not cost-effective can have unintended consequences that actually make matters worse. Chapter 4 of the *Report* illustrates how both the government and the private sector play critical roles in ensuring a flexible economic environment that promotes growth and prosperity by allowing economic resources to be redeployed as opportunities evolve. The chapter pro-

vides a framework for the evaluation of regulatory policies, focusing on federal regulation and how it can foster or hinder economic dynamism.

Regulation stems from a number of needs. Some demands for regulation reflect a desire to improve the efficiency of markets rendered imperfect by spillover effects, informational problems, or lack of competition. By compensating for or correcting these market imperfections, such regulation may enhance growth. Other demands for regulation, in contrast, reflect a desire to change market outcomes, for reasons that may be compassionate or selfish, far-sighted or opportunistic. Regulatory policy must identify and deny those demands for regulation that seek only economic rents for a privileged few, and instead be based on sound science and economics, along with a careful evaluation of the social needs behind the desire for regulation. The chapter suggests some guidelines for evaluating both new regulations and proposed regulatory reforms that will help reduce the costs of regulation and achieve the best possible outcomes. When regulation is necessary, it should be flexible and market based, and the burden of each regulation should be justified by the benefits it confers. An important Administration initiative is the revision of the Office of Management and Budget's Guidelines for the Conduct of Regulatory Analysis and the Format of Accounting Statements. Conducted jointly by the Council of Economic Advisers and the Office of Management and Budget, this initiative stresses the principles of sound regulatory policy based on economic analysis. The revised guidelines have recently been published and sent to agencies and external experts for peer review.

Part of a complete understanding of the consequences of regulation is recognizing that the impact and efficacy of specific regulations can change over time with changes in technology, economic conditions, and scientific knowledge. An excellent example is the President's Clear Skies Initiative. Aimed at reducing power plant emissions of atmospheric pollutants, this program was designed in light of scientific evidence linking impairments of human health to exposure to certain polluting chemicals. Importantly, however, Clear Skies has also been crafted in such a way that economic incentives provide the mechanism for reduction of these pollutants at least cost to the economy.

Regulatory review and reform offer an important means for policymakers to control the buildup of regulatory costs and limit the economic harm of outdated regulations. Although many regulatory changes have been clear successes, others have created problems. Examples include the experience with the savings and loan industry in the 1980s and the more recent experience with electricity markets in California. To avoid in the future the kinds of unsatisfactory outcomes that resulted from these episodes, regulatory reform should be guided by the same basic principles as the development of new regulations.

ANALYZING TAX POLICY

An efficient tax system adequately finances government activities, while imposing as few distortions as possible on household and business decisions. A tax system with high marginal tax rates or a complicated structure impedes work effort and saving and hinders the risk taking and entrepreneurship that are the foundations of growth. Tax rates that are unequal across activities encourage tax avoidance and lead to potentially wasteful efforts at regulation, reporting, and monitoring to control it. Tax deductions, exclusions, and credits are often undertaken with the aim of targeting resources to worthwhile social goals, but they can create considerable complexity for taxpayers. They can also impose high effective tax rates in the range of income over which the tax benefits are gradually withdrawn, in some cases discouraging additional work effort among the very people the preferences were intended to help. The combined result of all of these imperfections can be a tax system that imposes significant compliance costs and wastes resources by misallocating them to non-productive activities.

Chapter 5 of the *Report* considers how tax policy changes could improve economic growth and real incomes for all Americans. Such changes involve difficult questions of how best to balance the sometimes competing objectives of simplicity, fairness, and faster long-term growth. The chapter considers some approaches that economists have identified to achieve the gains of higher incomes and efficiency within the framework of the existing tax system. Even relatively modest changes can lead to important improvements in economic incentives and efficiency. In particular, the opportunity exists to reduce significant differentials in tax rates across different activities and to lower the tax on the return to capital in ways that improve incentives. Small improvements in this regard can have large long-run effects, because saving and investment decisions made now will affect capital accumulation, technological change, and innovation for years to come.

An excellent example is the President's proposal to abolish the double tax on corporate income. The current taxation of corporate income is an important example of how the current Tax Code falls short of the goal of taxing income only once. Taxing corporate income twice, once at the corporate and again at the individual level, reduces the after-tax reward to investing. It distorts corporate financing decisions, diminishes capital formation, and results in too little capital being allocated to the corporate sector. As a result, the capital stock grows more slowly than it could otherwise, lowering the productivity of workers and thus the growth of their real wages. The President's plan to eliminate this double taxation will boost long-term efficiency and support increased investment that will promote higher near-term growth and job creation.

The chapter also discusses ways in which the dynamism of the U.S. economy affects the evaluation of tax policies. For example, the effect of the tax system on an individual taxpayer is not well represented by a one-year, static snapshot of his or her income. Rather, its impact changes significantly over time as the taxpayer proceeds through the stages of life and his or her earnings rise and fall. Earnings typically rise through the working years, as the individual gains experience and human capital, then fall as the individual retires and exits the work force. (Chart 2 shows the progression of marginal tax rates for a hypothetical couple.) One's tax bill is also affected by, among other things, changes in employment, marriage and divorce, having and raising children, giving to charity, starting up a business, and buying and selling assets. The ebbs and flows of the business cycle also have an impact. In evaluating the distribution of the tax burden and how changes in the Tax Code affect that distribution, it is therefore important to consider the full range of individuals' lifetime experiences. For example, a college student is likely to have little income today but will benefit from tax relief upon entering the labor force. Conversely, a working couple nearing retirement who currently pay the top marginal income tax rate would benefit today from a reduction in that rate, but they might benefit less in the future once they have retired and their income is lower. In short, because everyone's tax situation changes over time for a variety of reasons, proper analysis of the distribution of taxation must consider not just who will benefit from tax relief today but who will benefit in the future as well.

DESIGNING DYNAMIC LABOR MARKET POLICIES

As noted above, employment growth during 2002 did not keep pace with the recovery in output. From December 2001 through December 2002, non-farm payroll employment fell by 229,000, while the unemployment rate stayed between 5.6 and 6.0 percent. These statistics may give the impression of a static labor market. Yet dynamism remains the predominant characteristic of the labor market in the United States: in 2002 millions of workers found new jobs, started new businesses, and raised their earnings. Chapter 3 of the *Report* documents some important dimensions of these labor market dynamics and discusses their implications for employment and productivity growth and for the design of policy.

The mobility of workers—across jobs, up the opportunity ladder, and even in and out of employment—is one important dimension of a dynamic labor market and one of the great strengths of the U.S. labor market. American workers change jobs frequently, particularly during the first decade of their working lives, in part because doing so allows them to gain new experience and skills and, importantly, to increase their earnings—most earnings growth for younger workers comes about through job changes. For these new entrants, however, employment itself is the key aspect of this dynamic, because tenure on a job provides returns in terms of skill development and on-the-job training. This improvement in skills, in turn, makes possible increased earnings. Although staying on the ladder of upward mobility means maintaining an attachment to the labor market, it does not necessarily mean staying put in any one job. In a well-functioning labor market, there are large flows between employment and unemployment, and a substantial number of jobs are created and destroyed each year.

These large flows are further evidence of the flexibility of the U.S. economy, as expanding firms and industries take on more workers while those in decline contract their labor forces. Research shows that frequent job changes for the young are, in an important sense, the means through which individuals are matched to the jobs that will provide them with the best opportunities.

Government policies are more effective when they recognize and foster labor market mobility. Policies can support this mobility—and earnings growth—by encouraging skill development and education. Another important policy goal is to meet the desire of individuals for social insurance against the adverse consequences of short-term macroeconomic fluctuations and personal misfortune. Policymakers face dif-

ficult tradeoffs in designing social insurance, however, because the provision of insurance can itself distort behavior, making individuals less likely to enter employment or to exert full effort toward finding a job. As an example, for decades the Aid to Families with Dependent Children program provided insurance against destitution, but it also created a financial incentive for recipients to stay out of the work force. Welfare reform and the Earned Income Tax Credit are examples of policies that have supported individuals in time of need while also giving them incentives to enter the labor market and find jobs.

The Administration has proposed a new program to help unemployed workers find jobs quickly. Qualifying workers would receive a Personal Reemployment Account of up to $3,000 each, with funds to be used for expenses such as training, child care, or relocation. These accounts, which are in addition to unemployment compensation, would be targeted to those unemployed workers who are deemed most likely to exhaust their unemployment benefits before finding a new job. Those who find a new job within 13 weeks would be able to receive a cash payment of the remaining funds in the account as a "re-employment bonus." Personal Reemployment Accounts thus would provide not only support for training and skill development, but also potential additional transition assistance. One advantage of these accounts compared to traditional unemployment insurance is that traditional insurance encourages workers to wait until their insurance runs out before finding a new job (Chart 3).

PROMOTING GLOBAL GROWTH

Chapter 6 of the *Report* examines how countries throughout the world can promote economic growth and thereby enhance the well-being of their people. In recent years many countries, especially in the developing world, have experienced robust growth, which has led to reduced poverty, lower infant mortality, improved health outcomes, and longer life expectancy. Many others, however, have been far less successful at promoting growth and have not seen similar improvements in social indicators. The central theme of the chapter is that all countries can experience faster growth by creating an economic environment in which market signals lead to better economic performance. Three principles guide these growth-oriented policy reforms. The first is economic freedom, in which encouraging competition and entrepreneurship leads to stronger growth. Economic freedom involves, among other things, a stable domestic macroeconomic environment with low inflation, appropriate government regulation, encouragement of entrepreneurial initiative, and openness to the global economy. The second pro-growth principle is governing justly—safeguarding the rule of law, controlling corruption, and securing political freedom Indeed, the relationship between the strength of the rule of law in a country and its per-capita income is striking (Chart 4). The third principle is investing in people. These investments include those that promote the health and education of the population, making workers more productive. No one of these principles is enough to guarantee strong growth; rather, all three are mutually reinforcing aspects of a pro-growth agenda. The specific policy measures that will implement these pro-growth principles similarly involve a number of elements: responsible fiscal and monetary policies, an appropriate size and role of government, domestic flexibility and internal competition, openness to the global economy, a healthy and educated population, and sound institutions. Countries that pursue a broad range of policies consistent with these principles perform better than those that do not. During the 1980s and 1990s, for example, those countries that were more open to the international economy grew much faster on average than those that were more closed.

The President has inaugurated three important policy initiatives designed to stimulate economic performance in countries around the world: trade liberalization initiatives negotiated pursuant to Trade Promotion Authority, which will promote countries' openness to international trade and investment; the Millennium Challenge Account, which will provide direct financial assistance to developing countries adopting pro-growth policies; and reform of the multilateral development banks, which will encourage private sector involvement in results-oriented development programs undertaken by the World Bank and the regional development banks. Through these and other policies, the United States will help countries address the challenge of improving their economic growth. Ultimately, however, creating a pro-growth environment is up to each country's own people and government. The initiatives of the United States will help in important ways, especially by reinforcing pro-growth decisions by governments and individuals. They are not, however, substitutes for the adoption of good policies in developing countries themselves, which are ultimately the key to success. The pro-growth agenda embodied in these three policy initiatives will enhance growth and prosperity both at home and abroad. This

is the most direct way to improve standards of living and thus the lives of people around the world.

CONCLUSION

The United States is recovering from both an economic downturn and the aftershocks of the terrorist attacks of September 2001. Government policies have aided this recovery in important ways, with support from both fiscal and monetary initiatives. Perhaps most important in ensuring recovery, however, has been the underlying flexibility and dynamism of the U.S. economy. In the midst of the downturn, workers continued to find new opportunities, savers continued to reallocate their funds in search of greater returns, and firms continued to regroup and to invest in future growth. The economic policies of the Administration will likewise continue to support this quest for growth, both here at home and around the world.

Thank you, Mr. Chairman. We look forward to your questions.

Chart 1: Equity Prices and Business Investment

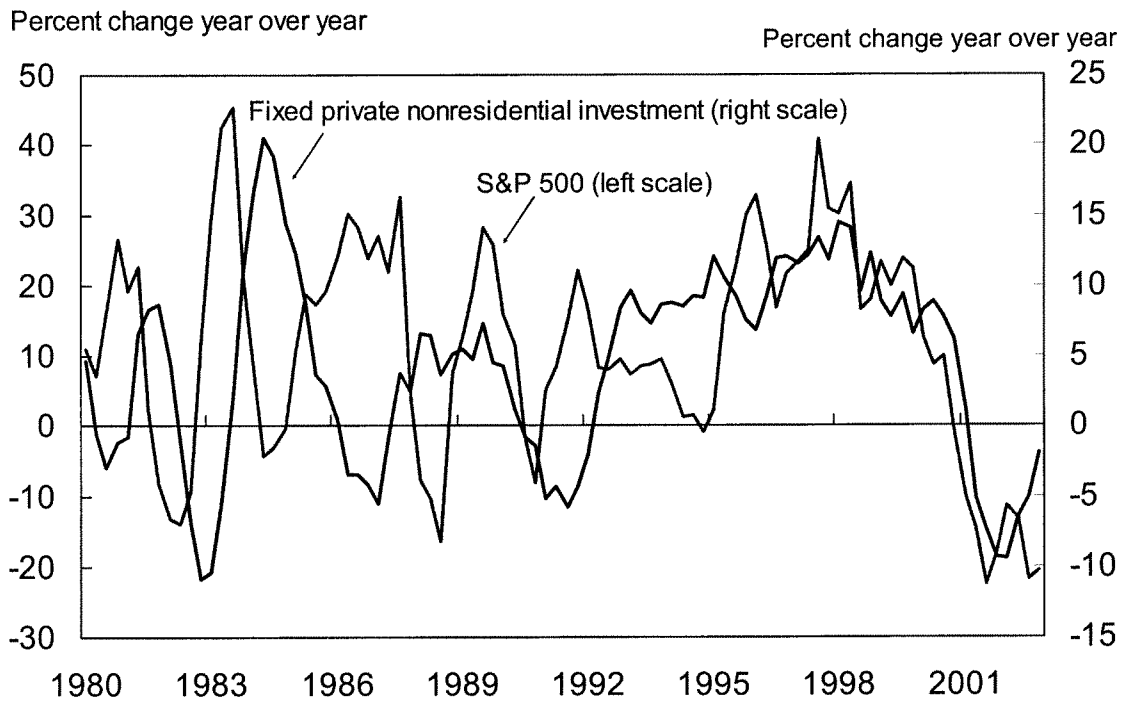
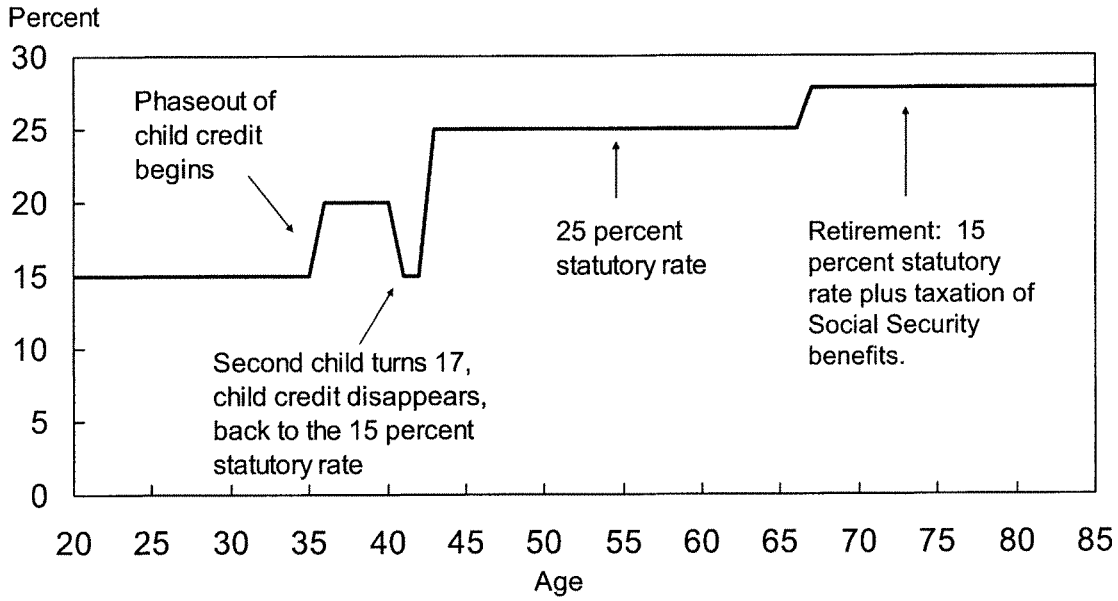


Chart 2: Effective Marginal Tax Rates by Age for Hypothetical Couple*



*Calculations are for joint-filer, two-earner family with moderate lifetime income and assume taxpayers not subject to the alternative minimum tax.

Chart 3: Fraction of Unemployed Workers Finding Work by Number of Weeks Unemployed

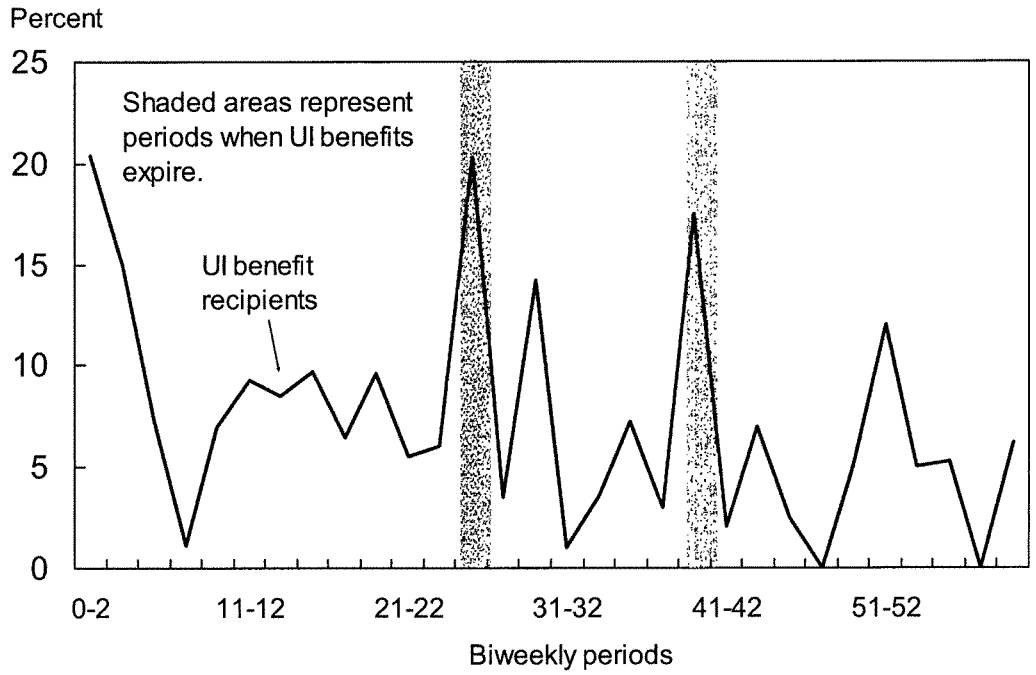
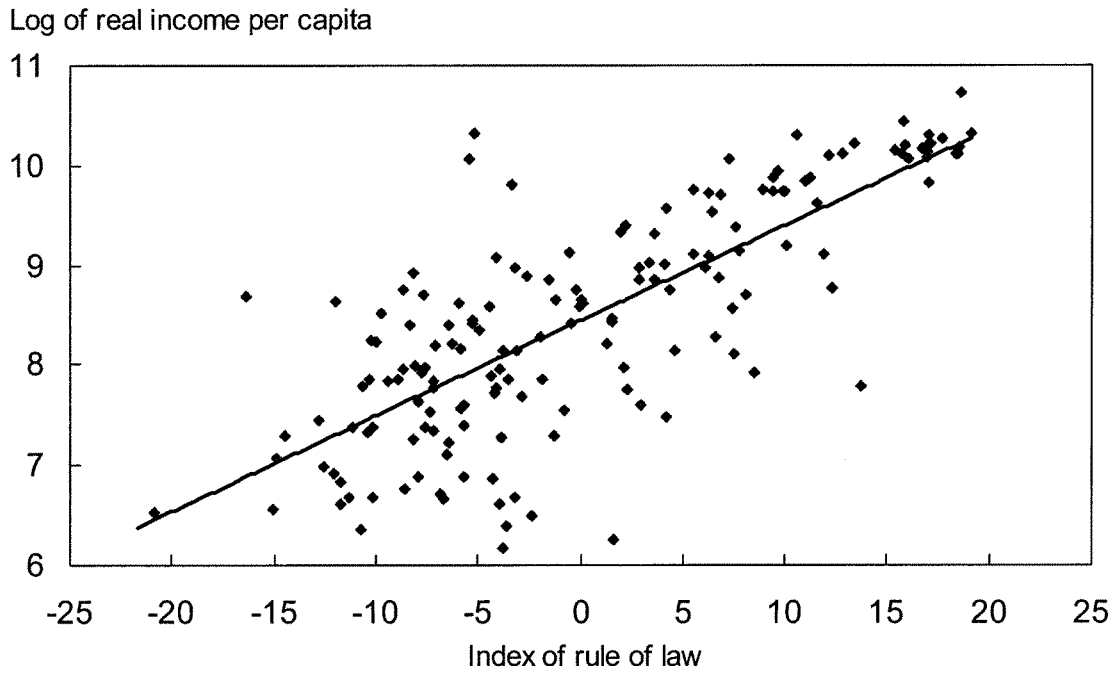


Chart 4: Rule of Law and Income per Capita*



*Income adjusted for purchasing power parity.

Additional information from Henry J. Aaron for inclusion at page 80.

The administration, and many who support it, defend the president's tax proposals as a move toward a consumption tax. In fact, the key proposals more closely resemble a wage tax than they do a consumption tax. Unfortunately, the proposals are not coherent and create opportunities to shelter wage income but only for those who have sizeable financial assets.

At any given time, the population receives *current* earnings and investment income on savings from *previous* earnings. *Looking ahead*, a tax on consumption is equivalent to a tax on earnings, *if, but only if, one ignores all initial asset holdings*. Thus, if one earns 100, one can consume it or save it. A wage tax of, say 10 percent would lower what one can consume now by 10 percent, and it would lower what one can consume later by 10 percent. Similarly, a consumption tax of 10 percent of gross spending would lower what one can consume now by 10 percent and it would lower what one can consume later by 10 percent. The effects of the two taxes are identical.

A true consumption tax falls not only on consumption financed out of current earnings but also on consumption financed out of savings. *The difference between and a consumption tax and a wage tax therefore consists entirely of the difference in treatment of consumption financed out of assets in existence at the time the consumption or wage tax is introduced*. A wage tax ignores such consumption. A consumption tax subjects to tax all consumption that is financed out of net withdrawals from previously accumulated savings. This point was made quite clear by the now-classic *Blueprints for Tax Reform* published at the end of the administration of President Gerald Ford.

A consumption tax can operate in one of two ways. It can directly tax all consumption sales. Such a tax obviously falls on consumption financed with previous saving. A consumption tax may also start with the conventional definition of income (earnings plus investment income) but then subtract net saving.

President Bush's various saving proposals give deductions for *gross* saving in certain designated accounts. Deposits in such accounts would be deductible, but such deposits could be financed by funds transferred from other accounts. Thus, the filer could transfer funds from, say, a brokerage account to a savers account and qualify for a deduction, although no saving is done. As an even more extreme example, suppose a married person in the 35 percent bracket sells a capital asset with a long-term gain of $15,000 and deposits the gain in two accounts, $7,500 each for the filer and the filer's spouse. This transaction will reduce the couple's tax. The gain will generate a tax of (at most) $3,000, as the maximum tax rate on long-term capital gains is 20 percent. Depositing the $15,000 in a savers accounts will lower tax by $5,250 ($15,000 multiplied by the assumed marginal tax rate of 35 percent). The net effect is a net tax reduction of $2,250, although the transaction involves no saving. This $2,250 can be applied toward tax on the couple's wage income.

Thus, the president's plan more closely resembles a wage tax because it does not tax consumption financed out of "old capital." But it goes even further, because it enables those with sizeable assets also to shelter wage and salary income from tax, an opportunity not vouchsafed earners without sizeable assets.

Testimony to The Joint Economic Committee
26 February 2002

of
Henry J. Aaron
Bruce and Virginia MacLaury Senior Fellow
The Brookings Institution[1]

Mr. Chairman:

Thank you for the invitation to testify before the Joint Economic Committee on the *Economic Report of the President*.

The main points that I wish to emphasize are these:

- An *Economic Report* can be no better than the policies it defends. *The current Economic Report is tied to an economic program that not only skirts the central fiscal problem* the United States faces—*how to prepare fiscally for costs that will be generated by retirement of the baby-boom generation—but one that aggravates those problems*.

- Although the Congressional Budget Office reports a ten-year, base-line cumulative budget surplus on the unified budget, *the Administration's program will push that budget into deficit by more than $1 trillion*.

- Under more realistic assumptions and more defensible accounting conventions, *the cumulative budget deficit over the next decade will be approximately $5.5 trillion*.

- By its reckless insistence on tax cuts, which aggravate the fiscal shortfall, and its use of trust fund accumulations to pay for current government spending, *the Administration's program will reduce growth* of national income by ever larger amounts—*just under $500 billion in 2013*. These tax cuts will add $130 billion annually to the governments interest payment burden in 2013.

- *The revenue sacrificed by the tax cuts* that the Administration has proposed since coming to office *is more than sufficient to eliminate the entire projected deficits of the Social Security system and Medicare Hospital Insurance, with enough left over to double federal aid to higher education and bio-medical research and to support a major initiative to improve life chances for America's children*.

I elaborate on these point below and ask that the full text of my remarks be included in the record.

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[1] The views expressed in this testimony are those of the author and do not necessarily represent those of the staff, officers, or trustees of the Brookings Institution.

The *Economic Report of the President* and the president's budget comprise the major economic statements of the Administration. They cannot be evaluated independently of one another. In fact, one of the foremost purposes of the *Economic Report* is to provide analytical arguments to buttress the president's proposals. This *Economic Report* is no exception. Nor is it exceptional in its inclusion of a welter of useful exposition, carefully reasoned and clearly written. The Council members and staff who prepared this document are, as ususal, skilled professionals.

The quality of the *Economic Report*, however, cannot be evaluated apart from the policies it advances. If those policies are flawed, no amount of analysis can spare the *Economic Report* from harsh judgment. To be sure, this *Economic Report* deals with many important matters. It contains sophisticated reviews of tax policy, regulation, and international trade. But *the central challenge facing budget policy in the United States is rather different—how to prepare the U.S. public finances for the fiscal challenge posed by the retirement of the baby boom generation*.

The first baby-boomers will become eligible for Social Security in just five years and for Medicare in eight. These dates usher in three decades of sharply increasing demands on the federal government to pay for pension and health benefits for the elderly, disabled, and survivors.

In brief, the federal budget will come under increasing stress—sooner rather than later. Action is required to prepare the nation to to handle this stress—now, and not at some indefinite future time. The fiscal challenge of the baby boom generation's retirement is not a distant problem that can be left to our children. It commences well within the ten-year planning horizon that Congress has been using for budget planning.

Yet *the president's 2003 budget* does nothing to meet these problems. On the contrary, if implemented, the president's budget proposals *would dramatically weaken the capacity of the federal government and of the nation to meet those challenges*. The Administration's tax program would add trillions to the national debt and slow economic growth. This indictment is harsh, but in no manner exaggerated. In my testimony, I shall draw on estimates of budget prospects beyond the five-year window shown in documents the Administration has released.

It is well known that budget prospects have deteriorated in the past two years. The magnitude of the deterioration is staggering, as shown in Table 1.

TABLE 1: PROJECTED BUDGET BALANCE (2002-2011)
January 2001, January 2003

Projection Date	Unified Budget (2002-2011)	On-Budget (excluding Social Security) (2002-2011)
January 2001	+ $ 5.6 trillion	+ $ 3.1 trillion
January 2003	$ 0 trillion	– $ 2.2 trillion
Net Change	**– $ 5.6 trillion**	**– $ 5.3 trillion**
Of which... Recession: outlay increases and revenue re-estimates	$2.6 trillion *46 percent*	
Other Outlays	$1.3 trillion *22 percent*	
Tax cuts	$1.8 trillion *31 percent*	

Source: Congressional Budget Office and tabulations by William G. Gale and Peter R. Orszag. [interest]

Three factors contributed to this deterioration—the recession (largely because of downward revisions of revenue projections), increased outlays (largely related to the military build-up), and tax cuts.

The *Economic Report* exonerates the current administration from responsibility for the recession. I think it is right to do so. The current recession is not the fault of the current president or of his predecessor. Variations in fiscal policy of the sort the United States has experienced in recent years do not cause short term economic fluctuations. With the wisdom of hindsight, most observers now agree that the giddy boom of the late 1990s was unsustainable. Perhaps different monetary policy might have resulted in a softer landing. Although this possibility will long be debated, history cannot be rerun. Few observers now believe that fiscal policy did play, or could have played, any significant role in preventing the recession. The automatic stabilizers doubtlessly helped attenuate the severity of the recession. But most economists now agree that fiscal policy can play only a small part in ending it.

Thus, in two years, the budget prospects of the United States have turned from rosy to gloomy. Unfortunately, even the comparatively dour projections embodied in the official budget projections from the Congressional Budget Office hugely understate the budget problems that the nation faces over the next ten years for four distinct reasons.

- *Official projections exclude the cost of the Administration's 2004 budget.*
- *The official projections exclude certain, or highly probable legislation that will dramatically increase the deficit.*
- *The projections are based on imprudent accounting conventions.*
- *The projections are entirely silent on the daunting budget problems outside the ten year window.*

IMPACT OF THE ADMINISTRATION'S 2004 BUDGET

The Congressional Budget Office has not yet made public its estimates of the cost of the proposals in the Administration's 2004 budget. Independent staff estimates suggest that the *initiatives contained in the 2004 budget will increase the unified budget deficit by an estimated $2.7 trillion* (see table 2). Tax cuts and associated increases in debt service account for nearly two-thirds of this $2.7 trillion shift in the budget. Based on graphs in the Administration's *Analytical Perspectives* (pp. 41-45), it is clear that the Administration expects the budget to remain in deficit forever under its proposed policies. [These projections appear in a chapter entitled "Stewardship." Whether Administration officials saw the irony in this title is not clear.]

TABLE 2: PROJECTED BUDGET BALANCE (2004–2013)

	Net change	Balance
CBO Baseline, January 2003		+ $1.3 trillion
CBO Baseline, modified to include effects of the Administration's 2004 budget	– $2.7 trillion	– $1.3 trillion
Adjustment for expiring tax provisions and corrections in the AMT	– $0.8 trillion	– $2.1 trillion
Adjustment for retirement funds	– $3.4 trillion	– $5.5 trillion

UNREALISTIC ASSUMPTIONS

The official projections embody a number of unrealistic assumptions. Nearly all understate prospective budget deficits. For example, *official projections assume that a variety of expiring tax provisions will be allowed to expire although they have been slated to expire in the past and have been repeatedly extended*. They also assume *that the sunset provisions of the 2001 tax cut will be allowed to take effect, although the Administration is on record that it wishes to make these provisions permanent* (and, in addition, to accelerate their effective dates, the consequence of which is included estimates of the effects of the Administration's 2004 program). Finally, they assume *that Congress will do nothing to prevent tens of millions of filers from becoming subject to the Alternative Minimum Tax*. Should this development occur, these households would not receive the full benefit of tax cuts legislated in 2001. If one assumes that repeatedly renewed tax provisions are once again not allowed to expire, that the 2001 tax cut is made permanent as the Administration requests, and that the Administration will take steps to assure that households will receive the benefits of the 2001 tax cut that spread of the AMT would block, then the projected budget deficit over the next decade rises to $2.1 trillion.[2]

PROPER ACCOUNTING FOR RETIREMENT PROGRAMS

Corporations are required by federal regulation to maintain adequate reserves for accrued pension liabilities. These reserves may not be used to pay for current company expenses. They may not be used to fund dividend payments, the corporate equivalent of federal tax cuts. *It is foolhardy to count as part of revenues available to finance current government operations reserves being accumulated to pay future Social Security, Medicare, or federal employee retirement benefits*. These additions to reserves, to be sure, are real saving...if these reserves were not being accumulated and other government spending and revenues were the same, the federal government would have to borrow more from the public and national saving would be correspondingly lower. But treating these additions to pension and health reserves as current revenues understates the degree to which revenues outside the pension and health trust funds fall short of current outlays. Over the decade 2004-2013, additions to reserves for future pension and health care benefits will total $3.4 trillion.

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[2] I assume that expiring elements of the AMT which would tend to increase the number of filers to whom it applies will be extended and that AMT exemptions, brackets, and phase-outs are indexed for inflation starting in 2004. The revenue estimates, which are based on tabulations from the Urban-Brookings Tax Policy Center, include feedback effects of increased interest on the public debt, and are reported by William G. Gale and Peter R. Orszag in "Perspectives on the Budget Outlook," *Tax Notes*, February 10, 2003, pp. 1005-1017.

WILL THE REAL ADMINISTRATION BUDGET PLEASE STAND UP!

Over the next ten years, a combination of Administration-favored tax cuts, increased defense needs, the residual effects of the economic slow-down, and the Administration's insistence on using trust fund surpluses to paper over its unwillingness to pay for current government spending mean that, by a proper accounting for the government budget, the federal government will be in deficit by a total of $5.5 trillion. Favorable events could make the actual deficit smaller; unfavorable events could make it larger. I have omitted one further adjustment that makes still larger deficits likely. I have assumed that domestic discretionary spending will remain constant in real terms. Should Congress decide, as seems plausible, that the richer and larger population in 2013 might wish to have more courts, national parks, air traffic controllers, and biomedical research than exists in 2004, the deficits would be larger by any such increment.

WHY THE ADMINISTRATION BUDGET IS ANTI-GROWTH

The numbers in table 2 indicate that with a proper accounting for the federal budget's prospects the United States faces a deficit of $5.5 trillion over the next decade. *The Administration is not responsible for all of this problem, but table 2 indicates that Administration tax policies have made it $3.5 trillion worse*. Any deficit means that the federal government is covering current public consumption with private saving that could otherwise have been invested in U.S.-owned capital. *Assuming that such investment yielded the current marginal return to capital, reducing U.S. owned capital by $3.5 trillion would* ***decrease*** *U.S. gross domestic product by about $280 billion in 2013*. In contrast, a policy of balancing the federal budget and saving additions to the trust funds would ***boost*** GDP by about $200 billion in 2013. *The $480 billion difference between a reduction in GDP caused by the large deficits that the Administration's program threatens and a policy of saving the trust funds' cash flow surpluses is the true price of the Administration's budget program*. That price would continue to grow steeper with each year, as federal deficits are enlarged by previously-enacted tax cuts that the Administration now wishes to accelerate and make permanent and the new tax cuts that it is seeking.

Rather than helping the nation prepare, the Administration's budget undermines the nation's capacity, to meet the fiscal challenge that the retirement of the baby-boom generation initiates. Years ago, my colleague, Charles Schultze, referred to such deficits as "not as the wolf at the door, but termites in the woodwork." The budget policy of the administration does not threaten any immediate calamity. Indeed, budget deficits during times of economic slack, such as the nation has experienced for the past two years, can help maintain demand and output. Over the medium and long term, however, demand will be determined largely by monetary policy, which is set by the Federal Reserve System. The budget serves primarily to influence how resources are allocated—within the public sector, in terms of domestic priorities—and between current consumption and saving, through the size of the deficit or surplus. *Administration policy not only lowers economic growth, it also squanders an opportunity to pay down the publicly held government debt and reduce a key element of government spending, government interest payments*. Instead, its

policies will add roughly $130 billion annually to debt service costs at the end of the current ten-year budget window.

THE DISTORTED PRIORITIES OF THE ADMINISTRATION BUDGET

Budgets express the policy priorities of any administration. What are the priorities of this administration? Are they ones that should command the respect of members of Congress? Do they justify the president's self-designation as a "compassionate conservative"? These are matters of personal judgment on which I have no special standing as an economist. But one can make informed judgments only if one knows the cost of the options the president has embraced and the costs of options he has rejected.

For at least two reasons, the ten year budget window is too brief a period to permit one to gauge the size of the policy choices that are at stake. First, some of the president's proposals are designed to cost little at first but much more later on. Pricing such initiatives over ten years misleadingly understates their long term cost. The so-called saving incentives in the 2004 budget illustrate the problem. Traditional IRAs and 401k plans exempt income deposited in such accounts from current income taxation but subject withdrawals to tax. The revenue cost of these tax breaks is immediately apparent, because the government immediately foregoes income taxes that it would have levied if funds deposited in such accounts had been used for other purposes.

The 2004 budget proposes to replace such accounts with plans modeled on Roth IRAs. Such deposits occasion no immediate income tax deduction, but all withdrawals are exempt from income tax. Because withdrawals take place many years or even decades in the future, the long-term cost of these tax concessions is largely excluded from the ten-year budget window. Expanding these accounts implants within the government budget a fiscal poison pill that slashes revenues, but not until long in the future. The actual proposals are even more insidious in that they enable many holders of traditional tax sheltered accounts to shift balances to the new accounts. This shift results in no new private saving. But it increases current revenues, which the administration uses to pay for other tax cuts, ignoring lost revenue later on. This step is equivalent to borrowing to finance today's tax cuts, but it is not recorded as an increase in the official public debt.

The second reason why a longer term perspective is desirable is that many of the most important obligations of the federal government entail obligations spanning several decades. Both the Social Security and Medicare actuaries annually present estimates of costs and revenues over the succeeding seventy-five years. All responsibly managed pension systems, including that serving federal employees, routinely solicit projections spanning periods much longer than ten years. For that reason, it is instructive to compare the long term cost of the tax cuts enacted in 2001 and proposed this year with the long term cost of dealing with the projected shortfalls in pension and health programs.

As with any large tax cut, the Administration's proposals would produce some beneficial effects. Lower taxes reduce economic distortions. Repealing the tax on dividends, for example, would as the Administration claims reduce some distortions in business investment planning. But it would also leave others untouched. A superior alternative, put forward by Urban Institute economist, Leonard Burman, would remove more distortions at less revenue loss than the Administration plan.[3] The Administration plan would also expand tax shelter opportunities and would almost certainly complicate tax planning. The expansion of limits on tax-sheltered personal saving would probably slightly increase saving by a small fraction of the wealthiest Americans. Unfortunately, it would also open up massive opportunities for tax avoidance by enabling the wealthy to shift assets from taxable accounts into tax-sheltered accounts.

These so-called "saving" provisions could also reduce saving by low and middle income families. This counter-intuitive effect requires some explanation. Most filers do not use currently-available sheltered saving vehicles to the maximum possible extent. Increasing maximum deposits would mean nothing to them. However, higher ceilings could cause some employers to drop qualified pension plans that were instituted primarily to provide shelter opportunities for highly compensated employees. Current nondiscrimination rules require that such plans be extended to employees who are not highly compensated. High limits on individual do-it-yourself sheltered saving will permit such employers to dispense with their qualified pension plans because they can save enough individually while saving costs "wasted" on pensions for others.

Whether the good direct effects of the various tax cuts will outweigh the bad effects is debatable. The direct distributional effects, however, are quite clear. They accrue disproportionately to upper income households.

Tax change	Percent of benefits flowing to filers with annual income greater than or equal to	
	$500,000	$200,000
Enacted, but not yet implemented, elements of EGTRRA[+]	55.1	60.8
"Economic Growth" package[+]	37.1	55.9
Making 2001 cuts permanent[#]	33.6	40.5
Distribution of tax payments*	n.a	40.1

Source: Urban Brookings Tax Policy Center and Joint Tax Committee

[+] Estimate for 2010

[#] Estimate for 2012

[*] Estimate for 1999

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[3] Leonard Burman, "Taxing Capital Once," Urban-Brookings Tax Policy Center, 21 January 2003, http://www.taxpolicycenter.org/research/Topic.cfm?PubID=410611 .

To call attention to such distributional patterns is sometimes labeled "class warfare." But if class warfare is present, it is initiated by those who insist on cutting taxes disproportionately for the wealthy while pleading poverty when asked to provide aid to states now forced to cut poor children and elderly from the Medicaid rolls, suspend social services, and curtail public library services. Those of us who call attention to who gains and who loses are not engaging in class warfare; we are merely reporting news from the front on the actions of those who have initiated hostilities.

My main point, however, is that tax cuts are not free lunch. The net benefit of any tax cut requires that one include what one must sacrifice in order to have the tax cut. We have to pay for them. Either we must pay more of other taxes or we must sacrifice public services. Given the enormous deficits that the nation faces under reasonable assumptions (see table 2 above), it is clear that the price of the Bush tax cuts is either higher future taxes or reduced public services. Table 3 below provides an illustrative menu of what the United States could have had instead of the Administration's tax cuts. It focuses on the tax initiatives that President Bush has embraced. The *Economic Report* goes to some pains to defend these initiatives.

The Bush tax program (including the 2001 tax cut and new proposals) will reduce revenues and increase debt service approximately $3.6 trillion over the period 2004-2013. Measured over seventy-five years, the reduction is equivalent to roughly 3 percent of gross domestic product. ***The value of these tax cuts is roughly twice the cost of completely closing the projected deficit over seventy-five years in the Old-Age, Survivors, and Disability Insurance program (Social Security) and the Hospital Insurance program (Medicare Part A)***. By citing this comparison, I do not mean to minimize the importance of the projected short-falls in these two programs. Furthermore, increases in the cost of Medicare, part B, three-quarters of which is funded by general revenues, will also make demands on the budget. Furthermore, Medicare is deficient as an insurance plan. It ranks at about the 15th percentile in terms of generosity when compared with private insurance for working Americans.[4] Nor should one ignore the budget costs for Medicaid, which will increase as retiring baby-boomers gradually become the frail elderly. *Rather I wish to emphasize that those who fret over the increased cost of entitlements should recognize that the Bush tax cuts have effectively derailed for years the nation's best—and I pray not the last—chance of dealing with these problems before they are upon us*.

Table 3 shows that even after one has closed the projected deficits in the nation's two largest entitlements, revenue absorbed by the Bush tax cuts would suffice to pay for several other federal activities that many would regard as high priorities.

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[4] Correspondence with Kenneth Thorpe.

TABLE 3: What Tax Cuts Cost

The Tax Program of the Bush Administration			*An Alternative Program*		
	10 year 2004-13 (trillion $)	75 year (% GDP)		10 year 2004-13 (trillion $)	75 year (% GDP)
2001 Tax cut	$ 1.7	1.5–1.9	Close Social Security deficit	0–0.8	0.7
Make 2001 cuts permanent	0.6		Close Medicare Hospital Insurance deficit	0–0.9	0.8
"Economic Growth" Package and other tax cuts	1.3	0.8	Children's program	0.9	0.7
Subtotal	$3.6	2.3–2.7	Double higher education assistance	0.5	0.4
AMT fix	0.7	0.5	Increase biomedical research 50 percent	0.3	0.3
			Short term fiscal relief to state and local governments	0.1	0
Total	$ 4.3	2.8–3.2	***Total***	$1.8–3.5	3.1

Source: Estimates of the Center on Budget and Policy Priorities and of William G. Gale and Peter R. Orszag

- College attendance is worth much more today than it was in the past because the payoff to education has risen sharply. Students from upper income families have taken advantage of this development and are attending college at increasing rates. Students from lower income families have not. Doubling college aid would contribute both to social and economic equality and to economic growth. The cost would be about one sixth that of the Bush tax program.

- Opportunities in bio-medical research are exploding. Opportunities for curing disease and extending life are proliferating in the wake of sequencing the human genome. The National Institutes of Health have been forced to deny funding for high quality

projects that would have been funded in the past. The cost of doubling government spending on bio-medical research would be less than one-seventh that of the Bush tax program.

- State and local governments closed deficits of approximately $50 billion for fiscal year 2003. By mid-fiscal-year, it is apparent that they will face additional deficits of more than $25 billion. For 2004, prospective deficits total $70-75 billion.[5] As a result, up to 1 million Medicaid eligibles will be cut from the rolls.[6] (The proposed legislative changes in Medicaid included in the 2004 Budget will result in at least 200,000 additional Medicaid enrollees losing eligibility.) Regressive state taxes will be increased. Not only does the Administration budget do almost nothing to relieve this fiscal distress, it aggravates these problems by lowering state revenues. Provision of $100 billion in fiscal relief spread over three years would cost 3 percent of the projected ten-year cost of the Bush budget program and would have a negligible long-run cost.

- A group of scholars organized by my colleague, former OMB Associate Director, Isabel Sawhill, has prepared a program of interventions to help improve the life prospects of disadvantaged children.[7] This program includes cash assistance to families with children under age 5 and annual incomes below $60,000; increased earned income tax credits and child care for full-time earners; health insurance for children, and universal pre-school for four-year olds. The total cost of these and other smaller items would be approximately $75 billion annually, about 0.7 percent of GDP.

My purpose in presenting this list of alternative uses of the revenues that the Bush tax program will absorb is not to embrace these specific measures, although I believe that many merit serious consideration. Revenues will be needed for other purposes, and tax cuts deserve to be on any list of such uses. But it is bad policy analysis to focus on the consequences of tax cuts—which are usually beneficial—without simultaneously counting the cost of the taxes that will later have to be paid to fill in the resulting fiscal gap or the value of the services we and our children will be denied. Nor does it make sense to embrace as reasonable and prudent the tax cuts that have already been enacted and others now on the table and, at the same time, to say that the fiscal challenges of restoring balance to Social Security and Medicare are fearsome burdens that should make us all quail. It is also wrong to say that we cannot afford to provide any fiscal relief to struggling states and localities because the nation faces unexpected outlays for national defense.

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5 These estimates are from Iris Lav, Center on Budget and Policy Priorities.

6 Leighton Ku, et al., "Proposed State Medicaid Cuts Would Jeopardize Health Insurance Coverage for One Million People," Center on Budget and Policy Priorities, 6 January 2003 http://www.cbpp.org/12-23-02health.htm.

7 *One Percent for the Kids: New Policies, Brighter Futures for America's Children.* Isabel V. Sawhill, editor (Brookings Institution, forthcoming 2003).

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Congressional Testimony

Testimony before Joint Economic Committee

Comments on the 2003 Economic Report of the President

February 26, 2003

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The Heritage Foundation

Mr. Chairman and members of the Committee, thank you for the opportunity to testify on the 2003 Economic Report of the President. My name is Daniel Mitchell. I am a Senior Fellow at the Heritage Foundation, though the views expressed here are my own and should not be construed as representing the position of The Heritage Foundation. The recently released Economic Report of the President covers a number of important issues. I would like to focus on two of them – taxes and international economic growth.

The tax policy discussion in Chapter 5 ("Tax Policy for a Growing Economy") is a very important contribution to the public policy debate. The chapter addresses a number of key issues, including the need to dramatically improve distributional analysis. The Economic Report explains how a growing economy enables people to climb the income ladder. Indeed, it includes very useful data showing the tremendous income mobility that already exists in America and makes a compelling argument that a more market-based tax code will facilitate even greater upward mobility.

Most importantly, the chapter focuses on how good tax policy can encourage better economic performance. The CEA estimates that fundamental tax reform can increase GDP by six percent. This additional growth occurs because:

- Lower tax rates encourage more work and entrepreneurship. Reducing marginal tax rates lowers the price of productive behavior. People have a greater incentive to earn income.

- Neutral tax treatment of savings and investment increases capital formation. Ending the multiple layers of tax on income that is saved and invested will boost the nation's capital stock and thereby increase productivity and wages.

- Elimination of tax preferences means decisions will be based on economic factors, not tax-minimization strategies. Resources therefore will be allocated on the basis of growth-maximization.

- Simplicity will free up resources for more productive uses. Some of our nation's most productive people will be able to concentrate on wealth creation instead of complying with a tax code that defies comprehension.

Drawing on the analysis in the Economic Report, I would like to focus on four issues:

Should America shift to a consumption-base tax system? Chapter 5 asks whether America should shift to a consumption-base tax. This does not necessarily mean a value-added tax or national retail sales tax. It also can mean a flat tax or USA tax (the old Nunn-Dominici proposal). A consumption-base tax is any system that only taxes economic activity one-time. A flat tax, for instance, taxes economic activity only one time – and presumably at one low rate – when income is earned. A national retail sales tax, by contrast, taxes economic activity only one time – and at one low rate – when income is spent. These kinds of tax systems differ from the "comprehensive income"

base of the current tax code, which taxes some forms of income more than one time and also taxes both changes in wealth and transfers of wealth.

If we want more economic growth, the answer to the question of whether we want a consumption-base tax code is yes.

Should there be double-taxation of income that is saved and invested? In some sense, this is just a different way of asking whether we want a consumption-base tax system. Chapter 5 examines different aspects of this issue. It shows how dividend reform eliminates the double-tax on corporate equity investment. It explains how front-ended IRAs and back-ended IRAs are ways to protect savings from double taxation. This part of the Economic Report is important because it explains why there should be neutrality between current consumption and future consumption. And since saving and investment is the same thing as future consumption, this means that discriminatory taxes on capital should be abolished.

The accompany chart illustrates how the current tax system can impose as many as four layers of tax on income that is saved and invested (See Graph 1 on page 6). This is why the answer to the question of whether it is right to double-tax income that is saved and invested is no.

Should businesses "expense" new investment or "depreciate" that investment? Another important issue raised in Chapter 5 is the appropriate tax treatment of investment expenditures by business. Under current law, businesses are not allowed to fully deduct (or "expense") investment costs. Instead, they often must "depreciate" these expenditures, deducting only a fraction of the cost each year for a specified number of years – even though the full cost is incurred the year the investment takes place. In other words, the tax code treats a portion of business investment the same way the tax code treats profit.

If we want a rational tax code – one that defines taxable income as the difference between total revenues and total costs, companies should be allowed to "expense" their new investments.

Should "worldwide" taxation be replaced by "territorial" taxation? Finally, the Economic Report also asks whether companies should be taxed on income they earn in other nations. This is an important question since it has the effect of significantly undermining the competitiveness of U.S.-based firms – particularly since the United States now has the fourth-highest corporate tax rate in the developed world. To cite an example, a Dutch-chartered company operating in Ireland only has to pay the 12.5 percent Irish corporate income tax on any profits. An American-chartered company competing in Ireland against that Dutch company, by contrast, has to pay the 12.5 percent Irish tax and the 35 percent U.S. corporate tax. Even if the U.S.-based company can take full advantage of America's complicated foreign tax credit system, it still faces a tax burden that is three times higher than its overseas competitor. No wonder some

companies are inverting to places with better tax law such as Bermuda and the Cayman Islands.

If lawmakers want American-based companies to successfully compete in the global economy, they should shift to "territorial taxation," the common-sense notion of only taxing income earned inside national borders.

Last but not least, I would like to comment briefly on Chapter 6 ("A Pro Growth Agenda for the Global Economy"). This chapter makes a number of useful observations on the importance of free trade, price stability, deregulation, low tax rates, frugal government, property rights, and the rule-of-law to economic development. It highlights White House efforts to improve economic growth in other nations, including trade expansion and a shift in foreign aid programs so that government-to-government transfer programs are less likely to subsidize bad economic policy.

But this section fails to address a critical issue – and that is the war that international bureaucracies are waging against fiscal competition. High-tax nations resent the flow of jobs and capital to low-tax nations. But rather than lower tax rates and reform bloated welfare states (Ireland is a rare exception), these uncompetitive nations are using international bureaucracies such as the Organization for Economic Cooperation and Development, the European Union, and the United Nations to pursue tax harmonization policies.

More specifically, high-tax nations want to tax income earned in low-tax nations if the factors of production that created that income originally came from a high-tax jurisdiction. This is why the international bureaucracies are so interested in destroying financial privacy laws and promoting the unlimited collection and automatic sharing of confidential financial information on nonresident investors. Simply stated, high-tax nations need a global network of tax police if they want to tax flight capital (and perhaps even emigrant labor income).

This type of policy would have a very adverse impact on economic development and individual freedom. It would mean that a developing nation – or even a developed nation – would not be able to use pro-growth fiscal policy to attract the factors of production. Why would a French taxpayer shift economic activity – either labor or capital – to a lower-tax jurisdiction, after all, if the French government had the ability to impose oppressive French tax rates on any resulting income?

Global information sharing (this phrase is a misnomer since the information flows only one way – from the low-tax nation to the high-tax nation), enforced by international bureaucracies, would destroy fiscal competition. This would be akin to creating a tax cartel – an OPEC for politicians. This would be tragic since the last 20 years have demonstrated that tax competition is a liberalizing force in the world economy. Almost every nation in the world lowered tax rates in response to the Thatcher and Reagan tax rate reductions. Oftentimes, this did not happen because politicians wanted to lower tax

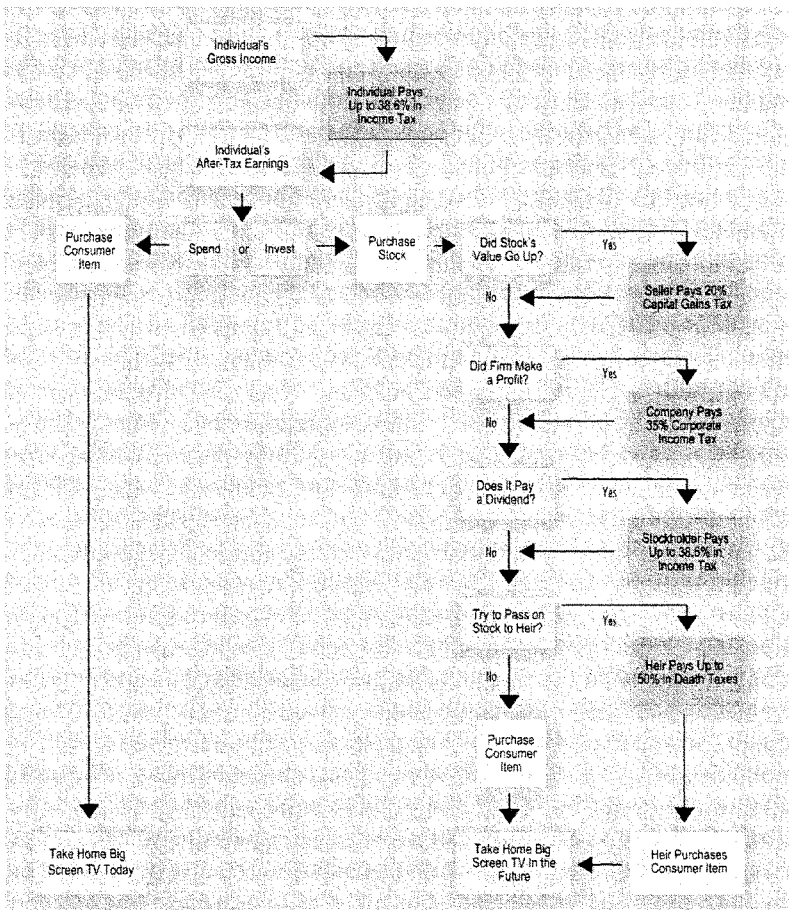
rates. Instead, tax rates were reduced because governments knew that jobs and capital would flee to more hospitable jurisdictions unless fiscal policy became more responsible.

The Council of Economic Advisers did not address this issue, though it is important to note that the Bush Administration generally has been critical of the tax harmonization schemes being advocated by the OECD, EU, and UN. Defeating these schemes is important, not only because fiscal competition helps promote pro-growth policy around the world, but also because tax harmonization schemes are a direct threat to American interests. The United States is the single largest repository of international capital flows (See Graph 2 on page 7). Any efforts to hinder those global flows – particularly schemes to cripple investor privacy – will limit capital flows to our nation and therefore harm our economy and financial markets.

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

Graph 1

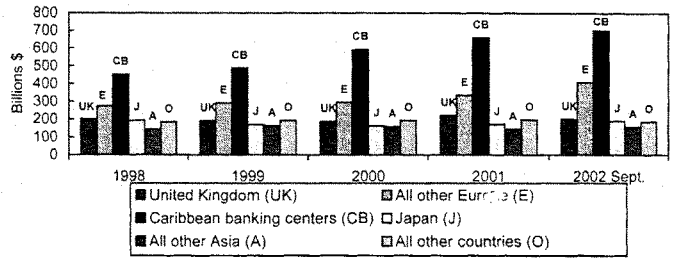
Up to Four Layers of Tax on Income that is Saved and Invested: Tax Code Punishes Capital Formation, Makes America Poorer



Source: IPI Policy Report #171, *Tax Reform: The Key to Preserving Freedom and Competitiveness in a Global Economy*, by Dan Mitchell, Ph. D.

Graph 2

Chart CM-A -- U.S. Liabilites to Foreigners Reported by U.S. Banks, Brokers and Dealers with Respect to Selected Countries



(In millions of dollars. Source: Treasury International Capital Reporting System)

Country	1998	1999	2000	2001	2002 Sept.
United Kingdom	202,280	190,706	187,145	222,321	200,964
All other Europe	274,354	290,632	294,716	336,485	408,711
Caribbean banking ctrs\1 \2	451,575	487,601	593,499	661,835	700,261
Japan	193,202	170,614	162,449	174,067	189,620
All other Asia	143,224	165,229	158,524	143,475	157,576
Subtotal	1,264,635	1,304,782	1,396,333	1,538,183	1,657,132
All other countries	184,327	192,495	192,856	197,792	186,186
Grand total	1,448,962	1,497,277	1,589,189	1,735,975	1,843,318

\1 Includes Bahamas, Bermuda, British West Indies, Netherlands Antilles, and Panama.

\2 Beginning January 2001, Cayman Islands replaced British West Indies in reporting format.

In the first three-quarters of 2002, U.S. banking liabilities increased $107 billion. In 2001, banking liabilities increased $147 billion.

U.S. banking liabilities to foreigners, excluding long-term securities, are concentrated in international financial centers. The data on this page show that nearly one-half of U.S. banking liabilities currently is reported opposite the United Kingdom and the banking centers in the Caribbean. Foreigners domiciled in the rest of Europe and in Asia hold an additional 40 percent.

U.S. banking habilities in the mid-1990s went through a growth spurt. The annual growth rate between 1993 and 1997 averaged 10 percent. From 1998 to 2000, growth slowed to about 5 percent per year, more in line with the 1989 through 1992 period. Last year, growth increased to almost 9 percent.

Source: http://www.ustreas.gov/tic/exhibita.pdf

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PREPARED STATEMENT OF ERIC M. ENGEN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Mr. Chairman and members of the committee, it is a great privilege to have the opportunity to appear before you today. My name is Eric Engen. I am a resident scholar at the American Enterprise Institute in Washington, D.C. where my research focuses on the effects of tax and budget policy on the economy. Prior to joining AEI, I was a senior economist and section chief at the Federal Reserve Board of Governors.

My testimony provides perspectives on some of the tax policy reforms discussed in the Economic Report of the President and proposed in the President's recent budget.[1] In particular, I focus on the investment and saving incentives provided by the tax relief for corporate earnings and the tax-free saving accounts.

My principal conclusions are as follows:

• The taxation of capital income, sometimes at very high marginal rates, in the U.S. tax system stands in marked contrast to the implications of optimal tax theory in the economics literature, which has generally concluded that the optimal tax on capital income is zero. Capital taxes reduce saving and investment, and a smaller capital stock reduces the productivity and wages of workers.

• The proposal to remove the "double taxation" of corporate earnings would lower the cost of investment for firms and increase the after-tax returns to savers that hold corporate equity, thus stimulating capital formation, boosting the productivity of workers, and raising wages and income.

• Exempting corporate profits from personal income taxation reduces the tax incentives for corporations to retain earnings instead of paying dividends. Higher dividend payouts would help improve the allocation of corporate capital and assist stockholders in monitoring corporate managers.

• Exempting corporate profits from personal income taxation reduces the tax incentives for corporations to finance investments with debt instead of equity. Less corporate debt reduces the probabilities of default and bankruptcy in an economic slowdown and thus would lower the risk premium included in the cost of financing corporate capital.

• The United States has the second highest corporate tax rate among its economic competitors and is one of only three countries in the OECD that does not provide dividend tax relief. Although the corporate tax rate would still remain relatively high, eliminating the double taxation of dividends would improve the competitiveness of U.S. firms in the global economy.

• The President's proposals for expanding tax-free savings accounts would continue the trend seen for more than twenty years of moving the personal income tax towards a consumption tax base.

• The Retirement Savings Accounts (RSAs) would be the most likely to increase personal saving as it would significantly increase the contribution limits associated with Roth IRAs, which RSAs would replace. The higher the contribution limits for these accounts then the greater the economic incentives for households to increase saving.

• The Employer Retirement Savings Accounts (ERSAs) typically do not increase the contribution limits that employees will receive from similar types of current plans—401(k) and 403(b) accounts, for example—and thus would not be expected to increase marginal saving incentives more than current plans. However, the simplification and lower compliance costs of ERSAs should increase the availability of employer-based retirement accounts, particularly for small-business employees.

• The effects of Lifetime Savings Accounts (LSAs) on aggregate personal saving are harder to estimate and more likely to be mixed, although they would probably be the most popular owing to their lack of withdrawal restrictions. Particularly in early years after the introduction of LSAs, households would have the incentive to merely shift assets from currently taxed bank accounts and mutual funds into an LSA. For lower- and middle-income households, eventually existing assets would be exhausted and marginal incentives to increase saving would start to become effective. For higher-income households, this process would take longer.

BACKGROUND

Capital income, which reflects the returns to saving and investment, can face substantial rates of taxation, particularly if generated by corporate businesses. The federal corporate income tax rate for most corporations is currently 35 percent, and state corporate taxes add, on average, another 4 to 5 percent to the effective cor-

[1] I am testifying on my own behalf and not as a representative of AEI.

porate tax rate. When corporate income is delivered to shareholders, it then often faces combined federal and state personal income tax rates on dividends that can exceed 40 percent. Thus, the overall marginal tax rate on distributed corporate income can easily be over 60 percent.[2] Even if corporate earnings are retained but ultimately dispersed to shareholders through the redemption of stocks that give rise to capital gains, which are typically taxed at a 20 percent rate in the personal income tax, the tax bite on the return from investment in corporate capital is still quite sizable. The high rates of taxation on capital income in the United States stand in marked contrast to the implications of optimal tax theory in the economics literature. Numerous economic studies have concluded that an optimal tax system in most scenarios will not include a tax on capital.[3] This conclusion reflects the highly distortionary effects of capital income taxes over long time periods—a distortion that "explodes" or "compounds" even with a small capital income tax.

Economic growth and a higher standard of living in the United States are ultimately achieved by increasing the productivity of U.S. workers. Increased productivity requires investment, which is funded by saving. Thus, the economic burden of capital income taxes is not just born by high-income capital owners. The lower level of capital accumulation that results from high capital income taxes also has adverse effects for workers. Less capital makes workers less productive. If worker productivity is lower, then wages are lower.[4] Therefore, even if workers owned no capital—a description that is increasingly less appropriate for households in the United States, more than half of whom own corporate stocks—then workers would still be better off with no tax on capital because their wages would be higher.[5]

When compared to our primary economic competitors, such as countries in the OECD, the United States has a relatively high corporate income tax rate and, unlike most of these competitors, does not provide relief for the "double taxation" of corporate income.[6] The combined U.S. federal and local corporate income tax rate is almost 40 percent, second only to Japan, while the average corporate income tax rate for other OECD countries is closer to 30 percent. Moreover, the United States is one of only three OECD countries that do not have provisions in its Tax Code for some relief from the double layer of taxation of corporate dividends. Switzerland and Ireland do not provide dividend tax relief but their corporate income tax rates are among the lowest in the OECD—21 percent and 12.5 percent, respectively.

The global economy is expanding rapidly. It is vital to the growth of the U.S. economy for U.S. businesses to be internationally competitive. Higher taxes in the United States on the returns to corporate capital inhibit the competitiveness of U.S.-based companies in foreign markets. As financial markets become more global, U.S. investors may tend to be more willing to invest in foreign-based rather than U.S.-based companies. Mergers may be more likely to be set up as a foreign acquisition of a U.S. corporation. Transactions where a foreign subsidiary acquires a U.S.-based parent company may become more frequent. The high rates of taxation on the return from corporate investment can tend to make the United States a relatively unbecoming location for the headquarters of a multinational corporation, which can, in turn, cause U.S. multinationals share in the global market to shrink.

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[2] This second layer of taxes on dividends can be avoided if the shareholder is tax-exempt, such as a non-profit organization, and are typically delayed until withdrawal if the dividends go to shares held in a tax-preferred retirement or insurance arrangement, such as a 401(k) or other pension plan, an IRA, or variable annuity. See William Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes* (Nov. 11, 2002).

[3] Ken Judd, "Optimal Taxation and Spending in General Competitive Growth Models," *Journal of Public Economics* (1999) and "The Impact of Tax Reform in Modern Dynamic Economies," in K. Hassett and G. Hubbard (eds.) *Transition Costs of Fundamental Tax Reform* (2001), and Alan Auerbach and James Hines, "Taxation and Economic Efficiency," in A. Auerbach and M. Feldstein (eds.) *Handbook of Public Economics, Volume 3* (2002) provide recent discussion and summaries of this literature.

[4] A recent National Bureau of Economic Research working paper by Casey Mulligan, "Capital Tax Incidence: First Impressions from the Time Series" (#9374, December 2002) finds evidence that the economic burden of capital taxes are shifted significantly on to workers over the long run.

[5] Greg Mankiw, "Commentary: Balanced-Budget Restraint in Taxing Income from Wealth in the Ramsey Model," in K. Hassett and G. Hubbard (eds.) *Transition Costs of Fundamental Tax Reform* (2001) presents an economic model that provides this result.

[6] Eric Engen and Kevin Hassett, "Does the U.S. Corporate Tax Have a Future?" *Tax Notes 30th Anniversay Issue* (2002) discusses more fully these issues concerning high corporate taxation in the United States relative to our economic competitors. Indeed, since that article was written, some European countries—such as Belgium, Italy, France, and Luxembourg, for example—have lowered their corporate tax rates even further than shown in the paper.

1. Reduction of the Tax on Corporate Earnings

There are several different methods in which relief could be provided for the double taxation of corporate dividends in the United States. One would provide a shareholder credit for corporate taxes paid. When a corporate shareholder receives a taxable dividend, the shareholder would be entitled to a credit against their taxes for the corporate taxes effectively paid on the dividend income. Many countries that have tax relief for double taxation of dividends use a form of the shareholder credit. However, the Treasury Department advised against this approach in a 1992 Report because of the complexity of actually implementing the shareholder credit.[7] In its Report, Treasury recommended instead that dividend tax relief could be better implemented if a shareholder was allowed to exclude from gross income the dividends received from a corporation. The President's proposal is consistent with Treasury's earlier assessment that this dividend exclusion framework is simpler than a shareholder credit, and could be implemented with less structural change to the Tax Code.[8] It also accounts for the fact that about half of dividend payments are currently not taxed, and thus removes the economic distortion of disproportionate taxes on dividends with a smaller reduction in federal revenues.

The President's proposal not only removes the double taxation of corporate earnings distributed to shareholders, it also removes the double taxation on corporate earnings that are retained. The retained earnings of a corporation should be reflected in an increase in the value of corporate shares, which when sold generate taxable capital gains. Although the advantages of deferral and preferential tax rates mean that the second layer of taxation on these capital gains is smaller than the tax on dividends, the tax is still positive. If the President's proposal only exempted dividends from personal taxation then dividends would be tax-advantaged compared to retained earnings. However, under this proposal, the tax treatment of all corporate earnings is equal.

There are a number of economic benefits that could be attained by having corporate earnings taxed only once. Taxing corporate earnings only once would lower the cost of investment for firms and increase the after-tax returns to savers that hold corporate equity, thus stimulating capital formation, boosting the productivity of workers, and raising wages and income. Although economists are not in complete agreement about the effect of dividend taxes on investment, typically the empirical results suggest that a reduction in the tax on dividends would markedly increase investment.[9]

The effect of reducing the tax on corporate earnings can also potentially raise stock prices. A fundamental determinant of the value of a share of corporate equity is the present discounted value of all future after-tax dividend payments. Thus, a reduction in taxes on dividends could lead to higher corporate stock values. However, if the reduction in dividend taxes stimulates new investment, then some of this new investment may be done by new firms that enter into markets and compete away the profits of existing firms, thus inhibiting increases in stock prices. The more (less) new investment then the less (more) likely that stock prices rise.

Exempting corporate profits from personal income taxation reduces the tax incentives for corporations to retain earnings instead of paying dividends.[10] Higher dividend payouts would help improve the allocation of corporate capital because this proposal would remove the "lock-in" effect caused by the current tax incentives that make it easier for a firm to keep and reinvest corporate earnings. Instead, there would be no tax disincentive for corporate earnings being reinvested in capital with the highest expected return, whether it is in the same firm or in another business venture. Moreover, a higher payout of dividends would assist stockholders in monitoring corporate managers. Dividends can only be paid with "real" earnings and

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[7] Department of the Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (January 1992).

[8] Indeed, for about a decade prior to its repeal in the Tax Reform Act of 1986, taxpayers were permitted a limited exclusion of dividends from gross income in the personal income tax.

[9] A seminal study by Jim Poterba and Larry Summers, "The Economic Effects of Dividend Taxes," in Altman and Subrahmanyam (eds.), *Recent Advances in Corporate Finance* (1985) found that dividend taxes had substantial negative effects on corporate investment. A recent study by Alan Auerbach and Kevin Hassett, "On the Marginal Source of Funds," *Journal of Public Economics* (2003), found a smaller but still economically significant effect of dividend taxes on investment.

[10] Jim Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity* (1987) found that dividend payout rates are quite sensitive to changes in marginal income tax rates.

thus corporate managers could not hide behind a Tax Code that discourages dividends while they generate only "paper" profits.

Exempting corporate profits from personal income taxation reduces the tax incentives for corporations to finance investments with debt instead of equity.[11] Less corporate debt reduces the probabilities of default and bankruptcy in an economic slowdown and thus would lower the risk premium included in the cost of financing corporate capital.

2. Tax-Free Savings Accounts

Retirement Savings Accounts. Of the three saving account proposals, RSAs would be the most likely to increase personal saving as it would significantly increase the contribution limits associated with Roth IRAs, which RSAs would replace. The profusion of asset shifting seen when IRAs were initially introduced on a universal basis over two decades ago has probably been exhausted. The higher contribution limits allowed by these accounts would result in a greater number of savers facing increased marginal incentives for saving.[12] These marginal incentives for saving would tend to be more prevalent for lower- and middle-income households.[13]

Employer Retirement Savings Accounts. ERSAs typically do not increase the contribution limits that employees will receive from similar types of current plans—401(k) and 403(b) accounts, for example—and thus would not be expected to increase marginal saving incentives beyond those available in current employer-based plans. However, the simplification and lower compliance costs of ERSAs should increase the availability of employer-based retirement accounts, particularly for small-business employees. The costs and complexity of setting up retirement plans are frequently cited by small business owners as reasons for not offering a pension plan to their employees.

Lifetime Savings Accounts. The effect of LSAs on aggregate personal saving are harder to estimate and more likely to be mixed. Particularly in early years after the introduction of LSAs, households would have the incentive to merely shift assets from currently taxed bank accounts and mutual funds into an LSA. For lower- and middle-income households, eventually existing assets would be exhausted and marginal incentives to increase saving would start to become effective. For higher-income households, this process would take longer. Moreover, because LSAs have no withdrawal restrictions then these accounts would be more likely to attract saving done for more short-term purposes than retirement saving, such as precautionary saving. Models of household saving typically imply that precautionary saving is less sensitive to changes in the after-tax return than longer-term retirement saving.[14] For this reason, even if an LSA provides a marginal tax incentive for a household to save more, it may not induce as much increased saving as an RSA or ERSA which focuses on retirement saving.

In general, the RSA and ERSA proposals are merely extensions of recent trends to increase the contribution limits to tax-favored retirement accounts and to simplify the provision of employer provided retirement accounts. Essentially, increasing the contribution limits for retirement accounts moves the personal income tax increasingly towards a consumption tax base as it exempts an increasing share of capital income from taxation. LSAs would be a much newer saving vehicle and would be a significant step further towards a consumption tax. LSAs would probably be quite popular since they do not have withdrawal restrictions. However, partly because the contribution limits prohibit households that save greater amounts from having a marginal incentive to save more, estimating the impact of LSAs on saving would be more speculative.

Another important issue in evaluating the potential net saving effects of these accounts is the possible interaction with household borrowing—in particular, tax-deductible mortgage borrowing.[15] To the degree that households that own a house essentially use increases in taxdeductible mortgage debt to essentially finance tax-favored saving, without having to reduce spending, then net personal saving does not increase. A complete shift to consumption tax treatment at the personal income tax level entails exempting all capital income received from taxation and also not allow-

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[11] John Graham, "Do Personal Taxes Affect Corporate Financing Decisions?" *Journal of Public Economics* (2002) and "Taxes and Corporate Finance: A Review" mimeo, Duke University (2003).

[12] Eric Engen and William Gale, "IRAs and Saving in a Stochastic Life Cycle Model" (1993) and "Do Saving Incentives Work?" *Brookings Papers on Economic Activity* (1994).

[13] Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups" NBER working paper #8032 (2000).

[14] Eric Engen, "Consumption and Saving in a Life Cycle Model with Stochastic Earnings and Uncertain Lifespan" (1993)

[15] Eric Engen and William Gale, "Debt, Taxes, and the Effects of 401(k) Plans on Household Wealth Accumulation" (1997).

ing interest paid for borrowing to be tax-deductible. Both of these features are important for getting the full benefits of increased saving by switching to a consumption tax. To the degree that these saving accounts limit contributions, and since the tax deductibility of mortgage interest remains available, then the positive effects on personal saving from these accounts are less than what would be expected from a complete switch to a consumption tax base.

PREPARED STATEMENT OF HON. EDWARD M. KENNEDY,
U.S. SENATOR FROM MASSACHUSETTS

I commend our Chairman, Senator Bennett, for his leadership in holding this hearing on the President's Economic Report, and I join in welcoming today's witnesses to the Committee.

Many of us in Congress have continuing concerns about the Administration's economic policy and its responses to the challenges facing our economy. When President Bush took office, his budget officials estimated that the cumulative surplus for the years 2002-2011 would be $5.6 trillion. Now, the Congressional Budget Office says the huge surplus for that period "has been all but eliminated." And that's before the President's proposed new tax cuts are factored into the budget.

The principal proposal that President Bush has put forward to strengthen growth is to reduce taxes for the wealthy. The Administration's plan ignores the basic needs of most Americans and their widespread concerns about the faltering economy. Massive tax breaks for the wealthy are wrong. We cannot afford to shortchange essential priorities such as protecting homeland security, protecting social security and Medicare and investing in health care, education and job training.

It was bad enough to pass a huge tax cut for the wealthy last year, when we had a surplus. Today, with the surplus gone, it is even more irresponsible for the Administration to propose huge new tax cuts now that drain the resources needed to meet obvious long-term commitments like national defense, Social Security and Medicare.

Only two years ago, the national unemployment rate was 4 percent—not 6 percent as it is now. The ranks of the uninsured and the poor were falling—not rising, as they are now. Workers were building retirement savings and planning for the future—not worrying about whether their jobs and their savings, as they are now. States had budget surpluses, not deficits that require cuts in basic services or new tax increases.

States are cutting Medicaid, denying needed care for as many as one million low-income Americans. Cities are closing fire stations and laying off police officers and firefighters, who are our first responders in case of terrorist attacks.

Yet the Administration is proposing more of the same old flawed policies. The President wants an even larger tax cut that is heavily tilted toward the very rich. That plan is not even an effective economic stimulus, since the most benefits go to the least likely to spend them.

The President's economic plan offers little tax relief now, when the economy most needs a jump-start. Less than five percent of his economic package will be felt in most people's pockets and wallets during this fiscal year. It's no wonder that more than 450 economists—including 10 Nobel Prize winners—signed a statement criticizing the President's proposal as an ineffective short-term stimulus that worsens our long-term budget outlook.

The President's proposal is not a serious economic stimulus package. A true stimulus plan should meet three key criteria: It should be an immediate stimulus. It should be temporary, to avoid long-term damage to the economy. And it should provide needed assistance to state and local governments to ease their budget crises. Unlike the federal government, they have to balance their budgets.

Obviously, Congress is sharply divided on these issues. I continue to hope that we can reach a fair compromise, but so far there seems to be little chance that we will do so. I urge the Administration to work with Congress on a plan that will genuinely help the economy and benefit all our citizens too.

GREENSPAN QUOTES FROM MONETARY POLICY HEARING BEFORE THE SENATE
BANKING COMMITTEE ON FEBRUARY 12, 2003

DEFICITS HURT THE ECONOMY

"There's no question that as deficits go up, contrary to what some have said, it does affect long-term interest rates. It does have a negative impact on the economy, unless attended."

Senator Corzine: "I just wanted to make sure that I heard you say deficits impact long-term interest rates, in your view, and have an impact then on the investment function over a period of time."

Chairman Greenspan: "you heard me correctly, sir."

"The presumption that deficits some how would increase the GDP—the more deficit, the greater the GDP—is a short-term view which I don't believe continues in the longer run. So I think we have to focus on, one maintaining maximum economic growth, but simultaneously recognize that a necessary condition to do that is that deficits have to be contained."

Greenspan confirmed his previously stated view that: "The desirability of eliminating the federal debt, which is still, frankly, my first priority because I think it's had an extraordinarily important impact on the economy, on the financial markets, on long-term interest rates, and on economic growth."

NO NEED FOR STIMULUS

"I'm one of the few people who still are not as yet convinced that stimulus is a desirable policy at this particular point."

TAX CHANGES MUST BE REVENUE-NEUTRAL

"I support the program to reduce double taxation on dividends and the necessary other actions in the federal budget to make it revenue-neutral."

On the new Bush tax cut—"I do believe it should be revenue-neutral."

"But it [eliminating the double taxation of dividends] should be done in the context of pay-go rules, which means that the deficit must be maintained at minimal levels."

THE TAX CUT DOES NOT "PAY FOR ITSELF"

"We are not going to make up for that huge revenue loss that the dividend tax cut would produce on spending."

"Faster economic growth alone is not likely to be the full solution to currently projected long-term deficits."

IMPORTANCE OF SAVINGS

"We must be sure that the Federal Government does not impinge on the private sector's capability of creating goods and services and expanding the standard of living of the American people. And that requires that it not drain the savings resources of the private sector, which it does when it's running a deficit."

"There are relationships between the government deficit, domestic investment and domestic savings which are all tied together. And they cannot go off in different directions without affecting each other."

"The more savings that we have that are productively used in our economy, the greater the productivity, the greater the growth, the greater the prosperity that we have."

"In my judgment to try to formulate a budget policy which is stable, meaning that it does not create pressures on private finance which eliminates the underlying growth pattern in the economy."

NEED TO CRAFT A BUDGET WITHOUT A STRUCTURAL DEFICIT

"We have to be very careful because there is no self-equilibrating mechanism when that [structural deficits] is occurring because a rise in the debt increases the amount of interest payments, which in turn increases the debt still further and there is an acceleration pattern after you reach a certain point of no return."

PERMANENT TAX CUTS DO NOT EXIST

"I don't think that we can have permanent tax cuts or permanent spending programs in the sense that they exist independently of the tax base or the revenue-raising base of the economy . . . The notion of permanence cannot rationally be consistent with the programs we're involved in."

AID TO THE STATES

"I have no objection obviously to having federal funds go to the states . . . I do have some problems—how would one in fairness create a program which did not essentially benefit those who are the least conservative in the programs relative to those who were? If that can be done, then I think that there are obvious arguments in favor of it."

"To the extent that taxes are raised in order to close those gaps, I would assume that it is restrictive of economic activity in the locality."

MUNICIPAL BONDS

"The issue that municipal finance, the interest rates that are involved would be affected by essentially creating a whole new segment of demand for un-taxable issues."

PROBLEMS DOWN THE ROAD

"Short of an outsized acceleration of productivity to well beyond the average pace of the past seven years or a major expansion of immigration, the aging of the population now in train will end this state of relative budget tranquility in about a decade's time."

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